INNOVATION BRIEFS
COMMENTARY

Restructuring the Transportation Program: A Dialogue Between "Conservatives" and Innovators"

January 2, 2008

TO OUR READERS

As we enter the New Year we send you our best wishes for a happy, healthy and prosperous New Year. And, as has been our custom, we take this opportunity to offer some reflections about the year past and the year ahead.

Overall, we have found 2007 the most eventful year since we started publication of our newsletter 19 years ago. It was a year marked by the emergence of a serious dialogue about the need to change direction of the nation's surface transportation program. Such a fundamental program reassessment has not been undertaken since the launching of the Intestate Highway program fifty years ago. Triggering the reassessment has been a confluence of several factors:

First, there has been a new realization that since the completion of the Interstate system several years ago the surface transportation program has been drifting aimlessly without any real sense of purpose or direction;

Second, the impending depletion of the Highway Trust Fund balance and the eroding purchasing power of Trust Fund income have made it necessary to search for additional sources of revenue to meet growing transportation needs;

Third, the bridge collapse in Minneapolis has dramatized the precarious condition of some (but by no means all) transportation facilities and has sent a signal that we need to devote more resources to the maintenance and reconstruction of the nation's aging transportation infrastructure;

Fourth, growing congestion on the nation's highways and its adverse impact on personal mobility, truck movements and goods delivery have elevated the challenge of congestion mitigation to a national priority.

Setting the stage for the reassessment, Congress created two congressionally chartered commissions and charged them with developing a plan for restructuring and financing the federal surface transportation program. Adding a sense of timeliness to the Commissions' mandate has been the approaching expiration (in October 2009) of the current federal surface transportation program authorization.

Three Emerging Trends

The Commissions' work and the unfolding public debate have been conducted against a background of three emerging trends: a growing acceptance by the traveling public and state and federal officials (but not all congressional lawmakers) of highway tolling as a logical means of supplementing existing transportation tax revenue; a willingness to employ variable pricing as a tool of congestion management; and greater public sector receptivity to partnering with the private sector in the financing, construction and operation of transportation facilities. All three trends have been reinforced by strong support of the U.S. Department of Transportation and by personal advocacy of market-driven transportation strategies by Transportation Secretary Mary Peters. Recently, President Bush added his own voice to that of Secretary Peters in support of transportation pricing.

There are signs the Administration's advocacy (supported by financial incentives) is bearing fruit. By our count, no fewer than 21 states are actively pursuing toll projects – many of them through public-private partnerships. In addition, a U.S. DOT-sponsored Urban Partners program has prompted several jurisdictions, including New York City, to experiment with the concept of congestion pricing. A new federal Congestion Reduction Demonstration program is stimulating additional road pricing initiatives, including a radical proposal by Los Angeles to convert its existing carpool lanes to variably priced toll lanes. Emblematic of the new policy environment has been a December 20 announcement by Virginia DOT and its private sector partners, Transurban and Fluor, that they have signed a contract for the private financing, construction and operation of new toll lanes on the Capital Beltway. The $1.93-billion project will be financed with $350 million in private equity and $1.2 billion worth of government credit assistance. Eventually, the Beltway toll lanes will form part of a seamless 70-mile network of variably priced express toll lanes in Northern Virginia, operated under an 80-year concession.

Looking Ahead

In the year ahead, we believe, the movement toward increased highway tolling and private sector investment in transportation infrastructure will accelerate. AASHTO's prediction that revenue from tolls and public-private ventures may account for as much as 50 percent of new expressways built in the U.S. over the next 10 years (*NewsBriefs*, November 5, 2007) may prove to err on the conservative side. We tend to think that the figure will be closer to 100 percent.

States are embracing tolls and public-private partnerships not out of any ideological commitment to "devolution" or "privatization" but out of sheer fiscal necessity. Increasingly, they are obliged to commit a major part of their budgets to preserving and reconstructing aging transportation infrastructure, leaving little money for new construction. Nor do state officials count on significant increases in federal aid. Their assessment seems justified by recent congressional action. Rep. Jim Oberstar (D-MN) proposal for a 5-cent-a-gallon federal gas tax increase to fund his proposed bridge reconstruction program was vetoed by Congressional leadership and received little support from rank-and-file Democrats and Republicans alike. These sentiments are likely to persist in the next Congress as consumers face record high price of fuel at the pump and as oil prices push past the $100-per-barrel mark. Prospects for raising motor fuel taxes at the state level are equally uncertain. Texas, Minnesota, Washington State and Iowa are the latest jurisdictions to have decided against tax increases to fund highway programs.

Private Investment Will Grow

Like tolling, private investment in toll roads, we believe, will accelerate in the years ahead for much the same reason, namely fiscal stress. Coming to the rescue will be institutional investors with long-term investment horizons. Private equity capital is prepared to make significant investments in toll roads because these assets offer a stable and predictable cash flow relatively unaffected by economic downturns, and because toll facilities with automatic inflation-indexed tolls (an increasingly accepted practice) are expected to deliver returns equal or better than those from fixed income and real estate investments— 13 to 15 percent on average. According to one survey, there are 71 highway projects in the U.S. worth $104 billion, currently proposed for private financing, construction and operation. Four to six of them could reach fruition in the new year. One of them, a Florida project to improve the I-595 corridor in Broward County has elicited six responses from private consortia, with 12 companies offering to contribute equity capital.

While to date most of the equity capital has come from foreign sources, U.S. investors appear ready to step in. Wall Street investment banks, private equity funds and public pension funds are actively pursuing opportunities as equity partners in toll road concessions. CalPERS, the nation's largest public pension fund ($246 billion in assets) has launched a $2.5 billion pilot infrastructure program focused on investments in new roads, ports and other public facilities. Infrastructure funds, notably those of Carlyle, Goldman Sachs and JP Morgan Partners are not far behind.

Uncertain Prospects for "Monetization"

Less certain are future prospects for conversion of existing toll roads into long term private concessions as exemplified by the Indiana toll road and Chicago Skyway deals. With the exception of Pennsylvania's Gov. Ed Rendell, governors have not evidenced interest in leasing state-owned toll facilities in return for upfront capital. Public support for such "monetization" initiatives appears low, with opposition transcending party lines. Sensing the political mood, New Jersey Governor Corzine has abandoned his plans for "monetizing" the New Jersey Turnpike in favor of creating a new public agency that would issue bonds backed by higher tolls on New Jersey toll roads. This turn of events, naturally, has come as a disappointment to the financial community but it does not necessarily doom the prospects for public-private partnerships. Rather, it shifts attention to what many PPP advocates contend should be the true function of public-private partnerships, namely developing more risky, capacity-enhancing "greenfield" projects — projects that otherwise would not be built because they do not fit the conservative financing standards of established toll authorities and do not meet the investment-grade criteria of the municipal bond rating agencies.

Conservatives vs Innovators

How to address the expected transportation funding shortfalls and reshape the surface transportation program will dominate the debate in the new year. The reports of the two congressionally-chartered commissions, to be released in early January, will frame the debate, at least initially. It is no secret that the Policy and Revenue Commission has been unable to achieve a consensus on some key issues and that its report contains a minority dissenting opinion. Divisions among the commissioners mirror similar divisions in the transportation community at large. In an earlier commentary ("The New Politics of Transportation Financing," *NewsBriefs*, August 30, 2007) we characterized the conflict as a clash of opposing philosophies between the ***Conservatives*** and the ***Innovators***. Both the Conservatives and the Innovators agree the program should be restructured and made more targeted, and both see a need to increase transportation funding. Where they differ is how to address the funding shortfall and the role of the federal government in addressing the challenge.

The ***Conservatives*** (i.e. those who are inclined to preserve the status quo) look upon the gas tax as an essential underpinning of the surface transportation program and favor a fuel tax increase (plus indexing) as the principal means of dealing with the funding shortfall. They cite the ease of collection and proven revenue raising capacity of the gas tax as compelling reasons for retaining it as the main source of highway funding now and in the future They acknowledge the value of tolling, private capital and public-private partnerships, but tend to dismiss them as minor contributors to solving the funding shortfall.

The Conservatives, in addition, favor maintaining a strong federal oversight of the surface transportation program and oppose any movement toward devolution. They fear (probably with good reason) that a diminished reliance on the federal largesse would lead to an erosion of congressional control, influence and leverage over the nation's transportation program and lessen the influence of the Beltway community of trade associations, interest groups and lobbying organizations. They further believe that private toll concessions would, in the words of Rep. Oberstar, "undermine the integrity of a national system" and lead to a patchwork of uncoordinated facilities.

The ***Innovators***, on the other hand, tend to think that the nation needs to fundamentally reconsider the way in which transportation is funded, financed and built. While they are not prepared to declare the fuel tax dead, they question whether it alone can continue to fund the nation's growing transportation needs. They point to the widespread voter reluctance to increase gasoline taxes, the need to reduce carbon emissions and the new legislative mandate to increase average vehicle fuel efficiency to 35 miles/gallon by 2020 as reasons why we need to diversify the funding sources.

The Innovators believe the answer lies in greater reliance on tolling, equity capital, private road concessions and public-private partnerships. Eventually, they think, fuel taxes should be replaced with a mileage-based fee system and highways financed and operated more like investor-owned utilities. They consider direct user fees as superior in their ability to raise revenue, promote targeted investment, address externalities, influence traveler behavior and reflect the actual costs that users impose on the highway system. With financial responsibility for new infrastructure shifted to the states, they see the federal role in transportation investment decisions diminishing. They view the national highway system as made up of 50 state-owned and -operated road networks and are comfortable with the notion of modifying the intergovernmental relationship to give states more authority over the methods of infrastructure financing. Texas Governor Rick Perry spoke for many Innovators when he opined that "forcing an increase in the federal gas tax through a system that has no meaningful congestion relief goal, pigeonholes money into inflexible categories, and then dilutes what is left through earmarks, simply does not make sense..." (letter to Reps. Oberstar and DeFazio dated July 2, 2007). Several other governors, notably Mitch Daniels (IN), Charlie Crist (FL), Ed Rendell (PA), Jon Corzine (NJ) and Arnold Schwarzeneger (CA) share a similar outlook and have welcomed private investment in their highway programs. Also among Innovators are several state legislatures (FL, VA, NC, MS, MI, WA, IN, ME) that have enacted or liberalized laws regarding public-private partnerships during 2007.

The combined effect of stagnant Highway Trust Fund revenue, popular opposition to tax hikes, growing political willingness to enter into public-private partnerships, and failing public confidence in how Congress spends the taxpayers' gas tax money, supports the Innovators' contention that the traditional financial model of total reliance on public investment and the fuel tax is obsolete.

Toward a Consensus

Inevitably, the two sides will have to compromise in order to reach agreement on a new surface transportation legislation. The process of striving for an accommodation and developing a consensus on future program directions will be driving the debate in the new year. With the immediate problem of the Trust Fund deficit resolved (through a transfer of funds from the general fund, as proposed by Senators Baucus and Grassley), the transportation community can turn its attention to the more fundamental challenge of devising a long term strategy to finance the surface transportation program. Some proposed approaches will be on display at a January 13 session of the annual meeting of the Transportation Research Board which will feature U.S. DOT's Assistant Secretary for Transportation Policy, Tyler Duvall, and representatives of the two congressionally-chartered commissions. A further opportunity to hear these issues debated will be a January 17 congressional hearing on the Policy and Revenue Commission's report. These presentations will provide a useful preview of the unfolding debate. But the dialogue between the Conservatives and the Innovators will not end there. It will continue throughout the new year and carry us well into the next Congress and the next administration.

Happy New Year!

C. Kenneth Orski
Editor/Publisher, Innovation Briefs

(celebrating our 19th year of publication)
Potomac, MD

tel: 301.299.1996
fax: 301.299.4425
www.innobriefs.com