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All change for US transport

The transition of power at the White House poses numerous questions for transport finance specialists. Barry Parker reports from the United States

As transport professionals return to their desks after the holidays, the transition between US administrations is due to culminate with president-elect Barack Obama taking control on 20 January.

In the clichéd words of numerous commentators, Obama and his team will need to 'hit the ground running' as they are set to enter office at a time of continuing economic malaise and, in many financial markets, outright disruption. The interconnected nature of the financial and industrial markets was demonstrated repeatedly during the downward credit spiral of 2008.

Actions in the United States, in the broader financial realms, will continue to affect transport funding worldwide. Other items on the US policy agenda, including environmental measures, fuel taxes and incentives for privatisation, will affect transportation businesses far beyond US shores.

Half of the USD700 billion to be devoted to the Troubled Assets Relief Programme (TARP) has already been allocated, including a USD13.4 billion dollop for two large automobile manufacturers. One feature of the financial rescue, which has been taking place since September, has been the conversion of financial companies to the more regulated bank holding companies. The move opens up funding from the US Federal Reserve's 'discount window' and, under TARP, directly from the US government at a time when traditional money markets have become unavailable. The second USD350 billion will be disbursed by the incoming presidential administration.

In late December, CIT Group, an industrial finance company best known for asset-based lending, announced that it had cleared a

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plethora of hurdles and would be converting to a bank holding company. Within CIT's USD81 billion balance sheet is a bank with roughly USD3.1 billion of assets and USD2.3 billion of funding through deposits. To facilitate the transition to a bank holding company, CIT needed to reshape its balance sheet, in line with regulatory capital rules. The company's financial restructuring included a USD300 million equity raise from the public markets, as well as an infusion of TARP money. The US Treasury will invest in CIT's preferred stock, funded with USD2.3 billion of TARP funds.

The debt side of CIT's ledger was also rejigged. Standard & Poor's (S&P) cut the company's credit rating from A- to a still-investment grade BBB+; in explaining the downgrade, S&P cited likely customer difficulties. CIT also hastened the conversion of nearly USD700 million of currently outstanding convertible debt into equity and also completed converting roughly USD2.4 billion of existing senior debt into new subordinated debt (USD1.15 billion), which qualifies as regulatory capital, and USD547 million of cash.

CIT's USD2.3 billion of TARP funding and the switch to a bank holding company are closely intertwined, as the TARP money comes in as Tier 1 capital. As part of the deal, CIT's capital ratios must conform with capital adequacy requirements for bank holding companies. For large banks, Tier 1 capital must be at least 4 per cent of assets. Although silence prevails, the potential exists for the new CIT to shed non-banking assets.

Just prior to the holidays, GMAC Commercial Finance, a financier of motor vehicles and other assets, still in the throes of a debt restructuring, also succeeded in gaining a banking charter and a USD5 billion investment from the US Treasury with TARP capital. The restrictions facing bank holding companies include limitations on ownership by non-bank-type businesses; GMAC holders Cerberus (51 per cent holder) and ailing General Motors

(49 per cent holder) will both need to reduce their stakes. At the same time, GMAC will diversify its activities, according to the Federal Reserve.

Equipment financing businesses are facing difficulties in funding. The finance unit of Textron, a conglomerate best known for Bell helicopters and Cessna aircraft, will withdraw from all receivables financing, other than those activities supporting the company's own manufacturing. GMAC, with a government mandate for diversifying, could begin financing automobiles for buyers of brands beyond General

Motors vehicles. As GMAC reconfigures, ownership of banks and leasing entities is not out of the question.

Under the Federal Reserve's Regulation Y, both leasing and ownership of industrial banks are permitted activities for bank holding companies. Indeed, CIT already plays an important role, serving mid-sized companies, including a railcar leasing business that had been for sale in the third quarter of 2008 but is now suspected to be off the market, and a role in aircraft finance through its CIT Aerospace unit.

CIT Aerospace recently put two A330 aircraft, originally scheduled for lease to the now-defunct XL Airways, on to 10-year operating leases with Mexicana Airlines. The Federal Reserve's Regulation Y, while prohibiting operating lease activities, does allow bank holding companies to hire third parties for the operation, maintenance and repair of assets.

GE Capital, another major transport equipment financier relying on short-term funding from money markets, has avoided the move to a bank holding company, as parent General Electric's AAA rating has remained intact. In late December, S&P affirmed the rating, but lowered the company's financial outlook from stable to negative. In its early December conference call, GE Capital executives described the company's GE Commercial Aviation Services (Gecas) subsidiary as comprising 7 per cent of its roughly USD700 billion finance portfolio, and that aviation-related defaults and impairments could reach between USD250 million and USD300 million, on a pre-tax basis, in 2009.

GE Capital has joined two federal government programmes, one in which the Federal Reserve - rather than private investors such as money market funds - has bought commercial paper, including unsecured notes with maturities up to nine months. Additionally, GE Capital, through ownership of bank entities, has availed itself of the Temporary Liquidity Guarantee Programme (TLGP), in which the Federal Deposit Insurance Corporation (FDIC) agrees to back the unsecured debt issues of participants.

One footnote to the whole bailout drama involves the US Senate's defeat of proposed legislation that would have allocated USD14 billion to automakers Chrysler and General Motors. Following the bill's failure - attributed by analysts to the unwillingness of organised labour to expeditiously implement concessions - the US Treasury announced that funding would be carved out of TARP money.

Infrastructure investment

But within the defeated bill were provisions that would have seen the federal government guaranteeing the obligations of transit agencies that had participated in sale-in/lease-out (Silo) and lease-in/lease-out (Lilo) transactions. In these transactions, at least several dozen US transit agencies had sold equipment and infrastructure to private-sector investors that benefited from tax credit that was not available to non-tax-paying public entities; for upfront payments, the transit agencies sold or leased equipment, garnering depreciation benefits.

A leading defeasement provider in these complex leveraged deals, banned by US tax regulators in 2004, was insurance giant American International Group (AIG), whose credit downgrade triggered provisions enabling banks to terminate the transactions, requiring immediate or stepped-up repayment of lease obligations.

There is a risk that the intermediary will typically escrow lease (rental) payments. A defensive move was announced in one such deal involving Denver, Colorado-based Regional Transportation District (RTD) in December, a week after the US Senate failed to pass the auto bailout bill. In a model for how these deals may flesh out, RTD set up a reserve for up to USD10 million "to resolve claims which may arise should AIG, the payment undertaker on the agreement, fail to make payments as required and should existing collateral securities posted by AIG prove insufficient to satisfy payments required under the lease" in a 1997 transaction between RTD and lessor Entrecap Financial - originally Pitney Bowes Financial Services - for the financing of light railcars. According to the non-partisan research group The Tax Foundation, RTD's sale/leaseback activities into the early 2000s totalled about USD145 million.

One bright spot in the US financing landscape has been the US Export-Import Bank (Exim), an independent agency tasked with promoting US exports, which has had a close relationship with Boeing in backstop finance provided to aircraft purchasers in developing countries. Other transport business includes an array of deals provided for the support of US-manufactured aircraft, some with additional support from the Private Export Funding Corporation (Pefco).

In late December, Exim announced authorisation for the provision of USD12 billion of guarantees to support US exports. The agency has also suggested that it would look into direct lending activities in an effort to fill a financing void created by reduced bank liquidity.

The US presidential transition has been unusual in terms of the rapidity with which the important players of the incoming administration have been assembled. The new team will be forced to pick up the pieces of the inchoate economic stimulus programmes and attempt to manage the amorphous and hastily crafted set of bailout measures, including TARP and TLGP, among many others.

Moving forward, a centrepiece of president-elect Obama's planned initiatives is a large-scale programme of public works. Although seemingly reminiscent of initiatives from the 1930s, when the administration of Franklin D Roosevelt simultaneously created jobs and built up US infrastructure, Obama's version, 75 years on, will include cyber infrastructure along with road and other projects.

The US Interstate Highway System, which was largely built in the 1950s and 60s, will be one beneficiary of Obama's renewed emphasis on infrastructure - part of an economic stimulus package that could be worth up to USD775 billion, according to a top Obama adviser. Transportation infrastructure, in the traditional sense, will comprise a modest portion of the overall total. As a guide, a portfolio of projects worth USD60 billion had been discussed in connection with an Obama-endorsed infrastructure bank. Also likely to be on the transportation agenda is the US air traffic control (ATC) system and the funding of Amtrak, the cash-starved, government-owned passenger rail system.

Private investors are likely to show renewed interest in surface transportation. Battery technology and automotive battery recharging infrastructure have continued to draw attention in the venture capital sector. In Hawaii, the state and a local power-generation company are working with a startup venture, promoted by a former Silicon Valley executive, that would create a network for recharging electric automobiles throughout the Hawaiian Islands.

At the helm of the US Department of Transportation, which is tasked with transport funding, including ATC, will be Ray LaHood, a member of Congress from Peoria in Obama's home state of Illinois, who will be retiring after seven two-year terms. Although LaHood, a member of the Republican Party of outgoing President George W Bush, is not considered to be a transport expert, he is well versed in the funding mechanisms of Washington having been a member of the Appropriations Committee of the US House of Representatives.

Knowledge of the inner workings of the congressional funding process will be invaluable at a time when cynics are expecting all manner of interference from special interest groups and competing projects. Indeed, in early December, the National Governors Association, in which members are leaders at the state level, identified projects worth about USD136 billion. A trade group, the American Association of State Highway and Transportation

Officials, tallies highway and road project needs at USD64 billion. Irrespective of the correct reckoning, the politicking for funds had already begun more than a month in advance of Obama's inauguration date. State governors have provided lists of shovel-ready infrastructure projects to their respective congressional delegations. The challenge for the new presidential administration is to fund useful projects and avoid 'pork-barrel' appropriations awarded to enrich a particular legislator's district.

Strategic reforms

During the presidential campaign, the idea of a US infrastructure bank, or alternatively a similarly purposed corporate entity, was proposed in various guises. Typically, debt funding for local transport projects has been provided by general obligation or revenue bonds, issued at a local level but not at the federal level. One expert with the ear of the incoming administration, Michael Lind, who is in charge of an infrastructure initiative at the New America Foundation (NAF), a Washington-based think-tank, said: "Creating an independent national infrastructure bank with the power to issue the equivalent of municipal bonds is the single most important strategic reform that President Obama and the Democratic Congress can undertake in the first 100 days."

Lind's rationale is that an economic stimulus package is ane-off, while nfrastructure finance requirements - a category that includes highways, as well as schools and information infrastructure - are ongoing.

Lind's colleague, Steven Coll, a Pulitzer Prize-winning writer and chief executive officer (CEO) of the NAF, offers a far-reaching perspective: "If the Obama administration plans and builds public-private infrastructure financing institutions now, with an eye on the recession's aftermath, it might help mitigate the next bubble before it inflates - or at least ensure that some portion of the next bubbly brew of global capital is invested in support of American productivity. This is the true promise of the Obama presidency - that his programmes for economic recovery might be designed to create a generational transformation."Coll, perhaps telegraphing the content of what his experts are whispering to the incoming president's economics team, intimates that the now-imploded housing bubble occurred, in part, because there were few alternative US investments to soak up huge surpluses. Indeed, he suggests that a victory for Al Gore in the 2000 presidential race could have provided such alternatives during the subsequent eight-year timespan.

"Rather than moaning impotently about Chinese trade imbalances, the argument went at this time that the United States could channel Chinese dollar surpluses into a renewal of American national capacity and competitiveness by creating financing vehicles - a national infrastructure bank, for example - that could reward both Chinese investors and American productivity," Coll says.

The incoming administration's tactical moves to meet its environmental objectives are also worth watching. Conservatives and business executives have expressed their concerns about the deleterious effects on company bottom lines of a 'carbon tax' or a 'cap-and-trade' programme - two ways of reducing carbon dioxide emissions that Obama is likely to consider. The venerable Wall Street Journal has described the incoming US Department of Energy unflatteringly as "a team of Al Gore's protégés".

The airline industry, with Ryanair being the most vocal, has strenuously railed against efforts by the EU to include the aviation sector in cap-and-trade schemes already in place for industrial companies. Although the US does not participate in the Kyoto Protocol, which is due to expire in 2012, it could potentially sign a subsequent pact and play its part in a worldwide solution to minimising aviation emissions.

Experts realise that airline emissions will now come under scrutiny in the US. In a teleconference organised by the International Society of Transport Aircraft Trading (ISTAT), industry veteran Fred Bearden, CEO of consultancy Aircraft Information Services Inc (AISI), suggested that a straight tax on aviation fuel would be superior to a trading scheme.

Bearden acknowledges that international treaties, notably the Chicago Convention of 1944, which could be construed as prohibiting taxation of fuel used in international aviation, would need to be amended if such an approach were to be implemented. Over time, he suggests that a move to carbon-neutral fuels - in which carbon is absorbed during the production process, instead of when burned - should be mandated and funded by the US government.

Taxes on gasoline will also figure prominently in discussions about funding surface transportation, as the existing funding programme is re-authorised. In the 12 months ending in September 2008, gasoline tax revenues deposited into the Federal Highway Trust Fund declined slightly relative to the previous year, as high fuel prices led to reduced demand. This fund is used to finance the federal component of highway construction and maintenance, which is cost-shared with states. One school of economists, spearheaded by Harvard's Robert Z Lawrence, also a fellow at the Peterson Institute for International Economics, has argued strenuously for a large gasoline tax increase.

Writing in the Financial Times about the need for drivers to buy fuel-efficient vehicles, Lawrence comments: "Consumers may have regretted their behaviour - buying truck-like sport utility vehicles - when gasoline prices soared above USD4 a gallon, but as gas prices descend there is no reason to believe that left unchecked they will not return to their gas-guzzling ways." His suggestion is a "plan that gradually increases duties on imported oil to ensure a minimum price of gas in five years' time".

New York Times columnist Thomas Friedman, best known for his books on globalisation, hastens the timeframe, advocating a federal gasoline tax increase of USD2.40 per gallon (versus present levels of USD0.18 per gallon at the federal level), phased in over two years.

President-elect Obama, who as a candidate opposed then-rival Hillary Clinton's notion of temporarily suspending the tax in mid-2008, when gasoline prices were at all-time highs, has been cool about such ideas, at least for now.

A big challenge for the new administration will be reconciling the seemingly conflicting goals of reduced gasoline consumption - for both environmental and energy security reasons - with maintaining a viable interstate highway system that is effectively funded by fuel consumption in the sense that more gasoline being consumed means more revenue for the Highway Trust Fund.

The ideas of Friedman and Lawrence notwithstanding, the National Surface Transportation Infrastructure Financing Commission, a group of Republican-chosen academics and business experts whose early 2008 recommendations were rebutted by US Department of Transportation Secretary Mary Peters, has recommended an increase of a mere USD0.10 per gallon over the current level.

The right wing of the political spectrum - the party of the outgoing Bush administration - now finds itself further in the minority. At a time when credit constraints will be rewriting the playbook for Washington policy-makers, the lure of private participation in the transport infrastructure sector may be hard to resist. The views of the right-leaning think-tank the Cato Institute provide a hint of how the politics of the right and the economic realities of leftward-facing Obama may gel.

In December, two Cato experts wrote of the benefits of privatisation: "Some policy-makers think that certain activities, such as ATC, are too important to leave to the private sector. But the reality is just the opposite. The government has shown itself to be a failure at providing efficiency and high quality in services such as ATC. Such industries are too important to miss out on the innovations that private entrepreneurs could bring to them."

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