

SURFACE TRANSPORTATION INFRASTRUCTURE FINANCE FOR THE FUTURE – GUIDING PRINCIPLES FOR DEVELOPING A NEW FEDERAL APPROACH

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“Unreliable transportation threatens the economic vitality of the United States and distorts business decisions. Our highways, seaports, rail yards, airports and border crossings all have a profound significance for bottom-line costs for businesses that depend on an efficient supply chain and product distribution system. . . Sustained growth is going to require serious rethinking about the way that we build, finance, manage and maintain the transportation system that moves our economy.”

Excerpts from a speech given by the Hon. Norman Y. Mineta, Secretary of Transportation, to the Bear Stearns Global Transportation Conference, May 10, 2006

“Congestion is a cancer on our economy. The country's 200 worst highway bottlenecks cost the trucking industry \$7.8 billion each year as a result of 243 million hours our trucks waste while idling on these gridlocked, so-called freeways. . . These costs filter through our economy, affecting our nation's global competitiveness, consumer prices and jobs. . . The facts are very simple - our infrastructure cannot support our future economic growth.

Excerpts from a speech given by Pat Quinn, Chairman, American Trucking Associations, to the ATA Board Meeting in Dallas, October 30, 2006

These comments echo a growing chorus of increasingly concerned voices calling for action on what is now generally acknowledged in informed circles to be an imminent freight and personal mobility crisis. This crisis is not “news”. Its existence and the growing danger it poses to the economic health of the U.S. has been known for years.

The performance of our surface transportation system has been deteriorating at an accelerating pace over the past decade. This alarming trend reflects the absence of workable, fiscally supportable and politically acceptable solutions to two distinct financing challenges: a) maintaining the existing surface transportation system; and b) adding new capacity to that system. The ability of the Nation’s land and water transportation infrastructure to support our economic growth, international trade and global competitiveness is a major economic and political challenge that has to be addressed as a matter of utmost urgency.

Advocacy of policies aimed at promoting economic growth and international trade without at the same time supporting policies which ensure commensurate growth in the capacity of the national surface transportation system is short-sighted and unsustainable. It is the equivalent of pursuing policies that encourage people to run while at the same time supporting policies that tie their shoelaces together. Yet, this is precisely the flawed path we have been following.

The cost of congestion across our surface transportation infrastructure is a tax – the nastiest kind of tax, hidden and regressive. Worst of all, the impact of this “congestion tax” multiplies as goods move through the supply chain, accumulating until we pay it in the price of everything we buy.

Finding a Way Forward

We must move from diagnosis to treatment, from discussing the problem and lamenting Congressional inaction to building support for enactment of a sound, practical solution. Accordingly, this paper offers as a starting point six principles to guide creation of a comprehensive, unified approach to address the competing demands of maintaining and upgrading the existing system and adding new capacity. The approach recognizes the abiding public interest in the adequacy and performance of the Nation’s surface

transportation infrastructure and the important role that government must play in planning, directing and financing it. At the same time it also recognizes the unavoidable truth that private investment in public infrastructure is both a practical necessity and a basic tool to measure the value of that infrastructure to its users and the national economy. Although there are many crossover similarities in transportation infrastructure financing, this paper does not address financing of public transit and air transportation systems.

Principles for Developing a New Federal Approach to Surface Transportation Infrastructure Finance

1. Start with a “blank slate”; avoid being captive to how components of the existing surface freight transportation system came to be part of the mature, successful system we have today.
2. Create two separate funding mechanisms and processes: one for maintaining/improving existing transportation infrastructure and another for adding significant new surface capacity through highways, railways, waterways and intermodal connectors.
3. Focus reform of existing surface transportation infrastructure funding (e.g., fuel taxes, user fees, federal programs and investment, etc.) on improving the efficiency of the existing system; create incentives (e.g., tax credits) to encourage private investment in existing rail and port facilities, which are not typically supported by the Highway Trust Fund.
4. Insist on “mode neutral” evaluation of major additions to the national system; recognize that the surface transportation system needs to utilize land, water and intermodal options.
5. Encourage innovation and creativity by accepting some risk in new infrastructure projects; support projects based on expected, measurable, positive impact on system capacity, not mode or sponsor.
6. Use the federal government’s creditworthiness to attract the maximum amount of private capital to surface transportation infrastructure projects at the least cost to the federal treasury.

Applying these Principles to Surface Transportation Infrastructure Finance – Recognizing Two Distinctly Different Challenges

Maintaining Existing Surface Transportation Infrastructure

Improving the performance of the existing surface transportation system can capture important “hidden” capacity and add it to the system more quickly in many cases than new projects can. Getting full value from existing surface transportation infrastructure and making it work as efficiently as possible are critical. Backed by a revived and strengthened Highway Trust Fund, the government agencies and processes already in place for identifying local and state priorities should concentrate on supporting infrastructure improvements of local significance and financing long overdue maintenance of, and upgrades to, the existing surface transportation network. We must recognize that, as our surface transportation system expands and ages, the cost of maintaining it in good working order grows at a quickening pace. Failing to distinguish between paying to keep what already exists working well and adding substantial new capacity is at the heart of our current crisis.

Adding New Capacity

Existing governmental and financing mechanisms are handicapped in advancing important state and local priorities when they confront projects of national and regional significance. A case in point is expansion of I-81 in Virginia, projected to cost more than \$6.5 billion. Expansion of this important transportation corridor is not a matter of “maintenance” nor is it a single state’s concern. It is a project best tackled and coordinated at the regional or national level. Our current fuel tax based system and the

governmental and political processes tied to it cannot address adequately such important new infrastructure projects without severely impacting the financing of maintenance of existing infrastructure.

We need financing mechanisms and processes specifically designed to add highway, railway, waterway and intermodal capacity based on national and regional priorities and targeted to address and reduce congestion in key national transportation corridors. DOT in consultation with the states and other key transportation stakeholders should develop clear, measurable surface transportation infrastructure investment priorities and guidelines, incorporating performance standards in the use of infrastructure, where applicable, and criteria such as economic benefits, environmental impact and sustainability, national defense attributes and social benefits. Public and private entities, separately or in combination, should be eligible to obtain financing/backing for new surface transportation infrastructure projects. To ensure these priorities and guidelines are implemented, Congress should create an independent, expert and self-financing non-governmental entity to allocate federal financial support for new surface transportation infrastructure projects in accordance with the priorities and guidelines established by DOT.

Each entity seeking federal financial support for a surface transportation project should be required to demonstrate how its project meets DOT's priorities and guidelines, how and over what period the project is to be financed, and how and how much of the project's capital cost is to be recouped during that period.

Financing – A Brief Overview of Options

There are five surface infrastructure government financing options: tax-funded (e.g., fuel, sales and income taxes); tax-preferred finance and tax incentives (e.g., tax exempt and tax credit bonds, investment tax credits); government loans (e.g., Transportation Infrastructure Finance Innovation Act – “TIFIA”; Railroad Rehabilitation & Improvement Financing – “RRIF”); government guarantees (e.g., TIFIA, RRIF, and Title XI Ship Finance); and buy/leaseback financing in which instances the government owns the asset (most often land) and leases it to private operators (e.g., state leases to railroads for investments in kind).

Tax-funded finance is straightforward. Projects are funded from fuel, sales and income taxes. Congress appropriates tax dollars to be spent or lent (directly or by the States) for projects covered by applicable legislation (e.g., Highway Trust Fund, TIFIA and RRIF).

Tax-preferred finance and tax incentives differ from tax-funded finance in that the “tax cost” is the tax revenue lost to the Treasury from the tax preference and credits. Congress limits how much tax-preferred debt can be issued, but the “tax cost” is not reflected in the budget and, therefore, is not “appropriated” by Congress. The amount generated by tax-preferred finance to fund projects is the maximum amount of bonds that can be issued. The amount of capital generated by tax credits depends upon the type of credits offered and the amount of capital private entities are willing to invest based on their circumstances and the attractiveness of the credit.

Government loan programs differ from tax-preferred finance in that they must be tax-funded at the start. Congress has to appropriate tax dollars and authorize the lending of these funds to approved borrowers. TIFIA and RRIF require borrowers to repay loans with interest rates set at or above the government's cost of borrowing. Recapturing borrowed funds enables these programs to fund new projects.

Federal guarantee programs differ from tax-funded and tax-preferred finance in that the federal government itself does not lend or spend cash. It guarantees lenders that they will be paid in full if the borrower defaults on its loans. Using the guarantees, borrowers are able to borrow money at favorable interest rates. Unlike the other finance options, the tax “cost” is primarily budgetary. That is, Congress must appropriate funds to be held as a “reserve” against potential defaults in guaranteed loans. The amount appropriated is a function of the percentage of the guarantee amount that OMB decides must be held against

default. For example, if OMB sets the reserve amount at 10 percent, Congress must “appropriate” \$100 to support the issuance of \$1,000 in government guarantees.

A Modest Proposal – Government Support for Private Infrastructure Financing

The following modest proposal applies the principles and financing options outlined earlier.

Principles 1 & 4 suggest a “unified” approach to infrastructure financing instead of the mode-oriented approach that has historically driven political debates over infrastructure funding and produced and perpetuated the “stovepipe” approach that exists today.

All surface transportation infrastructure projects involve the transformation of a surface (land or water) into usable infrastructure. On land, rights of way must be transformed by design, engineering and money into highways and railways. On water, design, engineering and money must be invested to enable ports and vessels to function in exactly the same way – as infrastructure. A unified approach should treat land and water options equally, evaluating each proposal on the basis of its ability to add capacity to the Nation’s transportation system, not on the surface or type of infrastructure used to do so.

Principle 2 acknowledges that there are distinctly different challenges associated with funding the less glamorous tasks associated with making what already exists work better, which are best managed at the local and state level, and those associated with funding additions of significant new capacity, which are in most cases best managed at national and regional levels.

Principle 3 suggests the use of tax-funded finance (e.g., a reformed and bolstered Highway Trust Fund and Harbor Maintenance Trust Fund) to pay for infrastructure maintenance which in essence represents the annual cost of keeping the infrastructure that exists in good working order.

DOT published a report – *The Freight Story* – in November 2002 on its three year study of mounting challenges facing freight mobility across the Nation’s surface transportation system. According to *The Freight Story* we should be spending \$76 billion (2000 dollars) every year between 2001 and 2020 to maintain the highway system as it existed in 2000. Yet, SAFETEA-LU provided less than two-thirds of that funding for the current six-year cycle (\$286 billion vs. 6 x \$76 = \$456 billion), a \$170 billion gap that the States are unlikely to make up with their fuel tax revenues. In other words, the maintenance deficit will have grown by the time of the next reauthorization in 2008.

Making up the maintenance deficit with user fees (e.g., tolls) on existing highways is not justifiable. User fees might be acceptable if they are supported by the creation of commensurate economic benefits. Highways create value for communities, not just for users. Furthermore, if tolls do not equal the economic benefits to users, they are likely to divert traffic to less suitable routes, thereby only shifting, not remedying, the problem.

Funding “infrastructure maintenance” has to include paying for incremental additions to existing surface transportation assets. What is needed is a principled basis for determining when such additions should be considered “maintenance” and funded as such instead of being classed as “new capacity”.

Principles 5 & 6 emphasize the need to involve all elements of surface transportation and acknowledges that innovation by necessity entails the risk of trying something new and suggests the use of loan guarantees as the most tax efficient way to finance new projects that are expected to pay their own way. A new solution is always going to be “untried” or “unproven” at first. The challenge is balancing risks associated with a new project against its promise for adding capacity to the surface transportation system.

The Build America Bonds Act of 2005 (S. 428) (“BABA”), which was incorporated into the Senate version of SAFETEA-LU as the Talent-Wyden Amendment offers a thoughtful and innovative starting point for developing a new federal approach to financing surface transportation infrastructure. BABA was not included in the final SAFETEA-LU legislation.

All requests for financing, regardless of sponsor, should be supported by a “business plan” that sets out the project’s economic justification and shows how it meets the priorities and guidelines set by DOT. There are surface transportation projects that need to be financed but may not be able to repay their capital costs over the customary long-term bond financing period (i.e., 25 or 30 years) or may only be able to recover part of their costs even over an extended period of time. BABA offers a creative, well-thought out approach for using tax credit financing for projects like this.

Water projects need port facilities and vessels to create new infrastructure capacity. Even if the surface – water – is free, making use of that surface requires significant investment in assets. The Federal Railroad Administration’s RRIF program (RRIF loans can be for 100 percent of capital costs, but must be repaid over terms not to exceed 25 years) is an existing model that could be applied more broadly. All water or short sea shipping projects, whether sponsored by public or private entities, ought to be required to repay their capital costs in full with interest either over the life of the assets being financed or 30 years whichever is shorter.

The use of loan guarantees is the most tax efficient (i.e., costs the least in terms of tax dollars needed to fund projects) to finance any new infrastructure project that can reasonably be projected to repay its capital cost plus interest (tax-exempt or not) over a maximum of 25 or 30 years. If a guarantee program is adopted, it should be self-financing. Sponsors seeking guarantees for their projects should pay for guarantees, like homeowners who purchase homes with loan-to-value ratios above a certain percentage pay mortgage guarantee insurance.

An important benefit of the government guarantee approach is that interest paid to holders of guaranteed debt is taxable as are the earnings of those engaged in construction of surface infrastructure projects financed through such guaranteed debt. The combined use of tax-credit bonds and guaranteed debt to finance added capacity for the Nation’s surface transportation system could generate more tax revenue than the “tax cost” of the tax preferences.

Where from Here?

This paper is intended to move the substantive discussion that is currently underway within the transportation community toward consensus on the key elements of a workable, fiscally supportable and politically acceptable solution to the twin challenges of (a) ensuring reliable, adequate funding for the upkeep of existing surface transportation infrastructure and (b) creating sufficient funding for much needed new capacity, including processes for making sure that funding is directed to projects in accordance with agreed upon principles and national and regional priorities.

The following quotation from a speech by Michael L. Eskew, Chairman and CEO of UPS, to the Houston Forum on March 30, 2006 summarizes why it is critical that we to shift from talk to action as quickly as possible.

“If we’re going to take our rightful place as a nation in the world of trade, we must have the best infrastructure. By now, we all know that it’s Rush Hour on our nation’s transportation systems. And statistics tell us it’s only going to get worse as global commerce expands. We need to ask ourselves, whether we’re in the public or private sectors: Are we willing to stand by and watch as we slide into gridlock? Or are we willing to take the necessary steps today to ensure a vibrant economy tomorrow? Do we really have a choice?”