THE RAILROAD WEEK IN REVIEW
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You can load 286,000-lb cars to 4750 cubic feet with wheat or 5161 cubic feet of corn before hitting 286K. – Factoid from TRAINS

Shortlines finally won significant congressional support for infrastructure improvements in the form of tax credits. Just passed this Monday the law permits up to $3,500 per mile in direct tax liability offsets on a 50-50 basis. On the details, Keith Hartwell of Chambers, Conlon and Hartwell writes, "While the IRS will write regulations governing the details, you will note that it applies to money (capital and maintenance) spend in 2005, 2006 and 2007.

"You can carry forward any unused credit as provided under section 38 of the Internal Revenue Code. Because the Congress was required to determine and offset the cost of the legislation over a ten-year period the credit only applies to short lines in business as of January 1, 2005." To that, Bear Stearns' Tom Wadewitz adds in a note to clients, "We believe that this tax credit would provide both a modest book value tax rate benefit and a cash flow benefit for rails that are paying cash taxes."

I'll say. A 100-mile shortline spending $5,000 a mile in any mix of capex and expense gets a credit of $2,500 a mile or $250,000. Using the rule of 100, say it has 10,000 carloads a mile at $250 each and has an operating ratio of 85. It has loan interest payments of $50,000 a year plus that much again in non-federal taxes. With a net taxable income $275,000, federal taxes at 35% come to $96,250 less track tax credits. Wipe out the tax owed and carry forward $153,750 for next year.

The same railroad spending $7,000 a mile gets credits of $350,000 but if track spend goes over $7,000 a mile the 50-50 provision caps the credit at $3,500 a mile. This will work well for shortline holding companies with multiple lines operating at different FRA track classes and varying maintenance levels. I see shortlines starting to take a page from the Class I track maintenance play book, matching spends to the FRA class of track to service criteria.

Elsewhere, Congress acted on the fuel tax, but barely. The 4.3 cent per gallon fuel tax comes down by a penny on Jan 1, 2005, another penny July 1, with the remaining 2.3 cents in place until Jan 1, 2007. Hardly a windfall. Wall Street estimates CY 005 earnings impacts a max of 1.5% at UP to as little at 0.6% at NS. The typical 10,000-car shortline burns something on the order of 120,000 gallons a year so it's not going to amount to much – the equivalent of maybe another ten revenue carloads.

September quarter carloads are in. The AAR reported 3.1 mm revenue units (commodity plus intermodal) originated on North American railroads, up 4% or 131,000 units. By comparison GWR-North America posted a 22.5% gain or 9,877 units and RRA was up 10% or 9,424 units. By this count, these two alone accounted for 19,300 units -- 14.7% of the AAR gains.

Most shortline units originate or terminate on a Class I and thus are captured in the AAR car count. The Class Is say shortlines touch cars representing on average about 20% of their revenue so one could argue shortlines (using the 70+ lines owned by GWR and RRA as a proxy) in Sep are losing share. By my reckoning two-thirds of all shortlines are paid handling allowances or switching fees out of Class 1 revenues on a flat-fee, per car basis. The price increases the Class Is (and analysts) are raving about do not typically make it to the shortline, so the only route to increased revenues is through increased volumes.

A better way is to put shortlines on a modified interline settlement basis where the shortline gets a percent-of-revenue division but the Class I handles billing and collection. Used to be that would be a huge hassle where every rate request over a lane involving a shortline would require negotiation with the shortline in the route. With market-based pricing on the internet, the Class I simply shovels the shortline a percent of the through rate. The higher the rate the higher the division, giving the shortline an incentive to go after high-value. Or is that too easy?

Track Maintenance Redux. On old hand in shortlinedom and frequent contributor to these pages writes, "Aside from the operating considerations -- tonnage, speed, base condition (especially percent of CWR) and geographic location -- accounting practices vary significantly between railroads with respect to the capitalization policies used to classify track expenditures. Railroads with strong balance sheets may choose, for instance, to expense most tie replacement, while other roads concerned about bank loan covenants or GAAP earnings may capitalize all theirs.

"On capital projects, the former may use a minimal burden rate representing only costs directly associated with the project (for example employee fringe benefits and payroll taxes) whereas the latter (and many Class Is) will use a much higher burden rate to capture indirect costs, that then get pulled out of the P&L. The latter method is particularly favored by some short lines that receive substantial public grant assistance for track maintenance since they can use some of the assistance to cover overhead costs.

"Thus, at a minimum, an evaluation of whether a short line is maintaining its track needs to include both the expensed items as well as the capitalized ones. A thorough understanding, though, requires an analysis of the underlying requirement for track work based on the conditions outlined above. Usually a visual inspection will reveal more than financial analysis in this area." And that, gentle readers, is what's *really* needed on most independent shortlines. The new tax credit program could not have come along at a better time.

A shipper who has been a fairly consistent rail user writes, "Due to the slowing market for our products and the railroads' sporadic service, we have pulled a significant amount of volume from rail. As a result, our use of rail is at an all-time low for several facilities. Making bad matters worse, the railroads have responded to our complaints of poor service with rate increases, even though -- in several lanes -- trucking is a better option all things considered."

He notes that the railroads with the poorest service metrics have cost the better-performing roads business as splitting major moves between truck and rail adds too much internal cost at his volumes. His conclusion s most telling: "In my opinion the railroads need to be re-regulated and it's doubtful they will consider customer needs until that time." How sad, especially given the fact that he just completed major capital projects to improve rail access to two plants was considering same for a third. The worst part is this is one brush that may tar all.

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