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TECHNICAL CORNER

"Grant Anticipation Revenue Vehicles"– A New Way to Retire Debt

Grant Anticipation Revenue Vehicles (GARVEEs) offer states a new way to assemble up-front capital on the basis of future Federal funds. The term GARVEE refers to a debt financing instrument that permits its issuer to pledge future Federal highway funds to repay investors.

What's New?

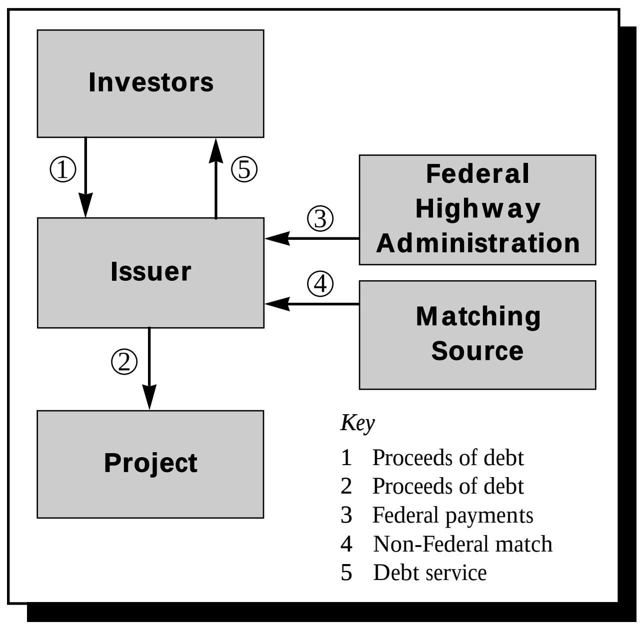
Prior to 1995, states could use their Federal highway grants to repay only the principal component of debt service on most projects. This restrictive rule was out of sync with the cash requirements that stem from real-world bond issues, since the predominant component of debt service during the early years of debt retirement is interest expense.

Section 311 of the National Highway System Designation Act of 1995 changed the rules by conferring Federal-aid eligibility on a wide array of bond-related costs. Specifically, a state may use future obligations of Federal-aid funds to reimburse the retirement of principal and payment of interest, issuance, insurance, and other costs incidental to the sale of an eligible debt financing instrument. Examples of "other" costs include capitalization of a reserve account or contingency fund. In all cases, the project for which debt is being issued must be eligible for "regular" Federal-aid funding. This significant change to the Federal-aid program was codified into permanent highway law as an amendment to Section 122 of Title 23 of the U.S. Code.

How Do GARVEEs Work?

Once a project is selected for GARVEE financing and its costs are estimated, the project must be approved as an advance construction (AC) project by the responsible FHWA Division Office. The AC designation preserves the project's future eligibility for Federal assistance. The amount of the AC designation should coincide with the Federal share (typically, 80 percent) of the debt-related costs anticipated to be reimbursed during the life of the bonds.

When the GARVEE is issued, the main form of security backing this debt financing instrument is the state's obligation of future Federal-aid apportionments. FHWA anticipates that the state would designate an AC amount up-front, and then obligate funds in each succeeding year in order to partially convert the designated AC amount. Each year, the issuer (state, state infrastructure bank, or other agency) would pay periodic debt service by receiving payments from FHWA for the Federal share of the expenditure. The following diagram illustrates how a very simple version of a GARVEE might work.



The diagram focuses on periodic Federal obligations (i.e., partial conversions of advance construction) and payments that occur over the life of the debt to help retire permanent financing. This, however, is just one

continued on page 2

Also in this issue. . .

Legislative Spotlight
Highway Infrastructure Privatization Act 3
End-of-Fiscal-Year Wrap-Up
Selected Innovative Finance Statistics 4
SIB Capitalization Activity 5
Resource Referral
Accessing .pdf Files 6

GARVEEs, continued from page 1

application of the GARVEE concept. Another potential use of this financing vehicle would be to repay short-term borrowing by using a single AC conversion upon project completion, with the resulting liquidating cash used to help take out construction financing. An entirely different approach would treat future Federal obligations as a secondary, rather than primary, source of repayment. The purpose of a "secondary GARVEE" would be to enhance the creditworthiness of obligations backed by other revenue sources.

One of the tricky parts of implementing a GARVEE is accurately calculating the Federal and non-Federal contributions. One possibility is to account for the contributions on a nominal, current-year basis. Alternatively, the state might elect to provide the non-Federal match up-front, and do so on the basis of 20 percent of the net present value of the anticipated payment streams. As a third possibility, the project sponsor might agree to separate the debt financing for the project into two issues, with one issue for the estimated Federal share and the other issue for the estimated non-Federal share. The costs associated with the former debt issue would then be reimbursed with Federal-aid funds; the costs on the latter debt issue would be reimbursed with non-Federal funds.

Are GARVEEs Marketable?

Although several states have considered issuing debt backed by future Federal-aid apportionments, none has yet done so. As a result, it is not yet certain how rating agencies and investors will react to GARVEE obligations. One obvious concern for investors is assessing the likelihood that future Federal funds will be available for debt service over an extended period of time. Thus, the term of the GARVEE will be an important criterion for rating agencies to consider when assessing creditworthiness.

Short-Term GARVEEs

Short-term GARVEEs are defined as notes that are backed by future obligations of currently-authorized Federal-aid funds. For example, assuming that a state issued the GARVEEs in the second year of a five-year authorization period, the term of the notes – or at least that portion backed by Federal funds – could not exceed four years. With regard to the adequacy of future Federal-aid obligations and payments to service the debt, the only risk presented by a short-term GARVEE is whether the annual U.S. Department of Transportation (USDOT) appropriations acts will provide sufficient obligation authority to cover the portion of debt service to be supported by Federal funds. This is known as *appropriations risk*.

Assuming an adequate coverage ratio, short-term GARVEEs would likely be able to attain an investment grade rating, given that annual obligation authority amounts typically fall within a relatively narrow range around authorized funding levels. Moreover, there is already precedent for this kind of short-term financing vehicle: grant anticipation notes backed by transit formula grants for urbanized areas. Thus, it appears unlikely that issuers would need to pledge a secondary source of revenues as a backstop in order to achieve an investment grade rating.

Long-Term GARVEEs

Long-term GARVEEs are debt instruments that are backed by future obligations of Federal-aid funds for a term that extends beyond the current authorization period. In addition to appropriations risk, long-term GARVEEs also present the risk that the Federal-aid program will not be reauthorized beyond the end of the current authorization period. This is known as *authorization risk*.

The outlook for long-term GARVEEs is less clear-cut. Although there is an 80-year history of Federal aid for highways, authorization risk appears more problematic than short-term appropriations risk, especially given recent debates over gas tax "turnback" and other dramatic contractions of the Federal-aid program. For long-term GARVEEs to attain an investment grade rating, it is possible that they would need to be backstopped by a secondary source of revenues that evidence at least a 1.0x coverage ratio.

GARVEEs in Action

Several states, including Ohio and New Mexico, are currently planning to put the GARVEE financing strategy into practice. It is anticipated that at least one of these projects will also involve a public-private partnership in which a selected contractor will hold responsibility for both financing and designing the project. Another project will likely rely on a State Infrastructure Bank to serve as the implementing agency.

As these projects' plans of finance are made final, *IFQ* will keep readers up-to-date on their particulars.

Are There Tax Considerations?

Federal tax law presently prohibits tax-exempt bonds from being directly or indirectly guaranteed by the Federal government. However, there is substantial historic precedent in the municipal bond market for recipients of Federal Transit Administration and Environmental Protection Agency grants to issue grant anticipation notes on a tax-free basis. Moreover, the Treasury Department in recent months has endorsed the concept of states using Federal grants to secure tax-exempt borrowings under the Administration's NEXTEA credit enhancement proposal and school bond interest subsidy proposal. Although each state will need to consult with its own bond counsel, it appears that GARVEE instruments should be issuable on a tax-exempt basis.

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LEGISLATIVE SPOTLIGHT

Highway Infrastructure Privatization Act

The previous issue of *IFQ* provided a description of the Transportation Infrastructure Finance and Innovation Act of 1997 (TIFIA), which would create a new Federal program to provide direct loans, loan guarantees, and other types of credit assistance to large transportation infrastructure projects. The other major highway financing proposal to emerge from the Senate this session is the Highway Infrastructure Privatization Act (HIPA), which would create an opportunity for private entities to issue tax-exempt debt for the purposes of developing public-purpose highway infrastructure. This quarter, *IFQ* describes the problem HIPA seeks to address and outlines specifics of the proposal. It is expected that as with TIFIA, HIPA's basic provisions will be incorporated into the Senate's final bill for ISTEA reauthorization.

HIPA: Background

Early in 1997, Senator John Chafee (R-RI), Chairman of the Committee on Environment and Public Works, introduced HIPA to level the playing field between public and private entities who borrow funds through issuing debt. HIPA was co-sponsored by Senators Warner (R-VA), Bond (R-MO), and Moynihan (D-NY). It recently passed the scrutiny of the Senate Finance Committee. HIPA could be an important step towards lowering one of the chief barriers to private participation in the provision of the nation's highway infrastructure.

Current Tax Law: A Built-In Bias Against Privately-Financed Highways

Before delving into HIPA's specifics, it is important to understand the conditions that brought it about. Throughout this century, public agencies have assumed the lead role in developing highway infrastructure. These public agencies' ability to finance the projects was greatly enhanced by the fact that tax law permitted them to issue debt on a tax-exempt basis. (The phrase "tax-exempt" refers to the fact that investors who purchase the debt instruments, such as bonds, need not pay taxes on the interest paid to them by the issuer.) Issuing tax-exempt debt is less costly to the issuer, because investors are willing to accept a lower interest rate in exchange for the resulting interest income being tax-free.

While public agencies may issue tax-exempt debt, current tax law significantly limits the permissibility of tax-exempt debt for highway projects that are privately owned and/or operated. This policy is at odds with a budgetary and political environment that is seeking to encourage the private sector to take a more active role in financing, designing, constructing, and operating highway facilities. HIPA seeks to address the tax code's existing bias against private sector participation in the provision of highway infrastructure, such as through long-term operating concessions.

HIPA's Key Provisions

Key features of the proposed legislation are listed below.

- HIPA would establish a program under which tax-exempt debt could be issued for privately-owned and/or privately-operated projects.
- Tax-exempt financing would be available for no more than 15 private projects.
- The total face value of bonds issued under this program could not exceed $15 billion.
- Bond proceeds could not be used to acquire rights-of-way.
- Selected projects would have to serve the general public, be on publicly-owned rights-of-way, eventually revert to public ownership, and be included in a state's 20-year transportation plan.
- Projects authorized under the program would be selected by the Secretary of Transportation, in consultation with the Secretary of Treasury.

The purpose of the aforementioned $15 billion volume cap is to limit the potential revenue losses under this program. This is because every dollar of debt issued on a tax-exempt basis results in forgone tax receipts to the U.S. Treasury. By limiting the aggregate volume of tax-exempt debt issuance, the potential fiscal impact of this program could be controlled. Bonds issued under the program would be subject to the Internal Revenue Code rules that govern private activity bonds, but they would not count against a state's tax-exempt volume cap.

Contact: David Seltzer, FHWA (202/366-0397).

TRB Workshop Announcement: Transportation Financial Planning

The Transportation Research Board's (TRB) 77th Annual Meeting will be held January 11–15, 1998, in Washington, DC. The TRB Committee on Taxation and Finance will sponsor a two-part workshop from 10:00 am to 4:00 pm on Sunday, January 11. The morning session will address capital markets and debt financing; provide an overview of municipal bond markets, including who the buyers are and what factors influence bond prices; and review recommended best practices for debt issuance. The afternoon session will address Federal-aid innovative financing techniques and statewide financial planning; ISTEA financial planning requirements, including how to perform effective statewide financial planning; and current and proposed innovative financing techniques that can be used in connection with Federal funds.

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END-OF-FISCAL-YEAR WRAP-UP

Selected Innovative Finance Statistics

Federal fiscal year 1997 was a busy year in innovative finance. One hub of activity centered on the State Infrastructure Bank (SIB) Pilot Program: the first 10 banks began to capitalize and finalize loan agreements; an additional 29 participants were named at a White House briefing, and these states obligated almost $150 million in newly appropriated capitalization grants. Other activity focused on Federal credit assistance to individual major projects: the first portion of the direct Federal loan to the Alameda Corridor Transportation Authority was disbursed, and the California Transportation Corridor Agencies' toll road projects, which previously received standby Federal lines of credit in fiscal years 1993 and 1995, continued to move ahead. The tables below and on page 5 provide a brief chronicle of financial highlights of the previous fiscal year.

Federal Credit Activity through Fiscal Year 1997

Project	Total Project Cost	Credit Instrument	Credit Amount	Scored Budgetary Cost	Cash Disbursements
San Joaquin Hills Corridor	$1.4 billion	Standby line of credit	$120 million	$9.6 million	None
Foothill/Eastern Transportation Corridor	$1.8 billion	Standby line of credit	$145 million	$8.0 million	None
Alameda Corridor	$2.0 billion	Direct loan	$400 million	$58.7 million	$140 million

BEYOND FY 1997: FY 1998 SIB ACTIVITY

Immediately following the close of federal fiscal year 1997, several SIBs registered new activity:

- On October 10, the Oregon SIB made two loans of $300,000 and $800,000, respectively, to the Tualatin-Sherwood Highway and Newberg-Dundee Bypass projects. These two projects have a combined value of almost $200 million.
- In Ohio, the Butler County Transportation Improvement District (TID) is repaying its combined $35 million loan for the Butler Regional Highway, with interest. The TID repaid the loan with proceeds from $155 million in bonds issued on November 1, 1997. Ohio SIB officials expect to lend $20 million of the repaid funds as a so-called "second-generation" loan to the City of Cincinnati to assist a $120 million Interstate relocation project. Ohio is also putting the finishing touches on an agreement to lend $6.9 million to a transit project in Cleveland.
- Arizona has completed two loan agreements. The loans are expected to be $26 million and $24 million, respectively, for construction of segments of the Price Freeway (Chandler, AZ) and the Red Mountain Freeway (Mesa, AZ).
- Missouri has executed two additional loan agreements for up to $6 million and $28 million, respectively, for Highway 179 in Cole County and the Cape Girardeau Bridge. The combined value of these projects is approximately $127 million. In addition, it is expected that an additional loan of approximately $1.7 million will be made to the Springfield Transportation Corporation in 1999.

Please see the next issue of *IFQ* for more detail on all of these projects.

END-OF-FISCAL-YEAR WRAP-UP

State Infrastructure Bank Pilot Program: Capitalization Activity

As of September 30, 1997, the 29 participants in the SIB pilot program had declared a total of $2.1 billion in advance capitalization of regular Federal-aid highway funds. Total obligations exceeded $310 million, including regular Federal-aid highway funds and the additional funds appropriated under the USDOT Fiscal Year 1997 Appropriations Act. The following table provides a state-by-state breakdown of obligations and Federal outlays that represent the actual deposit of Federal funds into a SIB.

Status of Accounts for Fiscal Years 1996 and 1997, Cumulative
(Data cover October 1, 1995 through September 30, 1997)

State	Obligations: Regular Highway Funds	Highway Obligations: FY97 Appropriations	Transit Obligations: FY97 Appropriations	Federal Outlays
Alaska	$0	$2,490,000	$0	$0
Arizona	14,519,799	6,700,000	0	14,519,799
Arkansas	0	1,500,000	0	0
California	0	3,000,000	0	0
Colorado	0	1,500,000	0	0
Delaware	0	1,500,000	0	0
Florida	20,077,605	8,650,000	0	20,077,604
Indiana	0	3,390,000	0	0
Iowa	0	870,000	630,000	0
Maine	0	2,540,000	0	0
Michigan	0	11,050,000	0	0
Minnesota	0	3,960,000	0	0
Missouri	13,000,000	0	7,410,000	8,500,000
Nebraska	0	2,830,000	0	0
New Jersey	0	1,500,000	0	0
New Mexico	0	8,140,000	0	0
New York	0	12,000,000	0	0
North Carolina	0	1,500,000	0	0
North Dakota	0	2,540,000	0	0
Ohio	35,000,000	5,100,000	6,900,000	35,000,000
Oklahoma	0	4,700,000	0	0
Oregon	8,973,000	5,510,000	0	8,973,000
Pennsylvania	0	1,000,000	2,390,000	0
Rhode Island	0	1,500,000	0	0
South Carolina	0	3,000,000	0	0
South Dakota	0	2,830,000	0	0
Tennessee	0	1,500,000	0	0
Texas	75,211,476	12,000,000	0	75,211,476
Utah	0	2,310,000	0	0
Vermont	0	1,500,000	0	0
Virginia	0	3,000,000	0	0
Washington	0	1,500,000	0	0
Wisconsin	0	1,500,000	0	0
Wyoming	0	2,510,000	0	0
Puerto Rico	0	1,500,000	0	0
Total	$166,781,880	$133,520,000	$10,430,000	$162,281,879

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Once it is installed, open the program called Acrobat Reader, and open any .pdf file you have downloaded from the Internet in the same way you would open a file in a word processing program. The document should appear on the screen in full layout. When you print the document, you will have a print-quality version that looks like something you would receive in the mail. A warning however: some documents are too complex for certain printers to handle. If this happens, your printer will likely display the message "Print Overrun." If that happens, try reducing the resolution (e.g., by decreasing the dots-per-inch from 600 to 300), or find a colleague who seems to know his or her way around a printer.

Finance Seminar for Transportation Executives

FHWA and the Institute of the Americas are hosting a seminar December 3-5, 1997 entitled *Financing the Bridge to the 21st Century: A Policy Workshop for Senior Transportation Executives*. FHWA has invited state and Federal transportation executives to attend the seminar, which will be held on the Institute's campus in La Jolla, CA. The seminar will focus on policy issues relating to the use of innovative public-private strategies for financing transportation projects. It will feature senior DOT officials and transportation finance experts who will make presentations, lead discussion groups, and facilitate teams analyzing case studies of actual projects.

The Institute of the Americas is part of the University of California at San Diego. It is an independent, inter-American institution devoted to finding effective responses to some of the major challenges facing the countries of the Western Hemisphere. The Institute is considered a leading institution of its kind and serves as an important location for leaders to define and refine the economic, political, and social agenda for the Americas.

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