

May 3, 2012

Loren Smith
loren.smith@capalphadc.com
202-548-0466

James Lucier
james.lucier@capalphadc.com
202-548-0072

CAFE/Highway Bill: CBO Spotlights Revenue Challenge

- The Congressional Budget Office released a new study yesterday. It asserts that new fuel economy (CAFE) regulations from the Obama administration could reduce Highway Trust Fund revenues by 21% by 2040.
- We believe the administration will finalize CAFE regulations through Model Year 2025 this July, as scheduled. The ultimate fate of the mandate, however, depends heavily on the election outcome this year. The party in power next year will likely write a Highway Bill and cement the new CAFE regulations - and the gulf between the two major political parties is wider than ever.
- A tougher fuel economy regime carries implications for auto suppliers, which could benefit, and for automakers, where the three Detroit-based companies won incremental concessions in the rule.

CBO Study: More Fretting About the Highway Trust Fund

The new CBO study on depleted Highway Trust Fund revenues ([here](#), 10 pages) is was greeted with yawns by seasoned observers. In fact, the Highway Trust Fund is facing a bigger day of reckoning next year, when Congress will likely decide to water down the “user pays” principle in order to pass a long-term Highway Bill. Having gas tax receipts cover the cost of highway programs has been a hallmark of transportation policy, ensuring that *users* - drivers - are *paying* for their benefit - roads.

Meanwhile, we don’t expect the study to affect the ongoing Highway Bill negotiations. A 21% reduction over the next three decades is actually better news than one might expect, and members of Congress are unlikely to act before the crisis actually strikes. (In the perhaps-hyperbolic words of one Congress-watcher: “Congress has a very long history of not caring one bit about future impacts of current policies.”)

The other two main options for managing surface transportation programs - cutting spending and raising taxes - are less politically palatable, though we expect a final deal could involve a share of each. The mix of solutions will depend on the election results, with a Republican sweep leading to possible spending cuts, and a Democratic triumph possibly leading to a gas tax increase.

CBO, meanwhile, floats the idea of a Vehicle Miles Traveled tax, or VMT, on page 10 of their study:

...a combination of fuel taxes and per-mile charges, sometimes called vehicle-miles-traveled taxes, could better offset the full costs that highway users impose on society. However, the systems necessary to administer

vehicle-miles-traveled taxes would be more complex than those used to collect the existing excise taxes on fuels.

We think the odds of such a tax being imposed this year or anytime in the current decade are near zero. However, the debate over alternative financing is worth keeping tabs on.

Another revenue angle is increased flexibility for the states to ratchet up tolling. This issue doesn't cut neatly along partisan lines, although the House, and Republicans in general, may be more amenable to using tolling as a component of a comprehensive solution.

CAFE: Elections Matter

Should Barack Obama be reelected, the new CAFE regulations will be cemented into place by industry accretion around them through 2017, the earliest year when he might be replaced by a Republican.

It's been suggested that because most of the automakers endorsed the new fuel economy rules, that there might be little incentive for Mitt Romney, should he be elected, to pursue changes. But we think the automakers' endorsement was somewhat less than wholehearted, and between Romney and a GOP-led Congress, we would expect aggressive moves to mitigate or even eliminate the new regulations.

We also hear that the NADA study we spotlighted in [our last CAFE note](#) - showing lower-income drivers being pushed out of the new car market by more expensive CAFE-compliant cars - has gone viral in many local publications and blogs. We don't expect it to impact the actions of a second Obama term, but it is likely to provide additional motivation to Republicans to combat the fuel economy mandate.

Previous Notes on This Topic

- [Automotive: Study on CAFE Costs Could Spark Fight](#) – April 12, 2011
- [Autos: CAFE Still in Play in Omnibus](#) – December 12, 2011
- [Autos: GOP Drops CAFE Rider](#) – December 8, 2011
- [Autos: CAFE Rule Unveiled](#) – November 16, 2011

Some Relevant Stocks

General Motors (GM), **Ford (F)** and Chrysler (owned by **Fiat SpA (F.BIT)**) all fare well under the regulation, which goes relatively easy on light trucks. **Toyota (TM)**, **Honda (HMC)** and other non-U.S.-based automakers were less enthusiastic at first but seem to have joined up, in hopes of winning concessions as the process unfolds.

Auto dealers are also watching the rule carefully, including **CarMax (KMX)**, **AutoNation (AN)**, and **Penske Automotive Group (PAG)**.

The regulation also has implications for major automotive component producers, including **MTOR**, **FDML**, **LEA**, **JCI**, **BWA**, **TRW**, **GNTX**, and **ALV**.

Capital Alpha Thesis

We expect the proposed rule to soften marginally over time through credits and provisions within the program, and possibly through external pressure from Congress. Each automaker will be affected differently under the new regulation, with negotiated provisions further complicating a simple reading of the rule. The final rule is scheduled to be released in July, but that could slip.

Analyst Certification

The following analysts hereby certify (1) that their views about any and all of the subject companies and securities discussed in this report are accurately expressed and (2) that no part of their compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this report: Charles Gabriel, Joseph Engelhard, Kim Monk, Rob Smith, Byron Callan, Loren Smith, James Lucier, Robert Kaminski..

Important Disclosures

This publication is for private circulation and distribution in its entirety; it is provided to you for information purposes only. This is not an offer to buy or sell or the solicitation of an offer to buy or sell any security/instrument or to participate in any particular trading strategy. Capital Alpha Partners, LLC makes every effort to use reliable, comprehensive information, but we do not represent or warrant that it is accurate or complete. The views in this publication are those of Capital Alpha Partners, LLC and are subject to change without notice. Capital Alpha Partners, LLC has no obligation to update its opinions or the information in this publication. Neither Capital Alpha Partners, LLC, nor any respective officers, directors, partners, employees, or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this publication or its contents. Analysts may own securities of the issuers discussed herein.

© Copyright Capital Alpha Partners, LLC (2012). All rights reserved. No part of this publication may be reproduced, sold, or redistributed without the prior written permission of Capital Alpha Partners, LLC.
