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"The Board shall adopt a method for determining the reasonableness of rail rates based on the railroad's actual costs, including a portion of fixed costs and an adequate return on debt and equity." – HR 2125

There are now three very real governmental initiatives potentially hazardous to the health of short lines. In EP 646, decided Sep 5, the STB "seeks to make its rail rate dispute resolution procedures more affordable and accessible to shippers of small and medium-size shipments." Since small shippers dominate most short lines' customer lists, the threat of more rate cases to defend could very well make these small shippers less attractive to the Class Is. The STB still allows the Class Is to base rates on cost-of-service (see below) and as those costs escalate, rates go up (or yields go down), and the whole matter spirals out of control.

In EP 644, decided Sep 4, the STB has stated its intention to change the way railroads determine their cost of capital and thus "revenue adequacy." The Board concedes (in EP 646) that "rail carriers should have an opportunity to earn adequate revenues defined as those that are sufficient to cover operating expenses, support prudent capital outlays, repay a reasonable debt level, raise needed equity capital, and otherwise attract and retain capital in amounts adequate to provide a sound rail transportation system."

The current cost of capital methodology puts that number at 12.2% for 2005 and the proposed calculation drops it to 7.5%, a 40% haircut. The way this non-legal mind sees it, even as the STB allows rates at the 180% of variable cost model (variable means if you don't run the train you don't incur the cost, never mind that payrolls and maintenance budgets remain), if total revenues exceed the 7.5% cost of capital you become *too* revenue adequate and invite STB scrutiny.

Here again the short lines take it in the shorts because as revenues are constrained, Class I resources will be directed to the commodity O-D pairs that will produce acceptable revenue-cost ratios. That will inevitably lead to a lot fewer single-car movements. So it seems to me the shortline community would be well-served by getting the message to the Members in their districts that pushing down the allowed cost of capital by 40% while making it easier to get caught in a "small rate case" does not enhance the health of the short lines that serve the companies that employ their constituents.

But it gets even more preposterous. Congress has before it a pair of bills masquerading as the "Railroad Competition and Service Improvement Act," aka HR 2125. As I read the thing, it looks like an attempt to roll back the clock to the pre-Staggers dark ages, before the age of contract pricing, before the rails could shut down money-losing services, before the days of shortlines that were created out of money-losing Class I branch lines.

Call me paranoid but I'm beginning to see a common thread. Some members of the rail-shipper community feel they're paying too much for rail service so they call in their chits from their Members of Congress. They in turn ask the STB to look into it and the first thing the Board does is to go after "revenue adequacy" and "cost of capital" calculations. Then they make it easier for shippers to ask for redress when they feel they've been overcharged. And, oh yeah, while we're at it let's take a look at paper barriers, not coincidentally one of the first topics in HR 2125.

Jim McClellan, retired SVP of strategic planning for NS, was asked by *Argus Rail Business* to jot down some thoughts on this re-regulation theme for their Sep 17 issue. He takes the approach of "if I were a Class I CEO this is what I'd do" and proceeds to tell how he'd deal with a number of financial, operational and commercial matters. I thought it would be helpful to put Jim's observations in a shortline context and came up with this task list.

First, follow the money. If the railroad industry begins to look like the returns going forward are likely to be less than what they were, the effects of re-regulation could dampen the enthusiasm of new investors for further acquisitions. If your track's not in great shape already, finding the capital to fix secondary lines might get challenging. Considering the fact that many short lines are operating on FRA Class 2 track or worse and possibly not 286-compatible, service quality will degrade and with it the revenue stream.

Second, learn to cope with decreased margins. Short lines will be under greater pressure to, as CFQ's Marc Laliberte put it, "harmonize" objectives with those of the connecting class I. The new core business model for Class Is will be intermodal and unit trains so the single-carload merch business is going to be at risk in many lanes. Service disconnects will kill the weakest links fastest.

Third, find competitive advantages. The Class Is will expand transload operations to cut local train-starts, turn equipment faster, and squeeze what incremental improvement they can out of margins. It will not be good for short line gathering and distribution networks unless they can offer competitive advantages. Chems, coal and grain are main regulated commodities in this context and short lines have significant roles in two out of three. High margin chems (think ferts, plastics and not the nasty stuff) can cover a lot of sins brought on by wood chips and aggregates. Take 'em away and what's left isn't pretty.

Fourth, acquire or be acquired. The need to reduce overhead costs will lead to more bundling of short line operations a la GWR or Watco or RRA. There will be fewer stand-alone mom-and-pop short lines; any stand-alone short line with annual revenues less than $1 mm will be at increased risk.
Fifth, move faster. Under re-regulation the single-carload network will shrink in any event and short lines will have to act quickly to change their business models to adapt. Not doing so will lead to becoming another fallen flag.

So the argument seems to be that the combination of STB actions on the cost of capital, small rate cases and paper barriers, plus passage of HR 2125, will lead to less capex, less capacity, and certainly fewer rail transportation options. Yet against this backdrop a recently hatched AAR study suggests that the present rail infrastructure – track, locos, cars – will need a $148 *billion* infusion over the next 30 years to meet future demand.

As is, the Class Is are investing more than $9 bn in 2007 alone to add track, locos, cars, IT systems, and so forth, a large chunk of which is for replacing what wears out. The AAR study says it's about $1.4 bn a year short and "without this investment, 30% of the rail miles in the primary corridors will be operating above capacity by 2035, causing severe congestion that will affect every region of the country and potentially shift freight to an already heavily congested highway system."

And so it is that the Members and the STB are conspiring to dis-incent railroad managers from making the kinds of capital investments the country needs to avoid total gridlock. As Mrs. Allen says in Jane Austen's *Northanger Abbey*, "The government has lost all sense of reason."

Does Wall Street get it? I'm not so sure. There doesn't seem to have been much ink on the subject of The Three Threats although a number of the regulars have weighed in on the benefit or harm of this week's interest rate cut. My read is that the intense focus on this quarter and the next and the impact of negative deltas in yoy loadings has clouded the longer outlook. Yet a common Class I thread during the Q2 analyst presentations has been “limit our ability to get the rates we need to make the capital requirements you need and you may not like what you get.”

My sense is that the net effect of the HR 2125 bill passing will be lower yoy volumes and lower yoy earnings for several years. There could even be cut-backs in share repurchases and if it gets tight enough dividends might be at risk. Then where would the PE guys with their cries for greater shareholder returns be? Certainly not in railroads.

But there’s hope here. As Atlas shrugs, the railroads will reinvent themselves as conveyor belts with limited or no rail-bound gathering and distribution networks, fewer local train-starts, and certainly a much smaller number of short lines. Maybe that’ll be the time to emerge from Galt’s Gulch.

A good friend who’s been in this business long enough to know his way around has a different take on the CP-DME deal and his network description is particularly insightful. He writes, “I was intrigued that you don't buy the street argument that CP overpaid. It could be that part of CP’s motivation to pay up may have been to use DME as a poison pill backup to the credit crunch -- they put the stake through any levered transactions for a good while.

“But they also decided to pay up in a most uncharacteristically CP way. In fact, it seems everyone thought that they would participate in a deal with many moving parts in a non-control posture so as not to anger US connections -- that would have been characteristic. But did they make such a dumb deal? Skeptics [and I may be one of ‘em – rhb] say they’ll never build the PRB -- that a deal was cooked. I beg to differ.

“All of the PRB compensation is contingent, so the ‘real’ price for the DME shares is 1.5 bn (my understanding this is not including debt assumed) plus $230 mm for the 2003 RRIF debt plus another $48 mm 2006-7 RRIF debt.” If that be the case, the price is closer to $1.7 bn assuming they have to pay off all the loans. Ebitda for the DME was given as $100 mm (WIR 9/7/2007) so we’re looking at a 17x multiple. Steep. However, they said on the call they could double ebitda in short order to $200 mm, so we may be looking at an effective 8.5x multiple.

My friend continues, “This is a brand new management with none of the Montreal mindset and apparently they decided to bet the farm. Why? CP is an also-ran in Eastern Canada except intermodal and autos. CN is working on dominating in IM and Prince Rupert is their latest move. CP has no real options here, just Canadian ports of Montreal in East and Vancouver in West. But these two ports are against a wall -- Montreal too far to steam down the St. Lawrence and Van has space issues big time.

“What about autos? Southern Ontario is the functional equivalent of a Detroit suburb and we all know what is going on in Detroit. What about minerals? Very strong in potash but so is CN. Pacific met coal is a big winner for CP, but this market is being seriously challenged by Australia and now Indonesia. CP’s routes across the Eastern US are on OPR (other people’s rails) so their reach is limited east of Chicago and you see why a master stroke may have been needed, and asap. P.S. When viewed from Calgary, Chicago *is* the East.” Well said, friend. Next?

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