GOVERNMENT FLEET MANAGING PUBLIC SECTOR VEHICLES & EQUIPMENT

Lease-Purchase Strategy Fueling Fleet Acquisition

January 2016, Government Fleet - Feature

By Paul Clinton

Facing rising maintenance costs for its aging fleet, the City of Baltimore hired Mercury Associates Inc. in 2012 to analyze the city's utilization of its fleet, vehicle cycling timetable, and maintenance operation. At the time, Mercury determined that the city was facing a $124 million backlog of vehicles that needed replacing.

For as long as anyone could remember, the city had used a replacement reserve (sometimes called an internal service fund) and charge-back system to raise the capital needed to purchase new vehicles. Under that financing model, the Fleet Management Division of the city's Department of General Services charged other agencies a monthly fee to fund replacement costs. The city had been spending between $6 million and $10 million per year from the reserve fund, which wasn't keeping up with vehicle replacement needs.

A Different Approach

The fleet consultant suggested the city implement a lease-purchase strategy that would leverage cash to close the backlog. This strategy would take advantage of low interest rates and enable the city to make a $90 million down payment over a three-year period to eliminate the backlog and modernize the fleet.

"Baltimore didn't just pick its numbers out of the air," said Paul Lauria, Mercury's president. "We developed a multi-year replacement plan for the 5,300-unit fleet that consists of more than 150 different types of vehicles and equipment assets."

This strategy is known by various names such as tax-exempt leasing, municipal leasing, and "dollar buy-out" — the instrument gives the agency an option to buy the vehicle for $1 at end of lease term — and has become a more popular option for tackling large vehicle replacement backlogs in a low-interest-rate environment.

Baltimore suspended the use of its replacement reserve fund with the 2013 fiscal year and has committed to this new strategy that's part leasing, part borrowing, said Chichi Nyagah-Nash, deputy division chief for the fleet unit. The city has entered the third round of its plan to replace vehicles at $30 million per year.

"Once you've forfeited the monies in the reserve fund, you're committing to lease-purchasing for the long term," Nyagah-Nash said. "We don't have that cushion any more. I'm not necessarily saying we would continue at $30 million (worth of purchases a year). We're now doing some analysis about how the $90 million put a dent in the replacement backlog."

Low Interest Rates, Tight Budgets

Macroeconomic conditions created by the recession that struck hardest toward the close of 2008 have increased the usage by government fleet managers of funding strategies beyond vehicle replacement funds. Historically low interest rates have spurred more financing and leasing, as lingering effects from the recession continue to hamstring municipal, county, state, and federal agencies with constrained budgets.

"Interest rates are at historic lows, giving fleets an unprecedented advantage in stretching their acquisition dollars," said Maria Neve, government sales manager for Merchants Fleet Management. "The cost of funds is so low that it may make sense to lease vehicles to replace older units that require significant maintenance, and the cost savings can be greater than the interest paid."

Government jurisdictions typically use one or more of four vehicle funding strategies, including outright cash purchasing, replacement reserve funds, leasing, and various forms of debt financing. Financially self-sufficient "enterprise fund" agencies that can charge users of electricity, power, or certain other city services usually are successful in replacing vehicles using the first of these strategies.

Outright cash purchases typically are funded by means of a direct appropriation from the city council or other elected leaders in the form of a budgeted, approved amount each year to buy vehicles. However, these allocations can fall prey to political winds, as elected leaders look to rob Peter to pay Paul, when they need funds to resurface roads, build bridges, or pay for other projects or programs.

Government fleets can finance vehicle purchases using borrowing or bond revenue if they want to own the asset at the end of the funding period. Financing more commonly comes into play for heavier trucks and equipment or vehicles that remain in the fleet for the longer term.

Public fleets can often access favorable financing terms from manufacturers for vehicles such as fire ladder trucks or pumpers, street sweepers, refuse trucks, or plow trucks expected to stay in the fleet for 10-15 years. Borrowing is advantageous because it allows a larger agency to acquire more vehicles and spread out the capital expenditure over a longer time frame.

Low interest rates have driven more bond-driven financing in recent years in larger municipalities such as Cleveland, Detroit, and Cincinnati. In January of 2015, Cleveland's City Council approved a privately offered $100-million municipal bond that included $20 million to replace police vehicles, fire trucks, refuse haulers, and snow plows. The city is now evaluating the condition of its fleet to determine how to spend the funds.

"I have seen more and more people using bonds," said Douglas Weichman, the director of Palm Beach County's fleet management division. "I've seen governments who are short on cash and vehicles that are in bad shape go to leasing. Why leasing? They just don't have the capital available to replace vehicles."

Tax-Exempt Leasing Explained

Baltimore isn't the only city using tax-exempt leasing in recent years. Grant Capital Management, which is based in the outskirts of Baltimore, has carved out a niche in this area by setting up deals for Baltimore; the District of Columbia; Fulton County, Ga.; and municipal fleets in Virginia.

Tax-exempt leasing offers a similar approach to bond financing without several pitfalls, including paying for vehicles that are no longer in the fleet or dealing with voter sentiment. The strategy also helps a fleet eliminate the higher maintenance costs of vehicles that have reached the end of their lifespan, and can eventually provide an economically self-sustaining model for replacing vehicles.

"There are various techniques for financing vehicles that look like a bond and smell like a bond, but are not a bond," said J.P. Grant, the company's founder. "Tax-exempt leasing is a debt instrument like a bond, but interest is tax exempt. It's easier to implement, and you don't need a voter referendum."

Grant secured the first two $30-million rounds of funding for Baltimore's fleet renewal plan, and helped Washington, D.C. acquire $100 million over four years to replace vehicles.

Tax-exempt leasing deals also include a "non-appropriation clause" that gives the government jurisdiction the flexibility of canceling the contract at the end of any fiscal year and returning the vehicle.

Leasing Uptick in Public Fleet Management

Vehicle and equipment leasing, once the province of the commercial fleet world, has offered another acquisition option that allows public fleets to replace a greater number of vehicles with available funds, eliminate rising maintenance costs from older vehicles, and outsource more specialized functions such as remarketing to fleet management companies.

"The lower interest rates have allowed them to go out and purchase without creating a replacement fund," said Bob Crowe, vice president of sales for Acme Auto Leasing. "On the government side, one of their biggest issues is that they're losing tax revenue. The funds aren't being replaced; it just keeps getting tighter and tighter. Each department is fighting over a smaller bundle of money."

Constrained budgets have forced fleet managers to extend the life of their vehicles. Lessors say vehicles often stay in fleets for at least three more years or an average of 40,000 miles. While leasing is forbidden in some agency bylaws, it also offers an appealing option to government leaders who often tie up capital funding in the near term and prepare budgets for two to three years into the future.

Municipal leasing varies from commercial leasing, because government agencies often keep their vehicles longer, need more certainty for budget forecasting, and typically have less interest in becoming a vehicle remarketing expert. Just turn in the keys at the end of the lease, and walk away. As a result, closed-end leases predominate, lessors said.

A closed-end lease is similar to a retail lease in that it has a set monthly payment that doesn't change, typically provides a term of three to five years, and includes overage charges if drivers exceed pre-set mileage benchmarks.

Federal agencies predominately use closed-end leasing because vehicles are used for a set time period and released. These agencies acquire their vehicles through GSA Leasing and then turn to the commercial lessors once GSA's allocation for vehicle funding runs out in a given year.

"They use a closed-end lease for a set period of time, and then we sell off the vehicle into the aftermarket arena," Crowe said. "They're better off running them for a set period of time before they run into maintenance issues. They can then take advantage of the manufacturers' incentives and replace the vehicles with newer vehicles two or three years later. It allows them to budget their costs."

Police vehicles used by patrol officers are also good candidates for municipal leases at a term of between 36 to 60 months because these aggressively driven vehicles bring back less residual value at auction. Most agencies will take advantage of the $1 buy-out lease finance option, Crowe said.

The alternative, an open-end lease that may include a Terminal Rent Adjustment Clause (TRAC), has become the dominant leasing instrument in the commercial fleet world. These leases are less restrictive with their shorter terms and month-to-month approach, but place the onus on the fleet to manage a vehicle's residual value. A TRAC allows the fleet to collect any proceeds after the vehicle's sale at auction.

Some police and sheriff's agencies use open-end leasing for their undercover and detective vehicles that stay in the fleet for 12 –18 months, before they are cycled out, Neve said. Others use closed-end leases with terms of 18–36 months, according to Crowe.

Leasing provides tax-exempt government agencies an advantage when they're looking to add green vehicles to their fleets. Because government agencies aren't eligible for the tax incentives associated with battery-electric vehicles, plug-in hybrids, and hydrogen fuel cell vehicles, they should partner with a lessor to acquire the vehicle with the incentive to pass along the savings.

Lessors such as Merchants, Acme, Enterprise Fleet Management, Vision Fleet, and LeasePlan operate in the municipal realm to provide this service to help agencies acquire these vehicles at a lower cost.

"There's a big benefit from leasing for alternative fuels and fully electric vehicles," Neve said. "With the federal tax credit on electric vehicles, state and local governments are not eligible for it by purchasing, but can be eligible for it by leasing. The fleet management can take advantage of that on their behalf and pass that benefit along to the customer."

State agencies especially have been using this strategy after facing mandates often from their own lawmakers to add more zero-emission vehicles and other cleaner vehicles to their fleets.

"States have mandates to use alt-fuel vehicles," Neve said. "It allows them to obtain the vehicles at a cheaper cost, and cut down on emissions."

And lastly, leasing vehicles through a fleet management company can benefit a smaller agency that doesn't have the staffing for remarketing expertise or license and titling work.

"Smaller fleets may not have the bandwidth to deal with licensing or remarketing," said Palm Beach County's Weichman. "We have a whole section that handles that."

Related: How Will Public Fleet Finances Fare in 2016?

Copyright © 2017 Government Fleet. All Rights Reserved.