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Road to nowhere?

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US public and project finance practitioners expect to see so-called Garvee bonds - grant anticipation revenue vehicles also referred to as Gans, an acronym for grant anticipation notes - used more frequently, and to migrate from fairly narrow usage to a wider range of deals. The mechanism has been used to finance railcars and to repair and build highways - but not often. Only a handful of deals have closed. But cash-starved airport officials may be next to jump on the Garvee train. And seaports also are a natural extension.

Three highway projects financed with Garvees have closed, including the now $11 billion Big Dig - Boston's Central Artery-Tunnel project - which connects the centre of the city with the airport and beyond. The Big Dig is infamous for its cost-overruns. However, the overruns will have no effect on bondholders.

With anticipated funding levels from federal and state sources deemed insufficient during the peak construction period of fiscal years 1998-2002, Massachusetts used Garvees as a bridge facility. In June 1998, the Commonwealth of Massachusetts issued $550 million in Garvees of a total programme of $1.5 billion, backed by future reimbursements from the federal government. Moody's rated the deal AA3. Specifically, the notes are collateralised by a first perfected security interest in funds reimbursed to Massachusetts by the federal government from the Highway Trust Fund (HTF).

At the time of issue, estimated cost of the project was $10 billion. As a backup, 10 cents per gallon from the state's gas tax receipts are also pledged. Note term is 17 years from the date of first issuance. Subsequent series will have a shorter life, with a final stated maturity of June 15, 2015.

The State of Ohio also accessed the Garvee market in May 1998 with a 10-year, $70 million issue launched through a syndicate led by First Albany. Moody's rated the transaction AA3. Bonds were collateralised by the state's allocation of federal highway funds with backup recourse to state gas tax revenues - although those revenues were not pledged to the bond deal - and a promise to seek a deficiency appropriation, if necessary, from the state general assembly. Bond proceeds were earmarked to partially finance the $116 million cost of completing a major highway project as well as the construction, widening and improvement of feeder roads. The deal is enhanced by a 14-month liquidity reserve to provide a cushion against unlikely drastic changes or suspension of federal highway funding.

Historically, Ohio has had large sums of prior years obligation authority from federal apportionments, which may be reallocated without legislative approval. Those funds exceeded $500 million in 1997, the year previous to the launch of the Garvee deal.

By almost a 4-to-1 margin in a special election on June 15, Arkansas voters approved a plan to issue $575 million in bonds for repairs to the state's interstate highways through the issuance of Garvees.

The bond issue will allow the reconstruction of more than 300 miles of an interstate highway system that is rated one of the worst in the country. The state highway commission plans to let contracts during the 18 months, with all work completed within five years.

Repayment of the bond issue will come from three sources: the $58 million a year allocated by the federal government to the interstate maintenance fund; money from a four-cent diesel fuel tax increase; and the state matching money that already is required to match the federal turn-back funds.

New Mexico completed a 30-year Garvee deal for a highway project which Moody's rated A3. Colorado is preparing to do a "naked Garvee" - a highway transaction secured only by anticipated federal funds. In January, a bill was introduced in the Virginia legislature calling for authorisation to issue up to $590 million of Commonwealth of Virginia Federal Highway Reimbursement Anticipation Notes. The purpose of the notes would be to provide funds, with any other available funds, for paying all or a portion of the costs for accelerated construction of projects. However, the bill has stalled in committee.

Rennee Boicourt, managing director for US states ratings at Moody's, says federal gas tax receipts used to fund the HTF have continued unabated since the genesis of the programme in 1956. Boicourt adds that the programme is re-authorised in six-year increments, and has continued as a part of sequential legislation Intermodal Surface Transportation Efficiency Act (ISTEA) - referred to as 'ice tea' - and successor legislation Transportation Equity Act for the 21st Century - dubbed Tea-21 ? of 1998.

"In fact, under Tea-21, the programme will basically even out, with every state getting at least 90% of what it contributed. There is also a requirement that a state spend its appropriation on approved projects. In addition there is a management competency requirement and a state match requirement, usually at the level of 90% federal to 10% state, or an 80% federal share against a 20% state match." Boicourt added that rules being applied by the government are flexible in terms of how the match requirement is applied.

Boicourt predicted that more Garvee deals will launch as state transportation departments continue to run large road projects. But states often have untapped resources to use for road projects, including unleveraged gas taxes, driver licence fees, and other revenues peripheral to transportation. The choice between using in-state funds and federal apportionments may also fall within the realm of what is politically expedient. Particularly during election years, politicians often crow about their ability to access funds from the federal trough while promising ? most of the time disingenuously ? to reduce the state tax bite.

Funding streams are basically the same amongst highways, rail systems and airports. Trade group Airports Council International indicates that yearly investment in US airports consists of three components: roughly $3.5 billion in revenue bonds, $1.5 billion generated through passenger facility charges (PFCs), and $1.75 billion made up of entitlements and discretionary funding. The last piece may possibly lend itself to Garvee bond financing.

Airport entitlement funding includes Airport Improvement Programme (AIP) funds apportioned each year according to a formula to specific airports. The formula is based on number of passenger boardings. Such funds are available to airports in the year they are first apportioned and remain available for the two fiscal years - three fiscal years in the case of non-hub primary airports - immediately following. AIP funds are reduced at airports that impose passenger facility charges. Discretionary funds can be annual or multi-year allocations. Of those funds, 75% must be used for preserving and enhancing capacity, safety, security and noise abatement. The remaining 25% - known as pure discretionary funds - may be used for any eligible project at any airport, at the discretion of the Federal Aviation Administration administrator.

Adam Whiteman, who heads up the airport analytical team at Moody's, does not see an avalanche of Garvees on the horizon. "For most larger airports, the percentage of government funding is decreasing, although for smaller airports it is still significant." Whiteman added that for major airports, GARBs - general airport revenue bonds - are the preferred financing vehicle because the variety of available individual revenue streams is not as volatile as single appropriations.

The Moody's analyst points to a 1993 debt issue by Reno-Tahoe airport that may be the mother of all grant anticipation deals. The issue was valued at under $50 million, with debt secured by general revenues of the airport. Underwriter PaineWebber added a letter-of-intent element to the issue. "All the letter-of-intent bonds accomplished was to spell out that debt service would mirror entitlement dates. But there was a general pledge." That pledge of general airport revenues mooted the need for LOI bonds.

"Any state or local government that is part of any federal funding programme can accelerate whatever it is doing through

Garvees," asserts William Streeter, senior director in Fitch IBCA's project finance unit. "New Jersey Transit (NJT) is the only rail agency to have done Garvee transactions".

NJT is the third-largest public transit agency in the US. The agency has an $867 million capital programme for the current year, expected to jump to $952 million and $993 million for 2001 and 2002 respectively. The use of Garvees has allowed NJT to significantly lower the average age of railcars in its fleet, and will accelerate the replacement of remaining rolling stock.

Both NJT transactions involved the purchase of transit equipment, including 500 buses in the first transaction, followed by a deal to fund the purchase of 200 single-level railcars. However, Streeter sees no hurdle to using Garvees to fund construction of entire light rail systems. "The structure is perfect for transportation deals," he adds. In its simplest form, Garvees allow government agencies to complete projects or acquire assets without relying on incremental funding which could drive costs up because of periodic materials and labour escalations as well as set-up costs.

NJT closed its second deal, a $236.9 million transaction, in January. Federal transit funds are the sole source of pledged revenue to the certificate holders. That deal and the $160 million March 1998 predecessor transaction were lead managed by Salomon Smith Barney (SSB) and wrapped by Ambac. S&P and Fitch gave both deals an ?A? rating.

The New Jersey agency is expected to launch another Garvee deal for 500 buses this year, followed by a series of Garvee transactions to eventually finance 3,200 buses.

Likewise, NJT is expected to bankroll the acquisition of 55 locomotive valued at about $3.5 million each in July or August. It is probable that public finance officials will use the successful NJT Garvee deals to convince officials of larger public transit agencies to launch Garvee deals. Some of these agencies - such as New York City's MTA, Atlanta's Marta, Boston's MBTA and the Dallas Rapid Transit Authority - already have experience in the capital markets.

NJT has a limited obligation to make basic lease payments solely from Federal Transit Administration (FTA) Section 5307 formula programme funds. That programme allocates funds to transit agencies based on population density and passenger volume. Basic lease payments essentially mirror scheduled principal and interest payments on the certificates of participation (COPs). Federal transit funds are the sole source of pledged revenue to the certificate holders.

The NJT transactions are bouyed by the expected low variability in the level of federal funding during the current authorisation period through 2003. Fitch IBCA assigns an extremely low probability of no future federal transportation assistance authorisation beyond 2003, a low probability of significant changes in funding levels to the State of New Jersey, and a low-to-moderate risk of significant changes in the allocation of federal transportation dollars between highway and transit programs. Formula funds allocated to New Jersey range from $150.5 million in 1999 to $203.6 million in 2003. From 1989 to 1998, the actual apportionment of Section 5307 funds to NJT ranged from $90.2 million to $130.2 million.

Ron Marino of SSB's public finance department says it has taken time for ratings agencies and insurance providers to get comfortable with Garvee issues, accounting for the paucity of deals. However, he predicted that a number of deals will come to market this year as comfort levels increase. He adds that Garvees are applicable to airport financing, with Federal Aviation Administration (FAA) officials lobbying to get enabling legislation in place. That legislation is taking a back seat to efforts to get the AIP renewed.

Jody Hecht, public finance analyst at Standard & Poor's, says, "We are comfortable with the FTA programme. It has been around for 40 years and we don't anticipate any major alterations." But a main concern with Garvees and grant anticipation transactions in general, is the possibility for changes in the funding formula during new appropriation periods.

This concern is mitigated in NJT deals by the state transit agency's requirement that the "first federal dollars go to bondholders." She adds that the terms of the two NJT deals extend to only two appropriation periods. This relatively short term contrasts sharply with a New Mexico highway deal which runs for 30 years, allowing for considerably more uncertainty concerning future funding.