PERFORMANCE AUDIT:

SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY

August 2012

August 17, 2012

Mr. Pasquale T. Deon, Sr.
Chairman
Southeastern Pennsylvania Transportation Authority
1234 Market Street
Philadelphia, Pennsylvania 19107

Dear Mr. Deon:

Enclosed is our performance audit of the Southeastern Pennsylvania Transportation Authority (SEPTA) for the period from July 1, 2006, through June 30, 2009, with updated information through August 3, 2012, as noted in the report. We conducted the audit in accordance with generally accepted government auditing standards as issued by the Comptroller General of the United States. Our report presents six findings and seven recommendations.

The most significant finding, which discussed swap agreements, is detailed in Finding One. We determined that SEPTA's use of interest rate swaps associated with its 1999 Series A and Series B bonds cost the taxpayers and SEPTA's fare-paying customers over $41.4 million more than if SEPTA had not entered into swaps agreements. It is our position that swap deals are inherently unsuitable for public finance because there is a multitude of hidden risks associated with swap deals. The use of swaps by government agencies essentially amounts to gambling with public money. We are recommending that SEPTA terminate all remaining swaps as soon as it is fiscally responsible to do so and SEPTA should prohibit the use of swaps in the future.

Three of our findings address management salaries and benefits. In Finding Two, we noted that salaries paid to top management were competitive with, or lower than, those paid to top management at other transit agencies similar in size and complexity to SEPTA. In Finding Three, we compared the benefits provided to SEPTA's top management with the benefits provided to top management at similarly sized transit agencies and found that, while competitive, SEPTA could achieve cost savings by making some modifications to its benefits package. In Finding Four, we compared the benefits provided to both union and management employees and found that the differences were not significant between the two groups of employees.

Our audit work related to contracts is presented in Finding Five. We found that SEPTA complied with policies and procedures with regards to procurement and monitoring. However, we noted that SEPTA did not exercise prudence with regard to its expenses for the annual safety banquet and for catering meals at board meetings.

Finally, our examination of outside funding sources is presented in Finding Six. We found that SEPTA effectively monitored its primary outside advertising revenue and took steps to maximize that revenue.

These findings are discussed in detail in the enclosed report.

Sincerely,

JACK WAGNER
Auditor General

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Introduction and Background

The Southeastern Pennsylvania Transportation Authority (SEPTA) provided us with the background information that begins below and continues through page eight.[1]

Mission

SEPTA's mission statement is this:

> *Our employees are dedicated to delivering safe, courteous, convenient and dependable public transportation services for the people of our region. We contribute to the region's economic vitality, sustainability and enhanced quality of life.*[2]

History

The Pennsylvania General Assembly established SEPTA on February 18, 1964, to provide public transit services for Bucks, Chester, Delaware, Montgomery, and Philadelphia counties. Over the years, SEPTA acquired the assets of several private transportation operators to form four operating divisions – City Transit Division, Victory Division, Frontier Division, and Regional Rail Division – thereby permitting the implementation of various collective bargaining agreements and the computation of local subsidies.

City Transit Division. SEPTA acquired the assets of the former Philadelphia Transportation Company in 1968 to form the current City Transit Division. The City Transit Division, which primarily serves the City of Philadelphia, operates 73 bus routes, 6 trolley (light rail) lines, 3 trackless trolley lines, and 2 subway-elevated (heavy rail) lines.

Victory Division. The Victory Division, formerly known as the Philadelphia Suburban Transportation Company, serves Chester, Delaware, and Montgomery counties. Also known as the Red Arrow Division, the Victory Division comprises 21 bus routes, 2 trolley (light rail) lines, and the Norristown High Speed Line (heavy rail).

[1] Fiscal Year 2010 Operating Budget and Fiscal Year 2011-2015 Financial Projections, September 22, 2009.
[2] Southeastern Pennsylvania Transportation Authority, Partnering for Regional Sustainability, Fiscal Years 2010 – 2014 Five Year Strategic Business Plan, pg. 6.

Frontier Division. The Frontier Division consists of 23 bus routes serving Bucks and Montgomery counties. These routes were formerly run by several private operators.

Regional Rail Division. The Regional Rail Division consists of 13 commuter rail lines that serve the City of Philadelphia as well as Bucks, Chester, Delaware, and Montgomery counties. This division also provides service to Newark, Delaware, and Trenton and West Trenton in New Jersey. The assets of the Regional Rail Division were previously owned by the Pennsylvania and Reading Railroads, who also operated that division. The commuter rail lines were operated by the Consolidated Rail Corporation from 1976 through 1982 and acquired by SEPTA in 1983.

SEPTA's Services

In total SEPTA's operation consists of the following transportation services:

- 117 bus routes
- 8 trolley (light rail) lines
- 3 trackless trolley routes
- 2 subway/elevated (heavy rail) lines
- 1 inter-urban high-speed line (heavy rail)
- 13 regional railroad (commuter rail) lines
- Shared ride service in the City of Philadelphia
- Americans with Disabilities Act paratransit service throughout the five-county region

In addition, SEPTA connects to passenger rail service via Amtrak, has direct rail service to the Philadelphia International Airport, connects to NJ Transit rail service, connects to the Port Authority Transit Corporation (PATCO) High Speed Line to New Jersey, and provides connection routes to Newark, Delaware. As of March 15, 2012,[3] SEPTA was the sixth-largest transit system in the United States and the largest transit system in the Commonwealth of Pennsylvania. SEPTA headquarters is located in the city of Philadelphia.

[3] Fiscal Year 2013 Operating Budget Proposal and Fiscal Years 2014-2018 Financial Projections, March 15, 2012.

SEPTA's Governance and Employees

SEPTA is governed by a board of directors with 15 voting members, including a chairman, a vice chairman, and committees. The 15 board members are chosen as follows:

- ✓ Two members appointed from each of the five counties in SEPTA's service area
- ✓ One member appointed by the Governor of Pennsylvania
- ✓ One member appointed by the Pennsylvania Senate majority leader
- ✓ One member appointed by Pennsylvania Senate minority leader
- ✓ One member appointed by Pennsylvania House of representatives majority leader
- ✓ One member appointed by Pennsylvania House of Representatives minority leader

The board of directors hires a general manager to run SEPTA. The general manager oversees all SEPTA services and operations and, along with the SEPTA board, provides leadership and direction. The general manager oversees a chief counsel, a chief financial officer/treasurer, and eight assistant general managers who are responsible for day-to-day operations.

In March 2009, near the end of our audit period, SEPTA's strategic business plan noted that there were over 9,000 employees working for SEPTA. According to *SEPTA Operating Facts - Fiscal Year 2011*,[4] there were 9,195 full-time equivalent employees in June 2011.

SEPTA's Service Area, Operating Statistics, and Financial Data

The southeastern Pennsylvania region has a population of 3.9 million[5] and is the most populous region in the Commonwealth. SEPTA's service area covers 2,202 square miles. According to U.S. Census data from 1980-2000, strong population growth was seen in the region. Population increased by 4.5 percent, or 167,197 people, over the twenty-year period in the five-county area.

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[4] http://www.septa.org/reports/index.html, viewed May 11, 2012.

[5] According to a 2008 Delaware Valley Regional Planning Commission estimate

The SEPTA system serves more than one-half million customers daily and provides approximately 325 million (unlinked) passenger trips annually. According to its five-year strategic plan, SEPTA is one of the only two truly multi-modal transit properties in the United States (Boston is the other) with bus, subway, high speed rail, trackless trolley, regional rail, and paratransit vehicles. SEPTA also has the unique distinction of operating all its modes directly.[6]

In fiscal year 2009, SEPTA experienced gains in ridership in both City Transit and Suburban Transit. Compared to fiscal year 2008, average daily passengers (linked) increased by 2.9 percent in the City Transit Division and 0.4 percent in Suburban Transit (Victory and Frontier Divisions). Ridership on the regional rail lines in fiscal year 2009 was level with fiscal year 2008, while total annual SEPTA ridership increased by 5 million unlinked passenger trips.[7] At the same time, according to SEPTA's fiscal year 2010 operating budget, there was a leveling off of ridership growth beginning in the fourth quarter of fiscal year 2009. SEPTA attributed the leveling off to the effects of the economic recession.

The table on the following page presents financial statistics (excluding footnotes) obtained from SEPTA's fiscal year ended June 30, 2010, audited financial statements. The data for 2009 represents SEPTA's restated amounts for that year as presented in the SEPTA financial statements.

[6] SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY, Partnering for Regional Sustainability, Fiscal Years 2010-2014 Five-Year Strategic Business Plan, March 2009.
[7] Fiscal Year 2010 Operating Budget and FY 2011-2015 Financial Projections, September 22, 2009.

SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY

Revenues, Expenses and Changes in Net Assets

(Restated for GASB No. 51 and GASB No. 53 Prior Period Adjustments)

For the fiscal years ended June 30, 2007, 2008, and 2009

	(Thousands of dollars)		
	2007	**2008**	**2009**
OPERATING REVENUES			
Passenger	$ 344,411	$ 392,568	$ 404,837
Other income	26,735	29,914	31,240
Total Operating Revenues	$ 371,146	$ 422,482	$ 436,077
OPERATING EXPENSES			
Transportation	$ 471,070	$ 555,947	$ 592,986
Purchased Transportation	46,674	49,033	49,889
Maintenance	266,851	318,185	338,719
Administrative	98,377	106,955	116,148
Public Liability and property damage claims	33,958	43,483	40,615
Rent and other	26,618	26,706	30,000
Depreciation	264,563	275,534	289,481
Total Operating Expenses	$ 1,208,111	$1,375,843	$1,457,838
Operating Loss	($836,965)	($953,361)	($1,021,761)
NONOPERATING REVENUES (EXPENSES)			
Subsidies			
Federal	$ 99,597	$ 32,620	$ 32,200
State	313,329	489,909	537,211
Local	74,457	68,243	75,787
Senior Citizen	65,776	19,802	18,950
Asset Maintenance	54,224	-	-
Total	$ 607,383	$ 610,574	$ 664,148
Investment income (loss) restated for GASB No. 53	6,804	(6,742)	(14,743)
Interest Expenses	(19,844)	(20,483)	(20,981)
Total nonoperating revenues (expenses)	$ 594,343	$ 583,349	$ 628,424
Loss before capital grants	($242,622)	($370,012)	($393,337)

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SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY

Revenues, Expenses and Changes in Net Assets

(Restated for GASB No. 51 and GASB No. 53 Prior Period Adjustments)

For the fiscal years ended June 30, 2007, 2008, and 2009

	(Thousands of dollars)		
	2007	**2008**	**2009**
CAPITAL GRANTS			
Capital grants	$ 349,193	$ 441,132	$ 457,149
Total capital grants	$ 349,193	$ 441,132	$ 457,149
INCREASE IN NET ASSETS	$ 106,571	$ 71,120	$ 63,812
TOTAL NET ASSETS			
Beginning	$ 2,590,597	2,697,168	2,768,538
GASB No. 51 prior period adjustment	-0-	250	-0-
Ending	$ 2,697,168	$ 2,768,538	$ 2,832,350

SEPTA issued its fiscal year ended June 30, 2010, financial statements and incorporated changes resulting from the adoption of GASB No. 51 and GASB No. 53. The adoption of GASB No. 51, which required the reporting of certain intangible assets as capital assets, resulted in a restatement increasing the June 30, 2008, net asset balance by $250,000. The adoption of GASB No. 53, which required the recognition of the change in fair value of certain ineffective derivative instruments under investment loss, resulted in a restatement decreasing the June 30, 2008, investment income (loss) by $16.1 million, and decreasing the June 30, 2009, investment income (loss) by $16.3 million. We have incorporated these changes in this financial schedule.[8]

[8] SEPTA's restated financial statements and the related note disclosure can be found at http://www.septa.org/reports. viewed October 21, 2011, verified May 14, 2012.

SEPTA's Customer Service

In its January 2007 report, the Pennsylvania Transportation Funding and Reform Commission concluded that SEPTA's mission and vision were focused on the operational budget and not on strategic planning, long-term capital program, and organizational vision.[9]

SEPTA redirected its planning efforts and in March 2009 released a revised strategic business plan that contained seven key strategies starting in fiscal year 2010. The first strategy was to improve customer service. As part of that strategy, SEPTA planned to address on-time performance and cleanliness.

The following is a list of some of SEPTA's initiatives to accomplish its goals:

1. Emphasize cleanliness, communications, convenience, and courtesy.
2. Continue programs to improve the cleanliness of stations.
3. Continue programs to improve on-time performance.

SEPTA's strategic plan included a provision for performance measurement. With respect to customer service, SEPTA established a key performance indicator to achieve system-wide on-time performance of 90 percent.[10] The strategic plan also emphasized a comprehensive program focused on the four C's of cleanliness, communications, convenience, and courtesy that involved all its employees. The program's aim was stated as follows:

> *SEPTA is moving toward becoming a passenger-focused business with every employee contributing to the organization's customer service efforts, whether he/she works on the front lines, with direct customer contact, or performs critical support, maintenance and management functions.*[11]

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[9] Pennsylvania Transportation Funding and Reform Commission, Investing in Our Future: Addressing Pennsylvania's Transportation Funding Crisis, Final Report - Technical Appendix, Transit Agency Operational Audit, Southeastern Pennsylvania Transportation Authority, Final Copy – January 2007, *GOVERNANCE*, Page 14.
[10] SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY, Partnering for Regional Sustainability, Fiscal Years 2010-2014 Five-Year Strategic Business Plan, March 2009, page 26.
[11] SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY, Partnering for Regional Sustainability, Fiscal Years 2010-2014 Five-Year Strategic Business Plan, March 2009, page 8.

SEPTA reported that it had achieved system-wide on-time service based on actual measurement that was greater than 89 percent.[12] In past customer satisfaction surveys, perceptions of SEPTA riders and non-riders about service reliability and timeliness were not rated that high. We concluded that SEPTA has made efforts to improve its customer service in terms of timeliness, and SEPTA should continue those efforts in order to increase customer satisfaction.

However, we note that many factors can impact timeliness. Some factors are within SEPTA's control, such as scheduling enough trains, while others—such as bad weather and accidents—create situations that need alternative responses. Enduring service interruptions, or hearing or reading about them, affects public perception. As long as SEPTA cannot effectively combat such negative public perceptions, negative perceptions will continue.

With respect to cleanliness of concourse areas, some improvements have been noted over the years; but more work is needed.[13] The perception of cleanliness will have to continue to be evaluated by future customer satisfaction surveys.

[12] SEPTA Five-year Strategic Business Plan (FY 2010-2014) Key Performance Indicators Report #1, Six-Month Report on Corporate Key Performance Indicators, April 21, 2010.
[13] Gammage, Jeff, "Riders say SEPTA change is behind schedule," *The Philadelphia Inquirer*, January 11, 2010, http://www.nextgreatcity.com/node/1472, verified July 20, 2011. Re-verified May 15, 2012.

Objectives, Scope, and Methodology

The Department of the Auditor General conducted this performance audit in order to provide an independent assessment of selected operations of the SEPTA.

Generally accepted government auditing standards, under which we conducted this audit, require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We also completed our audit under authority of Section 403 of The Fiscal Code of 1929, which empowers the Auditor General as follows:

> *To audit the accounts and records of any public agency, receiving an appropriation of money, payable out of any fund in the State Treasury, or entitled to receive any portion of any State tax for any purpose whatsoever, as far as may be necessary to satisfy the department that the money received was expended or is being expended for no purpose other than that for which it was paid.*[14]

Audit Objectives

The audit objectives encompassed the following areas: interest rate swaps, payroll, benefits, contract expenditures, and advertising revenues. The specific audit objectives were as follows:

1. To review SEPTA's overall accountability including its funding sources.
2. To examine selected expenditures incurred by SEPTA for the fiscal years ended June 30, 2007, 2008, and 2009. This objective included an examination of management compensation, including salaries and other benefits. We also examined selected purchase orders for propriety of use and compliance with Commonwealth and SEPTA policies and procedures.

[14] 72 P.S. §403.

3. To review revenue that SEPTA generated through outside advertising that was then used to supplement funding for daily operations.

Audit Scope

The primary scope period of the audit was for the three fiscal years ended June 30, 2007, 2008, and 2009. Our inquiry and analysis continued with updates through August 3, 2012.

Audit Methodology

To accomplish our objectives, we obtained and reviewed SEPTA records, interviewed various management and staff, analyzed policies and agreements, and reviewed pertinent laws of the Commonwealth of Pennsylvania.

More specific methodologies are discussed in each section of this audit report.

Audit Results

In the pages that follow, we have organized our audit results into three sections, one for each objective. Each of the three sections is organized as follows:

- Statement of the objective
- Relevant laws, policies, or agreements
- Audit scope in terms of period covered, types of transactions reviewed, and other parameters that define the limits of our audit
- Methodologies used to gather sufficient evidence to meet the objective
- Finding(s) and conclusion(s)
- Recommendation(s), if applicable

Audit Results for SEPTA's accountability

The Objective

In our objective to evaluate SEPTA's overall accountability, we looked at its funding sources.

Relevant Laws, Plans, and Other SEPTA Actions

Finding 1: Interest Rate Swaps
(pp 14-21)

The Pennsylvania General Assembly established the Southeastern Pennsylvania Transportation Authority (SEPTA) on February 18, 1964, to provide public transit services for Bucks, Chester, Delaware, Montgomery and Philadelphia counties.[15] The enabling legislation, as amended, provides for the make-up of the SEPTA board of directors.[16]

SEPTA has made its operating budget,[17] its annual financial reports,[18] and its 2009 and 2010 strategic business plans available to the public. These documents include informative disclosures about SEPTA's financial position, operating statistics and future plans.

SEPTA has the authority to issue long-term debt.[19] The proceeds of an issue of bonds may be used to pay the costs of a project; to finance any cash flow deficit of the authority; to reimburse any costs of a project initially paid by the authority or any person; to fund any required reserves; to capitalize interest; or to pay costs of issuance including, but not limited to, costs of obtaining credit enhancement for the bonds.[20]

SEPTA also entered into short-term financing arrangements in the form of swaptions. Swaptions are defined as an option to enter into an interest rate swap on or before a specified date in the future. Because a "swaption" is an option to enter into an interest rate swap at a later date, when the option is exercised, a "swaption" becomes and operates as an interest rate swap.

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[15] Fiscal Year 2010 Operating Budget and FY 2011-2015 Financial Projections, September 22, 2009.
[16] 74 Pa.C.S.A. §1713.
[17] Fiscal Year 2010 Operating Budget and FY 2011-2015 Financial Projections, September 22, 2009.
[18] Southeastern Pennsylvania Transportation Authority, "Driven to Achieve, Fiscal Year 2010 Annual Report," December 8, 2010;
Southeastern Pennsylvania Transportation Authority, "Sparking Progress, 2009 Annual Report," November 24, 2009;
Southeastern Pennsylvania Transportation Authority, "SEPTA 2008 Annual Report," December 12, 2008.
[19] 74 Pa.C.S.A. § 1701 and § 1763.
[20] 74 Pa.C.S.A. § 1763. (a)(4).

Scope and methodologies to meet our objective

We met with key SEPTA personnel, including the general manager, the assistant general manager for audit and investigative services, and the assistant treasurer to obtain an understanding of SEPTA responsibilities.

We reviewed various publicly released documents of SEPTA, including its operating budget, its annual financial reports, and its 2010 strategic business plan.

We analyzed SEPTA's bond and hedge activity surrounding the 1999 Series A and Series B variable rate bonds and associated swaps between February of 1999 and October 2010.

Interest Rate Swaps

<u>Finding One</u>: SEPTA's use of interest rate swaps associated with its issuance in 1999 of $262 million of "1999 Series A and Series B Bonds" cost the taxpayers and SEPTA's fare-paying customers over $41.4 million more than if SEPTA had financed at that time with conventional fixed rate bonds.

SEPTA's *Comprehensive Annual Finance Report* for the Fiscal Year Ended June 30, 2010 (CAFR) indicated that SEPTA had three outstanding swaps relating to $322.8 million of debt issued.[21] However, as is revealed in "Note 14 – Subsequent Event,"[22] SEPTA made significant changes to its bond and swaps portfolio after the period covered by the CAFR but before it was published. Note 14 revealed that in October 2010 SEPTA restructured its debt portfolio by issuing refunding bonds to refinance its 1999 Series A and Series B bonds and by terminating one of the swaps associated with the 1999 bonds.[23] Our analysis illustrates that SEPTA's use of swaps in connection with the 1999 bonds has cost Pennsylvania taxpayers (and SEPTA's fare-paying customers) $41.4 million more than if SEPTA had resisted the temptation to delve into swaps and simply paid off the fixed-rate bonds it had issued in February 1999 as scheduled.

When SEPTA needed to borrow $262 million in February 1999, conventional fixed-rate financing was available at a prevailing rate of about 5 percent,[24] but SEPTA chose to issue serial fixed-rate bonds with interest rates from 3.25 percent to 5.25 percent that created an effective interest rate on the entire 1999 bond issue of 4.988 percent. One of the

[21] As of June 30, 2010, the three swaps had a net negative fair market value of $60.4 million, which means that if SEPTA had decided or was forced to terminate all of its swaps on that date, it would have to pay the investment bank counterparties termination fees totaling $60.4 million.
[22] CAFR for Fiscal Year Ended June 30, 2010, "Notes to Financial Statements," page 80, "Note 14 – Subsequent Event."
[23] The terminated swap involved two investment bank counterparties in October 2010. The remaining swap tied to the 1999 bonds was not terminated, because SEPTA believed that it was still operating as intended. This swap was amended so that it is now associated with the 2010 Bonds. The third swap was tied to the 2007 bonds and is not part of our analysis.
[24]Federal Reserve Statistic Release dated February 1, 1999, accessed on December 15, 2011, at http://www.federalreserve.gov/releases/h15/19990201, lists the prevailing fixed rate in February 1999 as 5.01 percent.

terms of the bonds was that they could not be called (refunded) before 2009. SEPTA decided to issue un-hedged serial fixed-rate bonds.

Four years later, in April 2003, to take advantage of historically low interest rates, SEPTA entered into a type of swap transaction[25] with respect to the unpaid principal balance of the 1999 bonds. The counterparty paid SEPTA $9.53 million as consideration for the swaption, and SEPTA invested the $9.53 million to lower the effective interest rate on the 1999 bonds to 4.58 percent. SEPTA contends that it planned to issue variable rate bonds in 2009 if interest rates were still low at that time, and, if the counterparty exercised the swaption, an interest rate swap would have been created in connection with the new variable rate bonds SEPTA planned to issue. SEPTA apparently believed that the risk of unpredictable rises in interest rates on the bonds it planned to issue could be "hedged" by using swaps. In theory, the use of swaps would have the effect of converting the variable interest rate on the bonds to a "synthetic" fixed-rate that would be somewhat lower than the prevailing rate on conventional fixed-rate bonds. SEPTA claims that the synthetic fixed rate would have been 3.66 percent.[26]

For SEPTA's swap agreement, if exercised by the investment bank counterparties to the swap, SEPTA would pay a fixed rate of interest of 4.42 percent to the counterparties; the swap counterparties would pay a variable rate of interest set at 67 percent of the three-month LIBOR rate to SEPTA.[27] The three-month LIBOR rate at the time the agreement was

[25] The type of swap used is more precisely called a "swaption," which is an option to enter into an interest rate swap on or before a specified date in the future. However, most of the derivatives used in municipal financing are generically referred to as "swaps." This report uses the term "swaps" in that generic sense but also uses more precise terms when necessary to distinguish between the varieties of these instruments.

[26] The interest rate on debt can be "synthetically" fixed from the perspective that different financial instruments are combined such that the overall obligation resembles a fixed-rate bond. Porter, White & Company, Derivatives White Paper, July 2006, Number 1, "Swaps and Synthetic Fixed Rate Debt," at http://www.pwco.com/library_whitepapers.html.

[27] http://www.fedprimerate.com/libor/libor_rates_history.htm accessed July 9, 2012. The website defines the LIBOR as follows: "The London Interbank Offered Rates (LIBOR) can be described as the wholesale cost of money in the London interbank money market." "LIBOR is an average interest rate at which a select group of banks that participate in the London interbank money market can borrow unsecured funds from each other." There are different LIBOR rates that vary by length of term such as overnight, 3-month, 1-year, and others. LIBOR rates are based on a poll of 19 banks that participate in the London interbank money market including three U. S. investment banks.

established was 1.288 percent, so 67 percent of that rate was 0.863 percent.

The hedge mechanics of the swap when exercised would work as follows: SEPTA would issue refunding variable rate bonds with an interest rate of 67 percent of LIBOR, the same rate as the 67 percent of LIBOR rate flowing in from the swap counterparties. These rates would effectively offset each other. SEPTA would pay the counterparties the agreed upon 4.42 percent rate under the swap agreement. The result would be considered an effective hedge since the refunding variable rate bonds and the swap agreement would have the effect of converting the original 1999 bonds' effective interest rate of 4.988 percent to a synthetic fixed rate of 4.42 percent. SEPTA also contends that, because it invested the $9.53 million up-front money it received in 2003, the 4.42 percent fixed rate would be reduced to an effective rate of 3.66 percent[28]

Unfortunately, the swaps investment strategy did not work as planned due to the multitude of hidden risks involved in swaps transactions. In October 2010 SEPTA decided to cut its losses and unwind the swaps. Not only did SEPTA have to pay back $9.5 million of the up-front money, it also paid $627,710 of accrued interest expense and an additional termination fee of almost $26.4 million to the two large investment bank counterparties to terminate the swaps.[29] In addition, SEPTA incurred the cost of issuing new 2010 bonds to fund the losses incurred from terminating the swap.

As our analysis shows, SEPTA's use of swaps ended up costing SEPTA, its fare-paying customers, and Pennsylvania taxpayers $41.4 million

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[28] SEPTA invested the up-front payment and earned interest of $1.9 million which, it contends, would have reduced the fixed rate under the swap from 4.42% to 3.66%. SEPTA further contends that this proves that the up-front money was used properly in connection with the underlying debt, rather than being spent on other things. However, recent changes to the rules for reporting swaps in financial statements have compelled SEPTA to publicly acknowledge that the swaps associated with the 1999 bonds were not merely an innocuous hedging transaction but were, in fact, a highly risky investment in derivatives. The Governmental Accounting Standards Board's Statement No. 53 ("GASB 53"), which was promulgated to address this issue, sets forth standards for determining whether a swaps transaction is an "effective hedge" or merely an investment in a derivative. The CAFR for the fiscal year ended June 30, 2010, is SEPTA's first financial statement governed by GASB 53. In it, SEPTA was required to restate its financial statements for the preceding two years to disclose that the swaps associated with the 1999 bonds were an investment in a derivative and to disclose the investment's negative value. See: "Notes to Financial Statements," CAFR for the fiscal year ended June 30, 2010, Notes 1, 2, 5, 13, and 14.

[29] SEPTA informed us that the swap counterparties were two of the U. S. investment banks that set the swap rates.

more than if SEPTA had not entered into the swap. It should also be noted that $27 million of the money SEPTA lost on the swaps deal was merely rolled into the refinancing—i.e., the amounts must be paid off over the next 18 years with interest. We were able to determine from information related to the swaps settlement cost roll forward provided to us by SEPTA that SEPTA would incur an additional $7.8 million in interest costs just for the swap ($34.8 million additional debt service cost less $27 million swap payment). A further effect of rolling all these costs forward in the refinancing is that such action tends to disguise the fact of and the magnitude of the losses.

To illustrate the magnitude of the loss, we analyzed SEPTA's supporting schedules for the swaps associated with the 1999 Series A and Series B Bonds, to determine the total net cost of this financing.[30] Our analysis is illustrated in Table 1.

Table 1. The table on the next page illustrates the receipts and payments from the swaps agreements associated with the original 1999 Series A and Series B Bonds.[31] The total cost of this financing is the sum of the interest and other costs incurred on the 2003 and 2007 swaps deals, offset by the cash receipts (if any) from the terminated swaps to determine a total net cost.[32]

The swap termination fee totaled $36,509,000 consisting of three payments: repayment of $9,500,000 of the swap upfront receipt; payment of accrued interest payable in the amount of $627,710 for the outstanding 2003 swaptions; and payment of $26,381,290 in additional

[30] It is possible to determine the actual cost of the financing because the 1999 bonds and one of the two associated swaps were terminated and paid off in October 2010. The second associated swap was rolled into the now outstanding 2010 bonds. We were unable to perform this analysis on SEPTA's other bond/swap deal tied to the 2007 bonds because those bonds are still outstanding and still have an active swap associated with them. Even though this other swap is reported as an "effective hedge" under GASB 53 standards, that is no guarantee that one or more of the hidden risks inherent in swaps might not result in a future loss to SEPTA. It is practically impossible to predict the ultimate outcome until the swap is terminated and the 2007 bonds are paid off or refinanced.

[31] Key dates for the bond and swap activity: Principal amount of issuance $262,000,000, Series A and Series B Bonds, dated February 1999; Notional amount of swaption $215,290,000, executed March 28, 2003; Swaption exercised by counterparties March 1, 2009; Issued refunding bonds $245,220,282, executed October 6, 2010.

[32] It should be noted that the swap counterparties also received "spread fees" associated with the issuance of the swaps, a form of profit on the transaction which is not disclosed. These non-disclosed profits are, therefore, not included in the total cost illustrated in Table 1.

termination fees for the 2003 swaptions. The interest payable and the additional termination fees were rolled forward in the refinancing of the 1999 Bonds.[33] That refinancing would incur additional interest expense of $7,770,782 according to SEPTA's analysis.

Table 1
Actual Cost of the 1999 Series A and Series B Serial Bonds and Associated Swaps
February 1999 through October 2010

Years	Action	Receipts	Payments
2003	Swaption issuance costs		$ 174,896
2003	Swaption upfront receipt	$ (9,530,000)	
2003-2010	Interest earned on upfront receipt	(1,946,973)	
2003-2010	Swaption monitoring costs		21,000
2007	Swaption issuance costs		195,000
2008	Swaption termination receipt	(5,400,000)	
2003-2010	Swaption interest receipt	(1,055,261)	
2003-2010	Swaption interest payment		14,674,071
2010	Swaption termination fee (cash)		9,500,000
2010	Swaption termination fee (refunded)		26,381,290
2010	Swaption accrued interest (refunded)		627,710
2010-2028	Interest cost on refunded termination fees		7,770,782
	Subtotals	$(17,932,234)	$59,344,749
	Total net cost		$41,412,515

In its November 9, 2011 response, SEPTA explained why it terminated some of its swaps: "The swaps on the 1999 Series A and Series B Bonds that were initiated in 2003 via competitively bid swaptions, and exercised

[33] SEPTA's November 9, 2011, response to our inquiries states: "The total net present value cost to [SEPTA] to terminate the two swaps (one with Bank of America the other with Citibank) was $27.0 million. That amount represents the present value cost of debt service payments (principal plus interest) for bonds issued to fund the termination payment discounted at 3.357%, the total interest cost of the financing. The NPV [net present value] costs exclude $9.5 million cash paid by [SEPTA] because that payment was funded by unamortized cash proceeds received as an upfront payment when the swaptions were initially sold in 2003."

by the counterparties on March 1, 2009, were terminated in October 2010 because they were no longer serving as an interest rate hedge as originally intended."

SEPTA also provided this response on May 25, 2012, with respect to the reason the swaps did not work. SEPTA explained as follows: "SEPTA's intent in entering into this swaption agreement was to lock in a historically low, long-term fixed interest rate. The strategy would have executed as planned if not for a change brought about by the enactment of Act 44 in July 2007. This new law effectively precluded using the Public Transportation Assistance Fund dollars for debt service payments on new capital acquisitions, or to refund existing debt. With a change in the fiscal code in 2010, refunding w[as] eventually permitted, but the formula for qualification precluded SEPTA's ability to issue variable rate debt to refund the 1999 bonds."

We do not agree with SEPTA's conclusions. The three-month LIBOR rate in March 2009 was only about 1.27 percent.[34] Also, the interest received by SEPTA was only 67 percent of three-month LIBOR, or about 0.85 percent, in March 2009. The 3-month LIBOR rate then dropped steadily after March 2009 to about 0.29 percent by October 2010. The interest received by SEPTA was only 67 percent of 3-month LIBOR, or about 0.19 percent. It is a matter of speculation whether SEPTA could have issued variable rate refunding bonds at the low interest rates if the Commonwealth had not changed its fiscal code.

In SEPTA's May 25, 2012, response, SEPTA tried to minimize the swap losses by offsetting the $27 million refunded swap losses against the $23.4 million of net present value savings from the 2010 refinancing of the 1999 Series A and Series B Bonds ($34.8 million discounted at 3.357 percent). The 2010 bonds were issued at a lower interest rate than the 1999 Bonds so less interest expense would be incurred over the remaining life of the 2010 bonds, hence the savings. SEPTA claimed that the swap loss as a result of the offset was really only $10.2 million. We believe this offset is also incorrect.

We do not agree with SEPTA's loss calculation. If SEPTA had never entered into a swap agreement, then refinanced the outstanding 1999

[34] http://www.fedprimerate.com/libor/libor_rates_history.htm accessed July 9, 2012.

Series A and Series B Bonds in 2010, according to SEPTA's own calculations, it would have saved almost $34.8 million. Instead, by entering into the swap agreement, according to SEPTA's own calculations, it lost $10.2 million. In other words, instead of $34.8 million in savings it lost $10.2 million, a $45 million swing in cash flow in the wrong direction.

Conclusion and Recommendations

SEPTA's use of swaps associated with the serial 1999 bonds, a strategy designed to save money, proved to be disproportionately and far too costly. If SEPTA had simply issued its 1999 bonds in February 1999, and never entered into swaps agreements, it could have saved the taxpayers almost $41.4 million as calculated by us in Table 1, which equates to more than 1.26 months of passenger revenue.[35] Based on SEPTA's own calculations, the loss was $45 million.

As this finding illustrates, the multitude of hidden risks in swaps deals makes them inherently unsuitable for public finance. The Department of the Auditor General's position on swaps has been clearly stated on many previous occasions, and it bears repeating here. Quite simply, the use of swaps amounts to gambling with public money.

The fundamental guiding principle in handling public funds is that they should never be exposed to the risk of financial loss. Swaps may be perfectly acceptable in the private sector, where private citizens are free to decide how much risk they can tolerate when their own money is at stake. But swaps should have no role in government, where the taxpayers' money is at stake. Public debt should be financed with fixed-interest rate conventional bonds that are transparent, reliable, and easily understood by decision-makers and the public.

We also reject the counter-argument that not all swaps deals turn sour, and that many swaps deals have saved a great deal of money. That position brings no comfort to the many public entities that have been badly served by swaps deals that backfired. Any municipal finance vehicle that produces winners and losers is by definition unsuitable for the public sector. As we stated in our inquiry into the use of swaps by the

[35] According to SEPTA's CAFR for the fiscal year ended June 30, 2010, total passenger revenue for the year was $395.9 million, or approximately $32.9 million per month.

Philadelphia School District, we "respectfully disagree with any approach that condones gambling with public funds. After all, it is the taxpayers, not the public officials, who bear the losses resulting from a bad bet."[36]

Recommendations

1. The Southeastern Pennsylvania Transportation Authority should terminate all remaining swaps as soon as it is fiscally responsible to do so and refinance, if necessary, with conventional fixed-rate bonds.

2. The Southeastern Pennsylvania Transportation Authority should promptly adopt a resolution unequivocally and permanently prohibiting the use of swaps in the future.

SEPTA management's response

SEPTA management provided a written response to our audit report on August 8, 2012. The response can be found in its entirety in Appendix A of this report.

[36] Auditor General Jack Wagner, "Letter to the School District of Philadelphia," December 3, 2009, pg.2.

Audit Results for Objective Two

Finding Two: Salaries
(pp 25-28)

Findings Three and Four: Benefits
(pp 29-36)

Finding Five: Purchase Orders
(pp 37-44)

The Objective

The second objective of this performance audit was to examine selected expenditures incurred by SEPTA focusing on management compensation and purchase orders with outside vendors for the fiscal years ended June 30, 2007, 2008, and 2009.

Scope of our Audit Work

We examined management compensation, including salaries and other benefits, for the period July 1, 2006, through June 30, 2009.

We also examined purchase orders, for the period of July 2006 through November 2011, for their propriety and their compliance with Commonwealth and SEPTA policies and procedures.

Relevant laws, policies, and agreements

SEPTA has established policies governing employee compensation and benefits for its management employees.[37] It has also entered into collective bargaining agreements with its unions. We selected the agreement with the largest union, the Transport Workers Union,[38] for review of compensation arrangements.

SEPTA also established policies and procedures for procurement of goods and services.[39] Authority for establishing these policies was granted in the enabling legislation that created SEPTA.[40]

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[37] Southeastern Pennsylvania Transportation Authority, "Supervisory, Administrative and Management (SAM) Compensation Policy," Policy # E02, dated June 1, 2005;
Southeastern Pennsylvania Transportation Authority, "SAM Vacation Policy," #E07, dated January 1, 2006;
Appointment and Compensation Agreement between the Board of the Southeastern Pennsylvania Transportation Authority and Joseph M. Casey, dated December 20, 2007.

[38] Transport Workers Union, Local 234, Suburban Transit Division, dated November 8, 2009, and applicable for the period from April 2, 2009, to April 1, 2014.

[39] Southeastern Pennsylvania Transportation Authority, Procurement Manual, April 26, 2001, as revised through October 2005.

[40] 74 Pa.C.S.A. §1750.

Methodologies to meet our objective

To establish our understanding of the employee compensation, we reviewed SEPTA's policy statements for supervisory, administrative and management compensation. We reviewed the collective bargaining agreement between SEPTA and the Transport Workers Union. We also reviewed SEPTA's procurement policies to establish our understanding of SEPTA's procurement process.

We conducted interviews with the Assistant General Manager for Audit and Investigative Services to establish our understanding of SEPTA's implementation of its policies.

We reviewed the 2009 Public Transportation Management Compensation Report published by the American Public Transportation Association that compared SEPTA salary and benefits to those of comparable transit agencies of similar size.

We also reviewed the results of a survey regarding other benefits provided to management employees at 10 transit agencies similar to SEPTA in size and complexity.

We examined a comparison of benefits between management and union employees and verified the accuracy of the comparison by tracing benefits to the Transport Workers Union agreement and to the *Supervisory, Administrative and Management Compensation* policy.

We obtained an understanding of SEPTA's controls over the procurement process by reviewing the working papers of the independent certified public accounting firm who conducted the financial audit of SEPTA.

For testing the procurement of goods and services, we obtained a listing of more than 2,900 purchase orders that totaled over $1.2 billion in value that were opened during the period from July 1, 2006, through June 30, 2009.

Using our professional judgment, we selected 29 purchase orders valued at over $2.7 million to determine if the policies related to competitively bidding contracts were properly followed, if the required approvals were obtained, and if the goods or services obtained were justified and necessary for the operations of SEPTA.

We selected 10 additional purchase orders valued at $23.8 million and reviewed expenditures incurred for catering and special events to further evaluate whether SEPTA acted prudently in regards to its expenditures for these particular goods or services.

How did salaries for SEPTA management compare to salaries at similar transit agencies?

Finding Two: SEPTA paid its top management salaries that were competitive with the salaries paid to top management at transit agencies similar in size and scope to SEPTA.

The SEPTA board of directors hired a general manager to oversee SEPTA services and operations. Together with a general counsel, a chief financial officer/treasurer, and eight assistant general managers, the general manager was responsible for day-to-day operations. We will refer to these 11 individuals collectively as SEPTA's top management.

SEPTA has the following compensation philosophy:

> *The compensation philosophy of SEPTA is to pay salaries which are generally competitive within the marketplace for positions of similar responsibility.*[41]

SEPTA officials said that they strived to offer salaries and benefits that were in line with SEPTA's compensation philosophy and were competitive. Accordingly, we planned our audit work to identify whether management salaries and benefits were indeed competitive with those offered by transit agencies of similar size and scope.

As of June 30, 2009, the combined experience of the top management employees averaged almost 20 years with SEPTA. Individually, each management employee averaged about four years in his or her current position.

Comparative salary and benefit data already existed for 13 large transit agencies, including SEPTA

In examining the salaries and benefits paid to SEPTA's top management, we learned during our interviews that salary and benefit comparisons had already been performed by the SEPTA human resources division using data from the American Public Transportation Association. This 13-

[41] SEPTA's "Supervisory, Administrative, and Management (SAM) Compensation Policy," dated June 1, 2005.

agency comparison included SEPTA and twelve large transit systems[42] similar in size to SEPTA. SEPTA was the sixth largest.

The comparison was relevant for 9 of the 11 top management positions at SEPTA. These positions, for which there were comparable ones at the other 12 transit agencies, included the following: general manager, general counsel, CFO/treasurer, and assistant general managers for operations, human resources, engineering/maintenance/construction, public and operational safety, public and government affairs, and audit and investigative services. The comparison did not include the assistant general managers for business services and customer service because there were not entirely comparable positions at the other agencies.

SEPTA's management salaries were lower than the average of the comparables

Overall, we noted that SEPTA's salaries for eight of the nine positions were lower than the *average* comparable salaries, including general manager salaries, by as little as one percent to as much as 24 percent.

The one SEPTA position with a higher salary than the comparables was that of the assistant general manager responsible for public and operational safety. The table on the next page shows all nine of the SEPTA salaries compared to the averages. The table also shows how SEPTA ranked when compared to the other agencies.

[42] The twelve transit systems used in the comparison with SEPTA were: MARTA (Atlanta, Georgia), MBTA (Boston, Massachusetts), Chicago TA (Chicago, Illinois), DART (Dallas, Texas), MTA – Harris County (Houston, Texas), LA MTA (Los Angeles, California), New Jersey Transit (New Jersey), MTA Long Island Railroad (New York), MTA Metro – North Railroad (New York), MTA NYC Transit (New York), BART (Oakland/San Francisco, California), and WMATA (Washington, DC).

Salary Comparison (2009)

Position	*SEPTA Salary*	*Average salary for comparable positions*	*SEPTA salary as a percent of average*	*How SEPTA ranked*[43]
General manager	$202,020	$265,788	76%	12 of 13
CFO/treasurer	165,282	185,328	89	12 of 13
General counsel	158,990	184,312	86	8 of 11
Assistant general manager, operations	169,572	210,082	81	12 of 13
Assistant general manager, human resources	163,410	165,442	99	8 of 13
Assistant general manager, engineering, maintenance, construction	173,550	185,195	94	8 of 12
Assistant general manager, public and operational safety	164,346	158,258	104	5 of 12
Assistant general manager, government affairs	150,020	161,302	93	9 of 13
Assistant general manager, audit and investigative services	144,092	158,857	91	7 of 8

SEPTA's position of general manager, although the highest paid position at SEPTA, had the second lowest salary when compared to the salaries for the general manager position at the other 12 transit agencies, and 24 percent below the average salary. SEPTA stated that the entire salary package should be considered when doing a comparative analysis and that the above analysis does not consider other factors.

As noted on the table above, the only SEPTA position with a salary higher than the comparables was that of the assistant general manager responsible for public and operational safety. The person in this position serves as the head of safety, security, and police as well as overseeing the third party claims, workmen's compensation, and the real estate sections for SEPTA. His salary was four percent more than the average salary for comparable positions at the other transit systems, possibly because SEPTA's assistant general manager had more job duties and responsibilities than the positions at the other transit agencies. Even so, when compared to the *individual* salaries for this specific position at the

[43] Some of these rankings have fewer than 13 comparables because like comparisons could not always be made at all 13 transit systems. In such cases, SEPTA positions were compared to as many other like positions as possible.

other agencies (as opposed to the *average* salary for this specific position), we note that the SEPTA position ranked fifth.

Bonuses and Salary Increases

SEPTA's top management personnel received no bonuses during our audit period. Among the comparable 12 transit agencies, two paid bonuses to their top executives, and one of those two also paid bonuses to other members of higher management.

Regarding increases in pay, we learned that SEPTA employees in the supervisory, administrative, and management group with performance ratings of satisfactory or above received a one-time payment of $1,250. This payment, which was in lieu of a pay increase for the year, matched the amount brokered by former Governor Rendell to the SEPTA unions for approving the 2009 collective bargaining agreement. In prior years, SEPTA management employees were eligible for pay increases based on performance.

Our conclusion

Most SEPTA management salaries were lower than the average salaries for similar positions at comparable transit systems. The lower-than-average salaries actually benefitted the taxpayers and riders by not adding more to SEPTA's operating costs. As a result, we concluded that SEPTA salaries were not excessive compared to other transit systems and that SEPTA generally had followed its own philosophy, "To pay salaries which are generally competitive within the marketplace for positions of similar responsibility."

How did management benefits compare to those at other transit agencies?

<u>Finding Three</u>: SEPTA provided its top management with benefits that were comparable to those at transit agencies similar in size and complexity; for other benefits, SEPTA could have achieved savings to help control its operating costs.

Using the data gathered by SEPTA personnel from an email survey conducted in November 2009 of other similar transit agencies, we compared benefits offered to SEPTA management with benefits offered for similar management in the other transit agencies. The benefits we reviewed include pensions, deferred compensation, and health care co-payments.

Pensions. Among the 12 transit agencies SEPTA surveyed, ten supplied information that we could use for pension comparisons. The survey asked what type of pension is offered to management employees, and the responses indicated that management was provided with either a defined benefit pension plan or a defined contribution plan. Three of the ten transit agencies also offered deferred savings plans to its employees.

In comparison, SEPTA management employees were eligible to participate in a defined benefit pension plan, and all SEPTA employees were eligible to contribute to an employee savings plan. SEPTA management employees received an employer match of 10 cents on the dollar up to an allowable maximum of $727. Of the three agencies with a deferred savings plan, only one provided information regarding its employer matching funds. Specifically, one agency responded that it would match 50 percent of the employees' contribution up to a maximum of three percent of the employee's salary.

The survey results also indicated that one of the ten agencies paid additional benefits to its chief executive officer. Specifically, $25,000 per year was put into an annuity for the CEO. In comparison, SEPTA did not pay its top executives any additional pension benefit monies beyond the pensions paid for SEPTA's other supervisory and administrative non-represented positions.

Deferred compensation. SEPTA's general manager was the only management position in SEPTA that was eligible for deferred compensation. Among the other 10 comparable transit systems, there were six that reported offering deferred compensation to the chief executive. Four transit systems also reported that other higher management employees were eligible for deferred compensation as well.

The highest reported paid amount of deferred compensation was $25,000 at one of the ten agencies other than SEPTA. The SEPTA general manager received $22,000, an amount similar to the amount paid by most of the other transit systems who reported an actual amount.

Health care premiums. Nine of the other transit systems provided responses to the survey question which asked for the co-pay for monthly health care premiums. Seven agencies responded that the employees pay a percentage of the monthly premium, depending on which plan the employee was enrolled in. The percentages ranged from 25 percent at two of the agencies to only 5 percent at one of the agencies. The average percentage paid by employees for the other agencies was 15 percent. Two other agencies reported the co-pay dollar amount paid by the employee for monthly health care premiums. One agency said their management employees paid anywhere from $7 a month to $62 a month, while another agency reported that the employees' co-pay was $81.95 a month.[44]

By comparison, SEPTA's management officials paid five percent toward their monthly health care premiums, with SEPTA itself thus paying the remaining 95 percent. Simply comparing the co-pay amounts for health care premiums paid by the employees at each agency, SEPTA appears to have been among the most generous. We use the term "appears" because the responding agencies responded to the question in various ways (e.g., reporting by a percentage versus an actual dollar amount for the co-pay) thereby making it difficult to do a straight comparison. Further, in many cases the co-pay amount varies depending on which plan the employee is enrolled in. We also note here that our comparison was focused on co-pays and employer contributions and we did not compare the actual benefits of each plan.

[44] One transit agency paid for 100 percent of its top executive's health care copayments, but required 15 percent copayments from other top managers.

Our conclusion

Compared to transit systems of the similar size and complexity, SEPTA's benefits were comparable in the areas of pension contributions, deferred savings plan, and deferred compensation for its general manager. In the payment of health care premiums, SEPTA appeared to be slightly more generous.

Despite the fact that SEPTA's benefits appeared to be comparable, SEPTA should identify savings wherever possible and should thus look for savings in its provision of benefits—even if that savings opportunity means that SEPTA offers benefits less generous than those provided by other transit companies of similar size and complexity. It is for that reason that we offer the recommendations below.

Recommendations

3. SEPTA should consider reducing or eliminating the annual deferred compensation payment of $22,000 to its general manager to reduce SEPTA's operating expenses and to set an example to the rest of SEPTA's employees.

4. SEPTA should conduct a study of management's health care premiums to determine if management should contribute more than five percent towards their monthly health care premiums.

5. SEPTA should consider reducing or eliminating the ten cents on the dollar employer match for management employee contributions to the employee savings plan.

SEPTA management's response

SEPTA management provided a written response to our audit report on August 8, 2012. The response can be found in its entirety in Appendix A of this report.

How did benefits for SEPTA's management compare to those for union employees?

Finding Four: SEPTA provided more generous benefits to its management employees in some cases, and more generous benefits to its union-represented employees in other cases. The differences were not excessive by comparison.

Benefits provided to SEPTA management and union employees include life insurance, long-term disability, deferred compensation, pensions, sick leave and pay, and medical benefits that include vision, prescription, and dental insurance. We analyzed the benefits contained in SEPTA's supervisory, administrative, and management compensation policies. These benefits applied to all non-collective bargaining employees equally. We also examined the benefits provided to union employees as part of collective bargaining agreements.

A discussion of the comparative analysis follows, with a summary table at the end of the discussion on page 36.

Our comparisons of the benefits for SEPTA management and union employees revealed that some of the benefits provided to SEPTA management—including life insurance, long-term disability, deferred savings, and pension contributions—were more generous than those offered to union employees. At the same time, benefits provided to union employees—retirement age, pension benefits for earnings below $50,000, and sick time —were more generous than those offered to management employees. Examples follow.

- **Life insurance.** A management official's life insurance payout was two times salary, whereas a union employee's payout was capped at $40,000.
- **Long-term disability.** A management official's long-term disability payment was 60 percent of salary after one year of service, whereas a union employee received a flat rate of $500 a month after 15 years of service.
- **Deferred savings.** As discussed in Finding Three, both union and management employees were eligible to contribute to an employee savings/deferred compensation plan; however, only management

received an employer match of 10 cents on the dollar up to $7,272. That meant that management could receive up to $727.20 ($7,272 x 10 percent) in SEPTA-paid deferred savings. According to SEPTA's annual financial reports, this management benefit cost $333,000 in 2007, $339,000 in 2008, and $338,000 in 2009.

- **Pension benefits.** Although all SEPTA employees earned the right to acquire pension benefits (i.e., to become vested) after accumulating five years of service, management employees contributed at a lower rate toward pensions benefits. Specifically, management employees contributed only 0.9 percent of their social security covered compensation and 1.1 percent of their compensation in excess of social security covered compensation. Union employees contributed at a higher percentage, which was two percent of their straight time earnings. For example, a union person pays two percent of $50,000 of straight time earnings, or $1,000, towards the pension each year; a management employee pays only 0.9 percent of a $50,000 per year income, or $450, towards the pension each year. That equates to a $550 management advantage each year for this particular example.

  Depending on their salaries, management officials ultimately had the pension advantage because management did not have a $50,000 cap on the amount of salary eligible for pension benefits. For example, when we calculated the pension benefits for a union person and a management person when both were earning $50,000 a year and both retired with 30 years of service, the annual management pension benefit would equal $27,000 a year while the annual union pension benefit would be $3,000 higher, or $30,000. We found that management employee salaries are not capped so management employees' pension benefits would continue to rise with salary eventually surpassing the union capped pension. Because there is no cap on management's salary, any management employees with 30 years of service earning more than $55,556 a year would receive a pension greater than $30,000 a year.

  SEPTA officials contend that the union plan exceeds the management plans in that union employees can retire with 30 years of service <u>at any age</u>. Management employees cannot retire until the age of 55 along with 30 years of service. In addition, the union formula is better than the management formula. The union formula is based on approximately 2 percent of salary per year for the first 30 years of service while the management plan formula is 1.8 percent for the first 30 years of service. SEPTA officials further state that the union pension formula pays 1.8 percent per year in excess of 30 years while the management pension formula pays only 1 percent per year in excess of 30 years of service.

- **Retirement.** Management officials could retire with full benefits if they were age 55 and had 30 years of service. Union employees could retire at any age after 30 years of service. Management was eligible for early retirement with reduced benefits at age 55 with ten years of service or at any age with 25 years of service. Union employees were eligible for early retirement with reduced benefits at any age with 25 years of service.

- **Payments for sick time.** Union employees are entitled to more pay for sick time than management employees. Specifically, although management employees could receive 100 percent of their pay for 12 days of sick leave a year, union employees could receive 50 percent of their pay for up to 180 days a year as long as they had sick leave available.

- **Premiums for medical benefits.** Both union and management employees were eligible for medical benefits. As discussed in the previous finding, management officials paid five percent of the premium for medical benefits. For example, medical coverage would cost a management employee earning $50,000 a year, about $289.90 for single coverage for a PPO plan and $756.60 for family coverage for a PPO plan during the fiscal year ended June 30, 2009. The rates were set for the year.

  Union employees, on the other hand, paid one percent of their earnings for medical benefits. Medical coverage would cost a union employee earning $50,000 a year, about $500 a year, a rate between the single and family plan rates of management. Since union employee medical coverage is based on wages, the higher the wages, the higher the cost for the benefits (always one percent) so a well-paid union employee would pay more than a management employee for single coverage. A management employee would pay more for family coverage.

In addition, both union and management employees are eligible for dental insurance, although some union employees' co-pays were higher than those paid by management employees for dental insurance. SEPTA stated that the union determined its own copayments so the payments were not under the control of SEPTA.

Because the cost of medical benefits varied with respect to single coverage or family coverage for management employees, varied for union employees by the level of earnings, and management and union co-pays for dental coverage were different, we were unable to determine whether union or management paid more for medical and dental coverage.

Our conclusion

We concluded that, overall, the benefits received by management employees did not appear to be excessive based on our finding that SEPTA offered some benefits more favorable to management and others more favorable to union employees. As previously recommended, SEPTA should consider modifying or reducing the deferred savings benefit to management. As explained earlier under the deferred savings comparison, the annual cost for this benefit was approximately $333,000 in 2007, $339,000 in 2008, and $338,000 in 2009. Any reduction in this cost would have a positive financial impact by reducing SEPTA's annual operating costs.

Differences between Management and Union (TWU 234*) Benefits

Benefit	Management	Union
Life Insurance	Two times salary	$40,000
Long-term disability	Sixty percent of salary after one year of service	$500 a month after 15 years of service
Deferred Savings / Compensation Match	Ten percent of first $7,272	None
Pension retirement age	Normal retirement at age 62 with five years of service or at age 55 with 30 years of service	Normal retirement at age 62 with five years of service or at any age with 30 years of service
Early retirement age	Early retirement at age 55 with ten years of service or at any age with 25 years of service	Early retirement at any age with 25 years of service
Retirement benefit calculation	Benefit – 1.8 percent of final average earnings on the first 30 years, then 1 percent above 30 years	Benefit – 1.8 percent up to 10 years; 2.0 percent 11-20; 2.2 percent 21- 30; 1.8 percent above 30 years - $50,000 CAP
Pension contribution	Rate of 0.9 percent on social security earnings and 1.1 percent above social security earnings	2 percent of straight time earnings[45]
Sick pay	100 percent pay 12 days a year	50 percent pay after third day out for 180 days a year while sick leave lasts
Sick leave	Similar	Similar
Medical (HMO $5 – PPO $10/$20/70 percent), Vision ($100), Prescription ($5/$10/$20)	Same except contributions 5 percent of medical premium	Same except contributions 1 percent times 40 hours times the hourly rate of pay
Dental	PPO/HMO	PPO some higher copayments

Source: Comparison on benefits prepared by SEPTA management and provided to the auditors April 7, 2010.

[45] Collective bargaining employees will increase their pension contribution rates to two-and-a-half percent of earnings on January 9, 2012, and three-and-a-half percent of earnings on January 14, 2013.

Purchase Orders

Finding Five: Even though it followed applicable policies and procedures in processing purchase orders that we examined, SEPTA showed poor judgment in spending excessively on banquets and meetings.

SEPTA used purchase orders to secure goods and services for carrying out its day-to-day operations. The policies stipulate requirements to follow in cases when competitive bids must be obtained on purchases; the polices also stipulate requirements to follow in cases when competitive bids are *not* required and, based on the total dollar value, what management approvals are necessary for purchases to be processed in SEPTA's procurement system.

Our test work included a review of 29 purchase orders broken down as follows:

Type of Purchase Order	No. of Purchase Orders Reviewed
Sole Source	4
Less than $3,000	10
Between $3,000 and $10,000	8
Between $10,000 and $25,000	4
Greater than $25,000	3

Selected 8 purchase orders from 06/07 fiscal year; 7 from 07/08 fiscal year; and 14 from 08/09 fiscal year

For our sample, SEPTA provided documentation that was sufficient and appropriate for us to evaluate SEPTA's compliance with applicable policies and procedures as follows:

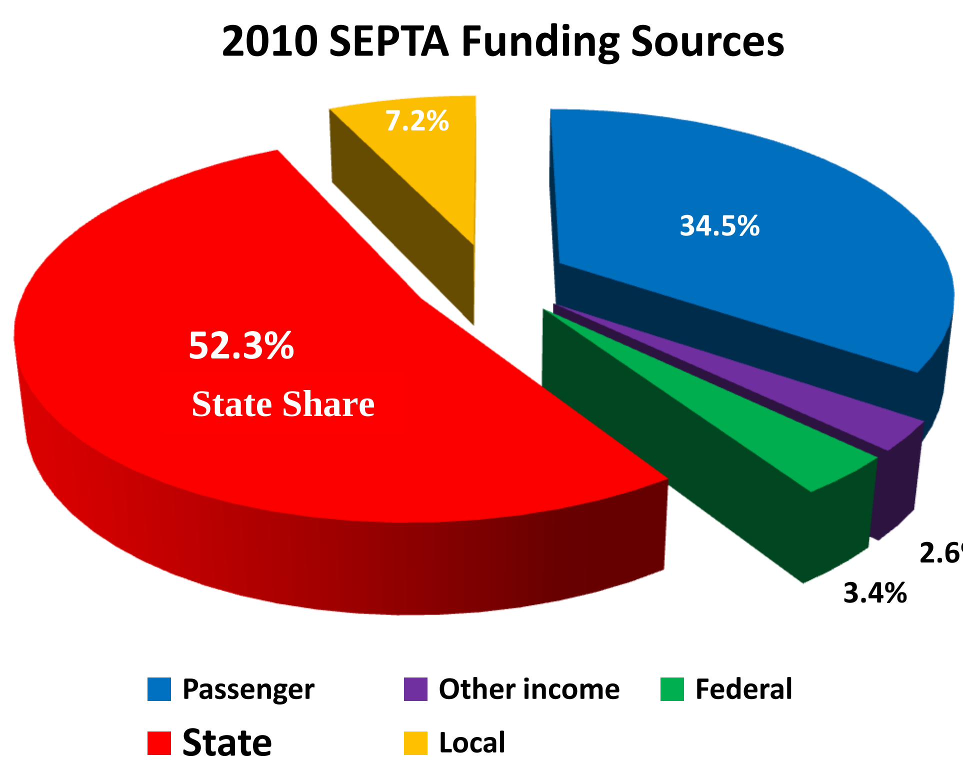
- For the 4 sampled sole source purchases, SEPTA provided adequate documentation to support the vendor selections.
- For the 22 sampled purchases between $3,000 and $25,000, SEPTA obtained the required quotes.
- For the 3 sampled purchases over $25,000, SEPTA obtained competitive bids.
- For all 29 sampled purchases, SEPTA processed and paid the associated invoices in accordance with applicable Commonwealth and SEPTA policies and procedures.

Additional analysis:
Looking beyond compliance to see if purchases were necessary and prudent

For 10 additional purchase orders chosen randomly beyond the 29 in our original test group, we focused on determining whether the goods and services were actually used to carry out the day-to-day operations of SEPTA. After reviewing the justifications that SEPTA provided, we found that these expenditures were in support of its operations.

However, we also noted instances in our review that caused us to question the actual necessity and prudence associated with some of these expenditures.

Looking beyond compliance is critical not only for us as performance auditors but should be critical as well for SEPTA as a public transit agency funded in large part by state taxpayer dollars as shown below:



Based on our concerns about actual necessity and prudence, we expanded our review to one area that caught our attention—that is, food and special events. In reviewing such expenditures from July 2007 through November 2011, and specifically those expenditures related to SEPTA's annual safety banquet, other special events, and board and committee meetings, we found that SEPTA did not always act with prudence and good judgment that Pennsylvania taxpayers have every right to expect.

Annual safety banquets: High-end affairs. Under provisions of a contract with its unionized employees, SEPTA is required to provide an annual safety banquet. The purpose of each banquet is to recognize the safe driving and operations of union employees in the workplace for the prior calendar year. Banquets were held at a hotel in center city Philadelphia.

The following table summarizes the total costs associated with the banquet and the number of attendees for the banquets from 2007 through 2011. We note here that, in 2009, an actual banquet was not held because of a labor strike; instead, the estimated cost of the would-be banquet was divided by SEPTA among the 1,068 employees who would have qualified to attend that year, with each employee receiving a check for $54.77 ($58,494 estimated cost divided by 1,068 eligible employees).

SEPTA Annual Safety Banquet Costs
Total for 4 banquets = $279,678

Year, excluding 2009*	Banquet cost	Attendees: Honored employees, their guests, and personnel who organized the banquet	Cost per attendee
2007	$68,394	639	$107.03
2008	64,766	601	107.76
2010	73,812	710	103.96
2011	72,706	672	108.19
Averages	**$69,920**	**655.5**	**$106.74**

* As noted in our narrative, there was no banquet in 2009 because of a labor strike. SEPTA's estimated $58,494 cost of the would-be banquet was divided among the 1,068 eligible attendees, netting each a check for $54.77.

In looking at invoices related to the four banquets, we found the following:

- **Dinner PLUS reception for honorees PLUS their guests PLUS other SEPTA employees.** Using 2010 as an example, we found that SEPTA paid $50 for each of the 710 dinners. But, prior to the dinner, SEPTA also footed the bill for a reception at $24 a person. Alcoholic beverages were *not* included, according to the invoices, so SEPTA's choice to pay $74 per person ($50 + $24) does not represent a low- or moderate-budget decision. And while that $74 may have included dessert, SEPTA paid still more money for custom chocolate bars, as the next bullet shows.

- **A total of $8,000 for custom chocolate bars at the four banquets, for an average of $2,000 at each event.** Persons attending the banquets received custom chocolate bars in a custom-sewn felt envelope. The actual price for chocolate at the 2010 banquet was $1,750.

- **Flowers—more than $11,000 combined for just four banquets.** At the 2010 banquet alone, SEPTA paid $2,952 for flowers.

- **More: Program books, music, coat checks, bartenders, soda, water, parking (including valet parking), cashiers, equipment rental, and hotel staff gratuity (service) charges.**

  Again, clearly these banquets were not low-budget affairs. Using 2010 as an example, the next table below breaks down the specific costs.

$73,812 for 2010 banquet:
Breakdown of SEPTA's spending

Items	Cost per person	Number of persons participating	Totals
Reception food	$24	710	$17,040
Dinners	50	710	35,500
Custom chocolate			1,750
Flowers			2,952
Program books			1,386
Music			900
Coat check	2	136	272
Bartenders*			600
Soda and water	5	65	325
Parking	14	42	588
Valet parking	44	1	44
Cashiers			300
Equipment rental			105
Service charges			12,050
			$73,812

** SEPTA paid for bartending personnel but said attendees purchased their own alcoholic drinks.*

As we stated earlier, SEPTA has been required by its union contract to hold these annual employee safety banquets. But the contract does not stipulate details such as $100 total cost per person or custom chocolates. Therefore, SEPTA's board and management had the discretion to determine how much to spend and should have used better judgment before deciding to spend more than $100 a person over a period when SEPTA has had to rely on taxpayer dollars and fare increases.

SEPTA should also consider the fact that, in the end, it likely paid for as many non-employees as employees to attend these banquets. The average number of 655.5 attendees over the years suggests that *at least* 40 percent of the eligible employees did *not* attend. The true percentage of actual-versus-eligible attendees is unknown; more than half of eligible employees might have stayed home. This suggestion is based on (1) comparing the 655.5 average actual attendees for the four banquets to the 1,068 employees *eligible* to attend the cancelled 2009 banquet, or 61 percent, and (2) recognizing that 61 percent represents honored employees *plus* their guests *plus* other SEPTA employees as well.

If SEPTA's contractual obligation for these banquets continues into the future, SEPTA needs to re-think how it can indeed honor *all* safety-eligible employees at a more moderate cost.

Breakfasts and luncheons for board, committees, and staff: How much and how many are reasonable? By reviewing catering expenditures for breakfast meetings, lunch meetings, and special events, we found that SEPTA spent more than $132,000 on such expenditures on purchase orders issued from July 1, 2006, through June 30, 2009. That total breaks down as follows:

SEPTA meeting and special event expenditures

Fiscal year ended	Meetings	Special events	Combined totals
June 30, 2007	$20,133	$28,590	**$ 48,723**
June 30, 2008	14,543	24,000	**38,543**
June 30, 2009	22,954	22,630	**45,584**
	$57,630	**$75,220**	**$132,850**

While governance meetings themselves—which include board and committee meetings, for example—are clearly necessary to SEPTA's ongoing operations, the catering expenses are far less defensible.

Attendees at monthly board meetings included the 15 board members, plus anywhere from 10 to 30 SEPTA staff members available to answer questions. Catered lunches were routinely provided to all who attended; the lunches were typically titled by the caterer as a "Corporate Buffet" and consisted of salads, sandwiches, and desserts, along with "gourmet" chips, coffee, tea, and assorted beverages.

In addition to monthly board meetings, various committees met on an as-needed basis throughout the year. These meetings were also attended by 30 to 40 persons and were also routinely catered.

The special events we reviewed included tours and meetings that did not occur on a regular basis, such as those in which joint participants included officials from federal, state, and local agencies. Other special events included groundbreaking and ribbon-cutting ceremonies, as well as SEPTA-sponsored city cleanup days.

Our review of invoices paid by SEPTA for catering expenses showed that, while the meals themselves might not be considered extravagant at \$9 for breakfast and \$19 for lunch, SEPTA should carefully review *all* its catering expenses. Furthermore, SEPTA should determine if it is really necessary for as many as 30 staff members to attend board and/or committee meetings as well. Again, when SEPTA relies on taxpayer dollars for most of its budget, and when fares have increased for its riders, SEPTA should exhibit good judgment and fiscal prudence in every spending decision it makes.

Our conclusion

Although SEPTA may have complied with its policies and procedures in the processing of purchase orders, management has not appeared to consider cost-saving measures related to spending for both the annual safety banquets and the board and committee meetings. SEPTA's expenses continue to outpace its revenues, as illustrated on page 5 of this report in the *Statement of Revenues, Expenses and Changes in Net Assets*. Thus, SEPTA's board, management, and union must all work together to eliminate any spending in excess of that which is actually needed.

Recommendations

6. SEPTA should examine all costs associated with its annual safety banquet —for example, food, venue, printed programs, flowers, custom chocolate, music, and number of attendees—to reduce and/or eliminate excessive costs.

7. For its board and committee meetings, SEPTA should provide catered meals only as needed and only to necessary attendees. One consideration might be to alter meeting times so they do not occur over meal periods.

SEPTA management's response

SEPTA management provided a written response to our audit report on August 8, 2012. The response can be found in its entirety in Appendix A of this report.

Audit Results for Objective Three

Finding Six: Advertising revenue

(pp 47-48)

The Objective

Objective Three was to review revenue that SEPTA generated through outside advertising that was then used to supplement funding for daily operations.

Scope of our Audit Work

We reviewed SEPTA's contract with an outdoor advertising agency and examined all revenue resulting from that contract.

Relevant laws, policies, and agreements

SEPTA is primarily funded by revenue generated from passenger fares and from federal, state, and local grants and subsidies. The Commonwealth also requires SEPTA to explore alternative means of raising revenue in addition to its other funding sources.

Commonwealth law includes the following requirement for SEPTA:

> *To explore alternative means of raising revenue or reducing expenses, including, but not limited to, real estate leases and rentals, equipment leases and rentals, contracting of services, the solicitation of competitive bids and the awarding of contracts to the highest responsive, responsible bidder for both interior and exterior advertising on all authority equipment on which the public is charged a fare for riding. However, on rail passenger units only bids for interior advertising shall be solicited.*[46]

In addition, state or local funds are required by the federal government to complement federal funds for capital projects. A match is also required by Pennsylvania in funding operations and capital projects.[47]

One method utilized by SEPTA to raise the matching funds required is to contract with outside vendors for advertising services as a source of revenue. Advertising includes displays and messages on SEPTA's

[46] 74 Pa.C.S.A. § 1741(a) (24).
[47] Southeastern Pennsylvania Transportation Authority Fiscal Years 2010-2014 Five-Year Strategic Business Plan as viewed at http://septa.org/reports/pdf/strategic.pdf on April 14, 2010.

vehicles and stations and on SEPTA's products such as schedules and maps.

Methodologies to meet our objective

We interviewed the SEPTA senior advertising specialist and the marketing and advertising director to gain an understanding of advertising procedures.

For our analysis of outside advertising revenue, we reviewed the contract terms between SEPTA and the contracted advertising agency; reviewed the advertising revenue received by SEPTA; determined if the amounts met the minimum annual guaranteed payments according to the advertising contract; and reviewed documentation received by SEPTA that supports how the advertising revenue was calculated.

Advertising Revenue

<u>Finding Six</u>: SEPTA effectively monitored its primary outside advertising revenue and took the necessary steps to maximize that revenue.

SEPTA entered into an agreement with an outdoor advertising firm on February 15, 2005, to solicit, create, and display advertising in transit and railroad vehicles and in public transit and railroad facilities. The agreement outlined the minimum annual guaranteed payments to be made to SEPTA. During the third year of the contract, an amendment was made to increase the minimum annual guaranteed revenues. The amended contract guaranteed that revenue amounts would increase by $1 million for the first four years, $1.25 million for the next two years, and $1.5 million for the final year.

In reviewing the amended contract, we noted that the advertising firm then requested that the contract revert to the original guaranteed amounts until such time as the firm's financial resources stabilized. According to the *New York Times*, the firm was experiencing the worst advertising market in decades along with the subsequent negative effect on mass transit advertising payments.[48] The same article also asserted that, due to a drop in both the price for ad rates and ad sales, advertising firms had not been able to make the agreed-upon payments to transit agencies.

We further noted that, even though the advertising firm may have been struggling to make its advertising payments to other transit agencies, the firm's advertising revenue paid to SEPTA steadily increased over the past two fiscal years as reflected in the table below:

Advertising Revenue

Fiscal Year Ended				
June 30, 2007	**June 30, 2008**	**June 30, 2009**	**Two-year Increase**	**Percentage Increase**
$9,762,701	$10,549,797	$10,902,472	$1,139,771	11.7%

[48] William Neuman, "Transit Authority Feeling the Pain From a Crippled Advertising Market," *New York Times*, May 24, 2009.

SEPTA management attributed the increase in revenue to the strength of the advertising firm’s staff in the Philadelphia market. SEPTA management believed that the advertising firm’s knowledge of the Philadelphia region and of the methods of advertising sales that work best helped increase the sales revenue paid to SEPTA. The following table reflects the agreed-upon minimum annual guaranteed amounts versus the actual advertising income received during the audit period.

Year	Minimum Annual Guaranteed Amount	Actual Advertising Revenue
2006 to 2007	$7,500,000	$9,762,701
2007 to 2008	$9,000,000	$10,549,797
2008 to 2009	$8,250,000	$10,902,472

Although the contract years for the minimum annual guaranteed amounts run from May 1 through April 30 and the actual advertising revenue amounts are reported by fiscal year, which runs from July 1 through June 30, the actual advertising revenues far exceeded the expectation.

Our conclusion

We concluded that the reduction in the amount of guaranteed payments had no impact since the advertising firm was able to continue to make advertising revenue payments in amounts greater than the original agreed-upon amounts. As a result of the continued increase in advertising revenue over the past three years, we are not recommending any changes at this time.

Department of the Auditor General's evaluation of SEPTA's response

SEPTA's management provided a written response to our audit report on August 8, 2012. SEPTA disagreed with some of our findings and recommendations, and SEPTA's rationale for this disagreement is detailed in its response. However, we stand by our findings and recommendations as stated in this report and we encourage SEPTA to consider implementing all of the recommendations.

With respect to swap agreements which we discuss in Finding One, we reiterate our position that swaps are inherently risky and not suited for the investment of public funds. SEPTA incurred losses of $34.6 million from extricating itself from the swap agreement related to its 1999 Series A and Series B bonds. SEPTA had to issue over $27 million of additional debt to finance this loss thereby incurring additional interest expense of $7.8 million for a total loss of $41.4 million in costs. We agree with SEPTA that between 2003, when the swap agreements were entered into, and 2009, when the swap counterparties exercised the swap agreements, economic conditions changed. We also acknowledge that the General Assembly enacted unforeseen legislative changes that affected SEPTA's swap deals. All of these changes reinforce our contention that swaps are too risky for the investment of public funds.

With respect to the identification of certain compensation, benefits, and banquet and other meal costs, we believe SEPTA should make reductions as appropriate in order to reduce its operating costs. We believe that our recommendations are examples of the kinds of cost reductions that SEPTA should make in its efforts reduce operating expenses.

SEPTA's management response is presented in its entirety on the next seven pages.

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August 8, 2012

The Honorable Jack Wagner
Auditor General
Commonwealth of Pennsylvania
302 Finance Building
Harrisburg, PA 17120

Re: Performance Audit of SEPTA

Dear Mr. Wagner:

The Southeastern Pennsylvania Transportation Authority is providing the attached response to the July 2012 Performance Audit of the Southeastern Pennsylvania Transportation Authority. Over the last three years, the Authority has provided significant information and support to assist the staff of the Auditor General's office in this performance audit. We believe that at all times, the Authority staff has worked diligently to provide every level of assistance and information which was requested.

Although the Authority clearly understands your position related to interest rate swaps, we respectfully disagree with several of the conclusions in the report and specifically disagree with the report's analytical methodology in a calculated loss of $41.4 million. With the benefit of 20/20 hindsight, the hedge transaction did not provide the intended result, which was in large part due to the enactment of Act 44's refinancing provisions in 2007. Without this change, it is quite likely that the transaction would have performed as originally planned.

The description of safety awards banquets as 'high-end' fails to recognize the mission critical nature of safety in the public transportation field where SEPTA provides more than one million daily passenger trips. We strongly believe that it is appropriate and necessary for the Authority to publicly recognize those employees who have achieved safe operating records. The safety banquets are held in Center City Philadelphia at a hotel which has a union workforce and these events are far from the 'high-end' affairs characterized in the performance audit. Further, the report describes Board breakfasts and lunches as modest in price but then sensationalizes the lunches by including 'gourmet' potato chips in the report, which is nothing more than a descriptive adjective listed on a vendor's invoice.

The Honorable Jack Wagner
Page 2 of 2

The review of benefits continues to focus upon employee co-pays and employer contributions rather than the actual benefit. The report and its findings continue to describe this section as a review and comparison of benefits; and we believe this characterization is inaccurate.

The Authority's detailed response to the report is attached. We are available to discuss any questions which you and your staff may have concerning the attached comments.

Thank you for an opportunity to provide comments on the performance audit.

Sincerely,

Joseph M. Casey

Joseph M. Casey
General Manager

Attachment

cc: James Sullivan, Asst. General Manager, Audit, Safety & Investigative Services
Richard Burnfield, Chief Financial Officer

Pennsylvania Department of the Auditor General

Performance Audit – July 2012

SEPTA Response

Finding One

- While we understand the Department of the Auditor General's position related to interest rate swaps, we respectfully disagree with several of the conclusions in the Auditor General's Report (the "report"), as related to the interest rate swap on SEPTA's 1999 Series A and Series B Bonds. Specifically, we disagree with portions of the report's analytical methodology that resulted in a calculated loss of $41.4 million, and in the report's conclusion that proactive management of the Authority's interest rate exposure is nothing more than "gambling with public funds".

- While the report is written with the benefit of 20/20 hindsight, SEPTA operates in a real-time environment that requires budget certainty and emphasizes cost controls that recognize reduced funding outlays for public transit agencies. As with all businesses, SEPTA management must make financial decisions based on the best available information at the time the decision is made. Any private or public company that issues debt must take a view on interest rates. For instance, issuers of debt today take views on the level of current rates vs. historic norms in determining the structure of a bond transaction and the value of imbedded call options. Issuers must decide if they should sell long or short dated maturities, and with variable or fixed rates of interest. These decisions are based upon the use of funds, historic interest rates, future expectations and relative value of call options, among other things.

- As previously discussed with the Auditor General's staff, interest rates in 2003 were at historic lows but SEPTA was locked into a fixed rate structure on its 1999 bonds until 2009 (the call option date). Given the historically low rates, it was incumbent upon SEPTA management to analyze the relative value of locking-in those low rates through an interest rate swap transaction. The ultimate decision to enter into the swap agreement was made in an effort to protect SEPTA against a rise in interest rates that could preclude SEPTA from exercising its call option on the bonds in 2009. The fact that interest rates in 2003 were at historic lows was a major factor in the decision process. The view of the Authority and its financial advisor was that there was a strong likelihood that rates would be higher in 2009.

- While the report notes SEPTA's rationale for terminating the swap related to the 1999 bonds, we believe it bears repeating. In July 2007, the Pennsylvania State Legislature enacted Act 44 which effectively precluded using Public Transportation Assistance Fund (PTAF) dollars for debt service payments on new capital acquisitions, or to refund existing debt. With a change in the fiscal code in 2010, refunding became permissible, but the formula for qualification precluded SEPTA from issuing variable rate debt to refund the 1999 bonds. As a result, when the counterparties exercised their option in 2009 to have SEPTA pay a fixed rate of interest, the Authority could not issue variable rate bonds to provide the offset needed for the hedge to work effectively. **Absent the change in law enacted by the Legislature in July 2007, SEPTA would have issued variable rate debt when the option was exercised in 2009, and the Authority would not have incurred any loss on the swap.**

- The report attempts to cast doubt on SEPTA's ability to issue variable rate debt in 2009, ostensibly because LIBOR was at a low and declining level. The Authority does not believe the absolute level of Libor would have had any affect on its ability to issue variable rate debt. SEPTA is convinced that absent the altered financing capabilities brought about by Act 44, SEPTA would in fact have been capable of issuing variable rate debt which would have served to reduce the Authority's long-term interest expense. By way of example, we would point to the swap on SEPTA's 1997 bonds. That swap was put in place at the same time the swap on the 1999 bonds was executed and SEPTA received an upfront payment of $8.2 million from the counterparties. In this particular instance, the counterparties exercised their option in 2007, but prior to enactment of Act 44. Upon exercise of that option by the counterparties, SEPTA issued variable rate refunding bonds to offset the variable rate received from the counterparties, and is left paying a fixed rate of 4.71% until the bonds mature in 2022. Importantly, when the upfront payment of $8.2 million that SEPTA received from the counterparties in 2003 is factored in, the effective interest rate that SEPTA is paying on the 2007 refunding bonds is actually 3.64%. When originally issued, the 1997 bonds had a true interest cost of 5.69%, so the effective refunding rate is over 200 basis points lower than the original rate. The swap on the 1997 bonds and related 2007 refunding is an example of an effective financing, one we believe would have been duplicated when the 1999 bonds were refunded but for the refunding restrictions included in Act 44.

- With the benefit of hindsight, the hedge transaction related to the 1999 bonds did not provide the intended result. In our opinion, that does not mean that the transaction did not have merit when executed, or that it was tantamount to gambling with taxpayer dollars. To the contrary, it was a measured response to a set of financial circumstances that could not be ignored.

- The Authority and Auditor General's staff have had discussions and exchanged methodologies for calculating the actual costs associated with the swap transaction but have not reached complete agreement on the analytical process. By way of example, since SEPTA elected to finance the swap termination payment over an 18-year period, we believe that the most appropriate calculation to determine that component of the swap termination cost is to utilize a discounted cash flow analysis of the principal and interest payments that will be made over that 18-year period to fund that payment, which results in a $27.016 million net present value cost. The report ignores the time value of money and simply adds together the $27 million swap termination payment to the $7.8 million total interest expense associated with financing the payment, for a total of $34.8 million. We do not believe the calculation in the report complies with basic financial principles and, as a result, overstates the actual cost to the Authority by approximately $7.8 million.

- The report states that GASB 53 compelled SEPTA to publicly acknowledge that the swaps associated with the 1999 bonds were not merely an innocuous hedging transaction but were, in fact, a highly risky investment in derivatives. That is a misleading statement as SEPTA would not attempt to disguise the true financial impact of the swap.

- The other major difference in calculating the swap associated costs is whether to include the net present value cost savings from the 2010 refinancing of the 1999 bonds. The report excludes the $23.4 million in present value cost savings from the analysis. Throughout the period of time SEPTA and the Auditor General's staff have been discussing analytical methodologies, the Auditor General staffs' approach has been to include all costs associated with the 1999 Bonds from issuance through the refinancing in 2010, including swap related expenses and potential savings from other financing structures proposed by the Auditor General's staff. As a result of this "all-encompassing" approach, SEPTA management believed it was appropriate to include the savings associated with the 2010 refinancing, in order to have an "apples to apples" comparison. The report is now solely focused on swap-related revenue and expenses, which we believe is the more appropriate analytical approach. Given this current methodology, we believe it is both reasonable and consistent with our previous approach, to exclude the $23 million in savings from the 2010 refinancing in our updated calculations and response. Under this approach, we believe the true swap related costs to the Authority for the 1999 bonds was approximately $33.6 million.

<u>Finding Two</u>

- The characterization of the General Manager's salary as low conflicts with the subsequent recommendation of finding three that the General Manager's annual deferred compensation payment be reduced or eliminated. There is no logic behind this recommendation.

Finding Three

- The characterization of finding three that benefits are comparable continues to focus upon employee co-pays and employer contributions rather than the actual benefit (i.e. pension, healthcare, etc.). For example, the pension benefit is primarily driven by the pension formula. SEPTA did not enhance the pension formula for management employees in the 1990's when many other public sector employers enhanced their pension formulas. In many cases, Pennsylvania State Government union contracts establish a pattern for other public sector employers in the Commonwealth. However, SEPTA has not increased the pension formula and associated benefits when approximately ten years ago the Commonwealth enhanced the pension formula and thus benefits. In fact, the SEPTA pension formula and its benefits are substantially less than those provided by the Commonwealth.

- The Authority, routinely and as a matter of sound business and financial planning, evaluates its provision of benefits in an effort to reduce operating expenses. An example, SEPTA has required all new employees since 2005 to enter a HMO healthcare plan only. In addition, lifetime prescription drug coverage for employees hired subsequent to 2005 is no longer provided. The Authority has recently competitively bid its prescription drug coverage in order to secure prescription drug coverage at the best price and value to the Authority.

- The Authority believes that it is important for our employees to plan for their retirement and to set-aside financial resources for those purposes. As such, the Authority disagrees with the recommendation the SEPTA should consider reducing or eliminating the ten cents on the dollar match. The maximum contribution to an employee is $727 dollars/year if the employee contributes the maximum to the deferred compensation program. We believe that this contribution is an extremely modest yet helpful incentive to encourage employees to save for retirement.

Finding Four

- The comparison of pension benefits for hourly and management continues to ignore the fact that hourly employees may retire after 30 years of service at any age whereas management employees can retire after 30 years of service <u>and</u> attaining the age of 55.

- Premium for medical benefits – SEPTA continues to point out that union employees paid 1 percent of their earnings for medical benefits for their straight time hourly rate (overtime earnings are not subject to this calculation). As such, the comparison of hourly and management premiums for medical benefits is inaccurate. Management's contributions is a percentage (5%) of premium. With the rising cost of healthcare exceeding wage increases, the contribution of management employees has risen at a rate greater than hourly employees.

- Dental insurance – union employees co-pays were higher than those paid by management employees. In some instances, hourly dental benefits exceed those of management employees with examples including an annual program limit of $1,750 for management employees versus an annual program limit of $2,000 for hourly employees and higher orthodontics benefits for hourly employees.

- The provision of benefits for hourly employees has been negotiated during contract bargaining. The amount of the benefit and co-pays is determined during that process. The overall conclusion that management's benefits are better than union-represented employees is not substantiated.

Finding Five

- Annual safety banquets – Described as High-end affairs. SEPTA reiterates that safety is mission critical for a transportation agency which provides more than one million passenger trips per day. It is important to recognize the Authority's appreciation for safe operation and the financial benefit that results from a safety-first mentality. With the event being held in center city Philadelphia at a facility which employees a unionized workforce and for which can accommodate our needs, we do not believe that an event which costs slightly over $100 dollars per individual can be labeled as high-end affairs. The menu selection is modest. Other services and expenses are reviewed annually in an effort to reduce costs.

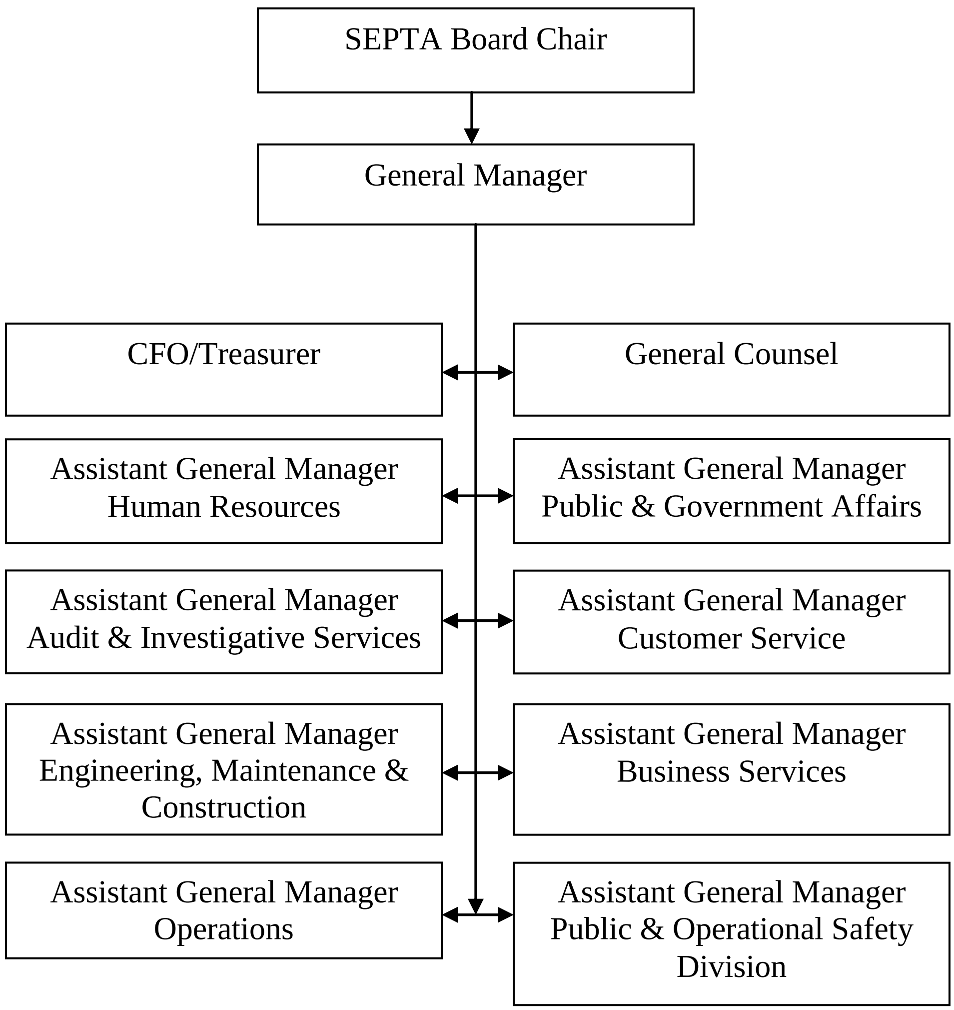
- The SEPTA Board consists of fifteen members representing the five counties along with appointees of the Governor and General Assembly. All members of the SEPTA Board serve without pay. As these meetings may last several hours, we believe that it is appropriate to provide a modest breakfast or lunch to Board members. As noted in the report, the price of $9 dollars for breakfast and $19 dollars for lunch is modest, although the report continues to focus on such items as 'gourmet' chips, which is really nothing more than a descriptive adjective listed on a vendor's invoice. SEPTA's Board members do not receive compensation and spend considerable hours on Authority matters and we believe that this practice is appropriate.

Finding Six

- No comment

Appendix B

SEPTA Organization Chart[49]



[49] Source: SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY, Partnering for Regional Sustainability, Fiscal Years 2010-2014 Five-Year Strategic Business Plan, March 2009.

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