Commission Briefing Paper 5B-03

Assessment of Potential Challenges in Phasing-in of New Financing Mechanisms for Passenger Rail, Freight Rail, Intermodal Facilities and Other Modes

Prepared by: Cambridge Systematics
Date: January 10, 2007

Introduction

This paper is part of a series of briefing papers to be prepared for the National Surface Transportation Policy and Revenue Study Commission authorized in Section 1909 of SAFETEA-LU. The papers are intended to synthesize the state-of-the-practice consensus on the issues that are relevant to the Commission's charge outlined in Section 1909, and will serve as background material in developing the analyses to be presented in the final report of the Commission.

This paper describes the potential challenges in introducing new financing mechanisms for passenger rail, freight rail, intermodal facilities, and other modes. It builds on the challenges described in Paper 5B-02, which summarizes the long-standing governance, planning, and funding modal "stovepipes" that characterize surface transportation in the U.S. Those stovepipes have perpetuated a focus on transportation modes singly, rather than on the needs of the larger transportation system and the interactions among multiple modes.

Background and Key Findings

Federal surface transportation policy and the associated funding structure create modal stovepipes and competition among modes for limited available funds. In the best of cases, that competition exists among the two primary modes – highway and public transportation – that have dedicated sources of federally-collected fees. In the worst of cases, specifically for those modes that lack dedicated sources of funds such as intercity rail, freight rail, and intermodal facilities, the challenges of competing with the other modes and receiving adequate funding can seem almost insurmountable.

While SAFETEA-LU provided some new funds and new flexibility for financing passenger and freight rail and intermodal facility investments, there is likely to continue to be a focus on single modes of funding given that the preponderance of funds are distributed by mode. Further, there are multiple restrictions that attach to the use of these funds, both at the federal level and varying widely at the state level. A major shift in federal, state and local transportation policy and funding would be needed to facilitate a truly multimodal approach to planning and programming of transportation investments.

Challenges to implementation of new funding and financing mechanisms for passenger and freight rail and intermodal facilities are:

- Willingness of the private sector to form partnerships with the public sector;

- Competition from other priorities (i.e., mainly highway and transit needs);
- Multijurisdictional nature of needs;
- Requirement of dedicated revenue sources for new financing mechanisms; and
- Requirement of state enabling legislation.

Other major challenges that are related to the implementation of new funding and financing sources for highway and public transportation also apply to other modes. These challenges are presented in paper 5B-02, and include:

- Development of a sound policy rationale;
- Conduct of credible and comprehensive technical analysis of alternatives;
- Recruitment of sustained leadership;
- Development of broad political consensus;
- Conduct of effective public education and communications;
- Development of consensus on institutional roles and responsibilities;
- Integration of current and emerging revenue collection and allocation;
- Development of effective administrative mechanisms;
- Establishment of the appropriate legal framework;
- Application of required technologies; and
- Commitment of the resources to support and sustain phase-in.

Challenges of Existing Funding and Financing Mechanisms to Support Multimodal Investments

Public investment in the nation's surface transportation system is funded primarily through user-based fees, including motor fuel and vehicle taxes that at the Federal level are deposited in the Highway Trust Fund (HTF). The HTF then provides funding to State and local transportation agencies for implementation of its federally-supported transportation programs.

HTF dollars can be used by State and local transportation agencies for highway and transit investment, but uses for passenger and freight rail and intermodal facilities are severely limited.

Passenger and freight rail needs usually cross jurisdictional boundaries, requiring multi-regional and/or multi-state partnerships. Existing policies generally restrict the use of funds to pay for investments outside the jurisdictional boundaries.

Another challenge is the differing goals of public and private investment in transportation. Public sector investments in passenger and freight rail and intermodal facilities are related to providing public benefits that are over and above the profit-maximizing criteria that private sectors firms base their investment decisions upon. Among the factors that public agencies might take into account in investing in freight and passenger rail are mobility for different population groups, air quality and other environmental considerations, and economic development concerns that are not typically part of private sector decisions.

Current Financing of Freight Rail and Intermodal Facilities

Freight rail assets and intermodal facilities are primarily owned and operated by the private sector. The railroad industry is a capital intensive industry, with almost 20 percent of its revenues invested in capital spending, compared to an average of 3.5 percent for all other U.S. industries. Capital investments are made selectively; most of the capital investments are related to infrastructure preservation, rather than capital expansion. Investors are reluctant to invest in railroad stock, because of the large cost of needs compared to available net revenues to support capital investments. The lack of capital funding has led some railroads to borrow to support maintenance and capital expansion, and to defer maintenance and capital improvements.[1]

The rapid growth of trade and freight volumes continues to put pressure on the nation's transportation system. The efficient movement of goods is key to the economic health of the nation. Governments at all levels have a critical interest in the health of the freight transportation network due to its role as an important contributor to local, state, regional and national economic growth and productivity. In addition, there has been increasing discussion over the last several years about government's role in helping to finance certain freight-oriented improvements, including investments in private infrastructure where there is a public benefit and, conversely, private sector investments in public infrastructure where a public benefit is identified.

Some believe that the Federal government and multi-state coalitions should play a larger role in the future of the nation's rail system[2]. Over the last decade, several public-private partnerships have been created to evaluate, plan and implement of rail capacity improvements. These include the Alameda Corridor in Southern California, the Reno Transportation Rail Access Corridor (ReTRAC) in Nevada, and the Chicago Region Environmental and Efficiency Program (CREATE). In addition, multi-state coalitions, such as the I-95 Corridor Coalition serve as models for how states and private railroads may work together to jointly meet both public and private objectives.

At the federal level, there currently are several potential sources of funding for freight rail and intermodal investments. Congestion Mitigation and Air Quality (CMAQ) funds from the Federal-aid highway program,[3] have been used in the past to pay for rail freight investments (e.g., rail sidings, rail track improvements, and intermodal transfer facilities) that result in air quality improvements by reducing truck traffic or reducing vehicle delays at rail-highway crossing. Federal financing tools including the Transportation Infrastructure Finance and Innovation Act (TIFIA) and Railroad Rehabilitation and Improvement Financing (RRIF) programs have been expanded in SAFETEA-LU to better address rail and intermodal needs. Other federal programs, such as Economic Development Administration (EDA) grants, provide funding for rail investments on economically distressed industrial areas, where rail investments will promote job creation and/or retention.

[1] AASHTO, *Rail Freight Bottom Line Report (draft)*, September 2006.
[2] Ibid.
[3] The CMAQ program provides funding for surface transportation projects that improve air quality in non-attainment and maintenance areas. SAFETEA-LU authorized $8.6 billion for fiscal years 2005 through 2009.

At the state level, several states have grant and loan programs in place to support capital investments on rail and intermodal facilities, primarily for shortlines and regional railroads, and more than 30 states have developed freight rail plans in recent years.[4]

Funding and Financing of Passenger Rail Needs

Amtrak is the main provider of intercity passenger rail service in the U.S. today, operating a 22,000-mile network that provides service to 46 states and Washington, DC primarily over tracks owned by the freight railroads. Freight railroads charge Amtrak the incremental cost associated with using their tracks. Amtrak is funded through the Congressional appropriations process and has been quite controversial. Amtrak depends significantly on federal subsidies for capital improvements and operating subsidies, and has not met the goal of becoming operationally self sufficient, as required by the Amtrak Reform and Accountability Act of 1997. Additional capital and operating funding is provided by state and local governments, generally for specific capital investments and operations of corridor routes operating within their jurisdictions.

There is no specific dedicated source of revenue for intercity passenger rail. Currently funds must be cobbled together from other sources in the form of:

- Regional coalitions of states cooperating to provide rail service between major metropolitan areas;
- State contributions to Amtrak for increased service; and
- Improvements to freight rail infrastructure over which most intercity passenger rail service operates.

States that have advanced passenger rail projects have done so through a variety of sources, but there is a widely varying ability and desire among states to fund passenger rail.

Recent New Financing Mechanisms

SAFETEA-LU responded in part to industry requests for new financing mechanisms that would better address investment needs of passenger and freight rail and intermodal facilities. These include modification of the eligibility requirements for the TIFIA federal credit program, and the introduction of the private activity bond (PAB) program. The State Infrastructure Bank (SIB) loan program was expanded to include all states, and modifications were included to allow the creation of rail accounts and of multi-state SIBs. SAFETEA-LU also reauthorized the RRIF Program, which was originally established by TEA-21. These programs that may be used for passenger and freight rail and intermodal facility investments are described below:

TIFIA Credit Program. Section 1601 of SAFETEA-LU provides federal credit assistance in the form of secured loans, loan guarantees, or lines of credit to surface transportation projects of national or regional significance, including highway, transit, and rail. The program, which is authorized at $610 million, is designed to fill market gaps and leverage substantial private co-investment by providing projects with supplemental or subordinate debt. The threshold for

[4] U.S. Government Accountability Office. *Freight Railroads: Industry Health has Improved, but Concerns About Competition and Capacity Should be Addressed.* October 2006.

eligible projects was reduced by SAFETEA-LU from $100 million to $50 million, making the program more accessible to more projects. Further, eligibility was specifically extended to include intercity passenger bus and rail facilities and vehicles (excluding Amtrak and magnetic levitation systems), and incorporated much broader eligibility for freight and intermodal projects, as summarized below:

- Public freight facilities or private facilities providing public benefit for highway users;
- Intermodal freight transfer facilities;
- Access to such freight facilities and service improvements to such facilities including capital investment for intelligent transportation systems (ITS);

Clarification was also provided regarding the definition of eligible freight projects, which may involve the combining of private and public sector funds in private sector facility improvement. When located in a port terminal, only surface transportation infrastructure modifications necessary to facilitate direct intermodal interchange, transfer, and access into and out of the port are eligible.

State Infrastructure Banks (SIBs). Section 1602 of SAFETEA-LU allows all states, the District of Columbia, Puerto Rico, and other U.S. territories to establish infrastructure revolving funds eligible to be capitalized with Federal transportation dollars authorized through fiscal year 2009. The new legislation allows the implementation of multi-state SIBs, which may encourage states to implement and fund projects that cross jurisdictional boundaries. States are also allowed to create a rail account within the SIB using funds available to capital projects under Subtitle V (Rail Programs) of Title 49 U.S.C. Through the SIB, states can issue loans and other credit tools to public and private project sponsors of transportation infrastructure projects.

Private Activity Bonds. Section 11143 of SAFETEA-LU authorizes up to $15 billion in tax-exempt private activity bonds to be issued by state or local governments for qualified highway and surface freight transfer facilities. Qualified highway or surface freight transfer facilities are defined as:

- Any surface transportation project which receives Federal assistance under Title 23, United States Code;
- Any project for an international bridge or tunnel for which an international entity authorized under Federal or state law is responsible and which receives Federal assistance under Title 23, United States Code; or
- Any facility for the transfer of freight from truck to rail or rail to truck (including any temporary storage facilities directly related to such transfers) which receives Federal assistance under Title 23 or Title 49, United States Code.

The legislation gives the Secretary of Transportation authority to allocate the $15 billion national limitation among qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.

Railroad Rehabilitation and Improvement Financing (RRIF) Program. The RRIF Program authorizes the Federal Railroad Administration (FRA) to approve up to $35 billion in loans and loan guarantees for the following purposes, with up to $7 billion reserved for projects benefiting freight railroads other than Class I carriers:

- Acquire, improve, or rehabilitate intermodal or rail equipment or facilities, including track, components of track, bridges, yards, buildings, and shops;
- Refinance outstanding debt incurred for the purposes listed above; and
- Develop or establish new intermodal or railroad facilities.

Eligible borrowers include railroads, state and local governments, government-sponsored authorities and corporations, joint ventures that include at least one railroad, and limited option freight shippers who intend to construct a new rail connection.

Other Proposed Funding and Financing Mechanisms

Transportation revenue studies by the U.S. Chamber of Commerce[5] and others have proposed alternative funding and financing mechanisms at the federal level to support rail and intermodal investments. None of these funding and financing mechanism have been implemented to date. These alternatives are summarized below.

Dedication of Current Custom Duties for Investment on Nationally Significant Port and Intermodal Freight Projects. Customs revenues currently go to the General Fund and certain other designated programs. Gill Hicks and Associates, among others, has advocated that a portion of existing Customs duties (e.g., 5 to 10 percent) should be utilized to pay for necessary port and intermodal improvements.[6] Customs revenues are derived from duties on imported goods passing through international gateways. The transportation of these goods imposes significant costs on ports, intermodal facilities, and the surrounding communities.

Investment Tax Credits to Fund Intermodal Projects. Investment tax credits represent another form of tax incentive to stimulate capital investment. Several proposals have been advanced in recent years to help finance freight and intermodal projects through this mechanism. A recent example is Senate Bill 3742, the "Freight Rail Infrastructure Capacity Expansion Act," which was introduced in July 2006. It would provide incentives for investments in capacity enhancing freight rail infrastructure through both tax credits and tax deductions. The proposal calls for a 25 percent tax credit for any taxpayer making certain capital expenditures for new freight rail infrastructure. In addition, the proposal would allow such capital outlays (less the amount of any tax credits claimed) to be expensed in the year they are made, rather than depreciated over time.

Qualifying capital expenditures would include those made for the following property types:

- Railroad grading, bridges, tunnels, marshaling yards, etc., excluding the cost of land;

[5] U.S. Chamber of Commerce, National Chamber Foundation, *Future Highway and Public Transportation Financing – Phase II*, November 2005.

[6] *Customs Duties as a Potential Source of Revenue for Marine Transportation System Infrastructure Needs*, Gill Hicks and Associates, August 2003.

- Addition of mainline track capacity or new and extended sidings to existing right-of-way;
- Construction of new intermodal transfer facilities;
- Technology-based expansions, such as signaling and communications equipment; and
- New locomotives that increase the horsepower capacity of a railroad's fleet.

This tax incentive program is designed to stimulate private capital investment by railroads as well as shippers, intermodal carriers and other companies that make qualified expenditures for capacity expansion projects as described above.

This mechanism is seen as a way for the Federal government to support projects involving freight rail, intermodal, or even intercity passenger infrastructure that might not otherwise be eligible for grant funding under the existing Federal Title 23 or Title 49 programs, but that generate substantial public benefits. In the past the U. S. Department of the Treasury has opposed tax credit or other types of special purpose Federal bonds on the grounds that they are more expensive to taxpayers than the issuance of regular Treasury debt.

Potential Implementation Challenges of New Funding and Financing Mechanisms for Passenger and Freight Rail and Other Multimodal Investments

Making more funding availability for passenger and freight rail, intermodal facilities, and other modes would require fundamental changes in federal, state and local policies, and potentially new dedicated sources of revenue that more closely align the benefits afforded by these services and facilities and the sources of the revenue. Key challenges are as follows:

Willingness of the private sector to form partnerships with the public sector. As mentioned earlier, rail assets and intermodal facilities are primarily owned by the private sector. Public sector involvement in funding for passenger and freight rail and intermodal projects requires the creation of PPPs. One such PPP was established to conduct the Mid-Atlantic Rail Operations Study (MAROps). Partners in this study included the States of Virginia, Maryland, Delaware, Pennsylvania, and New Jersey, three railroads (Amtrak, Norfolk Southern and CSX) AND THE I-95 Corridor Coalition. Objectives of the study were to assess current transportation sysem conditions and needs, to identify rail system improvements to the reduce the need for highway investments, to assess the benefits of multi-state rail programs and to develop innovative partnership and funding strategies. The study concluded that railroads could fund some but not all of the needed improvements in the corridor. Public-private partnerships would be needed to facilitate public investments and to develop innovative financing structures to bridge the gap.

Some railroads are reluctant to allow the public sector to invest in their infrastructure, due to the added requirements and standards that are inherent with the use of public funds. In addition, the public sector may be interested in investing on projects that, from the private sector's perspective, are less cost-effective and would not provide the highest return on investment. Government interference in railroads' decision-making is another concern of the private sector. Another issue is that railroads believe that public investment should be made such that all railroads are treated equally and that public investments are distributed equally among railroads. Bringing the public and private sectors together on rail and intermodal investments requires: 1) active involvements of all stakeholders in the definition of needs and in the development of plans

and programs on multimodal investments; and 2) development of agreements among all stakeholders in which roles, financial participation, and risks are clearly defined.

Multijurisdictional Nature of Needs. As discussed above, passenger and freight rail systems usually cross jurisdictional lines. Most Federal-aid highway funds are apportioned by formula and must be matched by state or local funds, making it difficult for states to invest in projects beyond their state boundaries. In addition, justifying the use of scarce state resources to support multi-state investment may be difficult, if not impossible. However, the SAFETEA-LU provisions for the creation of multi-state SIBs and freight rail programs such as Mid-Atlantic Rail Operations Study (MAROps) could open the door to future investments on important passenger and freight rail corridors.

Requirement of Dedicated Revenue Sources. The financing mechanisms described above require a dedicated revenue sources, such as tolls, user fees (e.g., container fees), or dedicated taxes (e.g., sales taxes) to repay debt. Some state DOTs and MPOs find it difficult to identify or develop such dedicated sources of revenue, limiting the use of these financing tools. However, some rail investments, such as the Alameda Corridor and ReTRAC, have used these tools and were successful in implementing new revenue sources dedicated to debt service payments. In the case of Alameda Corridor, revenues from container fees are used to repay bonds, whereas the City of Reno has dedicated revenues from hotel taxes and local sales taxes to repay debt issued for ReTRAC.

Requirement of State Enabling Legislation. While the use of innovative financing tools has proven to be very useful to accelerate and implement transportation investments, some states are unable to use these tools. For instance, some states have reached the limits on the amount of debt that can be incurred, whereas other states may need enabling legislation that authorizes the use of these mechanisms.

Paper 5B-02 presents major challenges that may be faced in efforts to phase in new funding and financing sources for highway and public transportation. These challenges are also applicable to the implementation of new funding and financing mechanisms for other modes, and include:

- Development of a sound policy rationale;
- Conduct of credible and comprehensive technical analysis of alternatives;
- Recruitment of sustained leadership;
- Development of broad political consensus;
- Conduct of effective public education and communications;
- Development of consensus on institutional roles and responsibilities;
- Integration of current and emerging revenue collection and allocation;
- Development of effective administrative mechanisms;
- Establishment of the appropriate legal framework;
- Application of required technologies; and
- Commitment of the resources to support and sustain phase-in.

CONSOLIDATED COMMENTS FROM MEMBERS OF THE BLUE RIBBON PANEL OF TRANSPORTATION EXPERTS - PAPER 5B-03

One reviewer commented as follows:

On page 3, the paper states: "The lack of capital funding has led some railroads to borrow to support maintenance and capital expansion, and to defer maintenance and capital improvements." Although this statement might correctly describe some smaller railroads, it does not accurately describe the situation for Class I railroads. Class I railroads routinely borrow capital to enable their operations and build for the future, so accessing capital markets is not the exception that this sentence would lead one to believe. Furthermore, the term "deferred maintenance" has a specific, negative meaning in U.S. railroading and the presence of this circumstance, prevalent during the 1960s and 1970s, has all but disappeared on Class I railroads.

On pages 7-8, the paper lists obstacles to public-private partnerships involving railroads, such as the reluctance of some railroads to allow public sector investment in their infrastructure "due to the added requirements and standards that are inherent with the use of public funds. In addition, the public sector may be interested in investing on projects that, from the private sector's perspective, are less cost-effective and would not provide the highest return on investment. Government interference in railroads' decision-making is another concern of the private sector." These are all legitimate issues, but in many public-private partnerships in which railroads have been involved they are resolved in negotiations. The issues are certainly not always insurmountable.

Also on page 8, the paper states: "Another issue is that railroads believe that public investment should be made such that all railroads are treated equally and that public investments are distributed equally among railroads." This reviewer would note that railroads believe that all railroads should have the opportunity to participate in public investment projects if they so choose, but railroads do not believe that public investments should be distributed equally among railroads.