

**American Short Line and
Regional Railroad Association**

The Voice of America's Independent Railroads

April 15, 2013

The Honorable Kevin Brady
Energy Tax Reform Working Group
US House of Representatives
Washington, DC 20515

The Honorable Mike Thompson
Energy Tax Reform Working Group
US House of Representatives
Washington, DC 20515

COMMENTS: ENERGY TAX REFORM WORKING GROUP

Dear Representative Brady and Representative Thompson:

On behalf of America's short line and regional freight railroads I thank both of you for your repeated co-sponsorship of the Section 45G railroad track maintenance credit. The following remarks are submitted on behalf of the 500 railroads and 447 rail supply and contracting company members of the American Short Line and Regional Railroad Association.

Why are these comments directed to the Energy Tax Reform Working Group?

There is no "transportation" working group among the eleven groups created by Chairman Camp and Ranking Member Levin. ASLRRA has instead addressed comments to both the "Energy" and "Manufacturing" working groups. Freight railroads are the most fuel-efficient way to move goods, including energy-related raw materials. Short lines move tremendous amounts of crude oil and coal, and the pipe, sand, and other materials essential to enhanced oil and natural gas recovery. Section 45G and short lines have a key role in maintaining America's growing domestic energy independence.

It is my hope that you can assist ASLRRA by inserting appropriate reference to these comments and the benefits of 45G in the record of the Tax Reform Working Groups.



Figure 1 - Farmrail System, Inc. hauls hopper cars of frac sand destined for oil wells in western Oklahoma. Photo: Dave Snyder courtesy of Farmrail System, Inc.

What is a short line?



Figure 2 - Fort Worth & Western Railroad delivers a new electrical transformer for Comanche Peak Nuclear Power Plant. Photo: Ken Fitzgerald, fl9.com

“Short line and regional freight railroads” (collectively referenced here as “short lines”) are “Class II” and “Class III” railroads as defined by the federal Surface Transportation Board, but they are small businesses by any definition and 335 short lines have gross revenues of \$5 million or less. Less than 10% of short lines have gross revenues in excess of \$20 million. Class II railroads have gross revenues between \$433 million and \$34.6 million and have combined estimated revenues of \$1.2 billion. Class III railroads have gross revenues between \$34.6 million and \$0 and the 537 Class III railroads had total combined revenues of \$2.1 billion. For

context, the seven large Class I railroads that do not qualify for 45G have collective revenues of \$65 billion.

Short lines are unique in many ways. They must maintain extensive track structures under federal common carrier obligations on very limited and regulated revenues. Their competition is heavily subsidized by state and federal taxpayers. They have substantial federal payroll taxes that are not imposed on other industries. The cost of maintaining their infrastructure to federally regulated standards is so high that even the best short line operators must reinvest 18 to 25 percent of revenue to maintain the status quo. For some, this figure is as high as 33 percent of revenue. As a group, the costs and regulations imposed on short lines make them different from many other industries using business tax credits.

Short lines and American energy independence

Short lines use approximately 184 million gallons of fuel to move 10 million carloads of freight annually in comparison to the billions of gallons of fuel required to move a fraction of that traffic by truck.

Short line railroads in Pennsylvania have played important roles in the development of the Marcellus Shale and have enhanced natural gas production. Over fifty short line freight railroad companies operate in Pennsylvania, many in the heart of the shale formation. A key to enhanced oil and gas recovery from shale formations is frac sand. Short lines in Michigan, Wisconsin, and Illinois load frac sand that is delivered by rail to short lines in Pennsylvania for final delivery to wells. Fracking costs would rise significantly without short line transportation.

Short lines are involved in shale oil in North Dakota, Oklahoma, Texas, and Ohio. Crude oil is moving by rail allowing American oil companies to produce light sweet crude with transportation flexibility and pricing margins not available by pipeline and at a lower cost and societal impact than comparable truck transportation.



Figure 3 - "Unit trains" of crude oil handled by short line railroads can be over a mile long. Photo: Watco Companies, Inc.

Why are short lines worth preserving?

Over 550 short lines preserve 47,000 miles of track that would have likely been abandoned under previous large railroad owners. This track received little investment by its previous Class I owners and must be upgraded to keep over 10,000 rail customers connected to the national rail network. These rail connections are critical to preserving the first and last mile of connectivity to oil and natural gas fields, coal mines, frac sand pits, power plants, refineries, and thousands of other facilities that employ over 1 million Americans. Entrepreneurial short lines are able to respond flexibly to customer needs. But, short lines cannot change the cost required to maintain and upgrade their track.

While highway infrastructure is maintained by federal and state governments, freight rail infrastructure is maintained by private sector investments. A recent preliminary analysis of short line traffic estimated that it would require 8,420,000 additional trucks traveling 13,411,400,000 highway miles and burning 2,000,000,000 gallons of diesel fuel to move 25% of current short line traffic from origin to destination. The associated congestion, pollution, highway damage, and increased cost to customers makes the case for preserving short lines.

What is the underlying public policy goal of Section 45G?

In 2003, Rep. Jerry Moran and Rep. Dave Camp introduced H.R. 876 (108th Cong.). That bill amassed 267 co-sponsors and was the basis for Section 45G as enacted in the American Jobs Creation Act of 2004. Short lines continue to be confronted with three serious externalities that they faced in 2003:

- (1) **The "286" problem:** Infrastructure acquired from previous Class I owners could be safely operated with rail car weights of 263,000 pounds. However, when customers and large railroads moved to pricing and equipment that favored 286,000 pound loads short lines were forced to upgrade track or else their customers would be at a competitive disadvantage.
- (2) **Taxpayer subsidized truck competition:** Short lines lack the ability to increase rates to cover their higher infrastructure costs because an increase in rates would drive traffic to fierce trucking competitors that benefit from highway infrastructure that is heavily subsidized by automobiles. Failure of short lines, or dramatic increases in short line rates, would increase truck traffic on highways. This is a less energy and resource efficient outcome that Congress sought to avoid.

(3) **Contractual and regulatory rate limitations:** Railroad rates are closely regulated by the Surface Transportation Board and short lines do not have full pricing freedom.

The combined effects of these externalities threaten rail service in communities served by short lines. When short lines are abandoned or can no longer handle freight for a customer, that customer must either close its doors, move to another location, or ship goods by truck. Moving goods from origin to destination by truck would create billions of additional truck-miles every year. The costs to the taxpayer would run into the hundreds of millions of dollars.



Figure 4 - A Watco locomotive helps load a crude oil train. Photo: Watco Companies, Inc.

In 2004 it was recognized that a 1970's-style grant program would be a poor solution to the system-wide infrastructure shortfall caused by increasing rail car weights. The old "solutions" of grants, subsidized loans, and the nationalization of larger bankrupt railroads had not enhanced the short line system. To the contrary, the previous approaches had failed with regard to infrastructure. To Rep. Moran and Rep. Camp, government was not the solution. The market was the solution. The solution adopted in the JOBS Act used a business tax credit to reduce the federal tax burden and allow these small, local, and entrepreneurial businesses to retain more of the income that they earn and to reinvest that revenue in rail infrastructure.

Summary of Section 45G

Section 45G provides a 50 percent credit on "qualified railroad track maintenance expenditures." 26 USC 45G(a). This credit is capped at the product of \$3,500 multiplied by the number of miles of railroad track owned or leased by the eligible taxpayer. (b)(1). With roughly 47,000 miles of short line track, the credit has consistently been given a 10-year score by the Joint Committee of \$165.5 million for each year extended. Qualified expenditures are generally those made to roadbed, bridges, and related track structures. (d). Some short lines operate at a minimal profit, not all short lines have sufficient tax liability to utilize the credit, and roughly two-dozen freight railroads are tax-exempt units of local governments. For these reasons the credit allows a limited class of eligible taxpayers to earn credits, such as railroad customers, provided that those customers pay for or incur the qualified expenditures. (b)(1)(B)(ii) and (c)(2). However, each dollar of mileage-based credit limitation may only be claimed by one taxpayer. (b)(2).

A Pro-Growth Tax Code

Increased investment by small businesses leads directly to economic growth and job creation. The 45G credit increases investment by small business in the transportation sector.

Most short line railroads are small pass-through entities and pay taxes on an individual basis. Any proposal that trades the 45G credits for a lower corporate tax rate will have profoundly negative impacts on infrastructure investment made by these small businesses. A lower corporate income tax rate is a laudable goal supported by ASLRRRA. But a lower corporate rate will not create private-sector short line infrastructure investment to the same extent as 45G. Elimination of the 45G credit will raise taxes on private-sector infrastructure investment, and this will result in less private-sector infrastructure investment.

The 45G credit would be less defensible if the policy goal of increasing track expenditures was not aligned with the primary need of short line railroads. Thankfully, the credit allows small local railroads to keep more of the revenue that they earn to reinvest in infrastructure that benefits thousands of communities and customers. The credit allows the market and taxpayers to determine which investments are most critical to moving railroad customer traffic. The credit encourages cooperation between railroads and customers. Creating incentives for customers to invest private sector funds in freight infrastructure ensures that heavy truck traffic stays off of the nation's woefully underfunded highway infrastructure and creates a fair system of infrastructure financing.

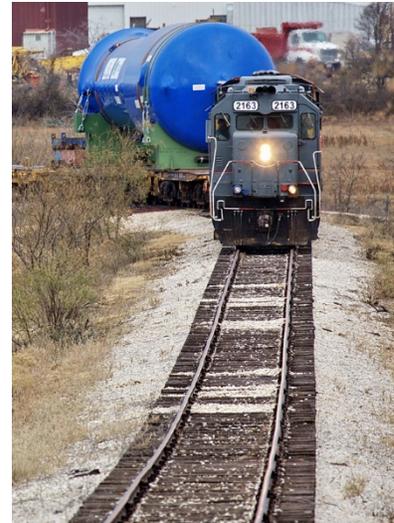


Figure 5 - Fort Worth and Western Railroad delivers a trainload of 200-ton steam generators for the Comanche Peak Nuclear Power Plant. Photo: Ken Fitzgerald, fl9.com

Impact of the Current Code

Simplicity, not complexity

The 45G credit is a model of efficiency and simplicity that should be mirrored elsewhere. Most short line railroads are small pass-through entities and at this time of year the complexity of the tax code is readily apparent to individual taxpayers. The 45G credit is claimed by filing Form 8900. This form is one-third of a page long and consists of ten lines. **The form is simple because the tax credit is simple to calculate and simple to utilize.** The form is not required for taxpayers if the only source of 45G credit is from a pass-through entity. Those taxpayers may report the 45G credit directly on Form 3800. While the Form 3800 is admittedly more complex, this has not proven to be daunting to the short line industry and the complexity of other business credits does not strike ASLRRRA's members as a sufficient reason to dispense with a statute that works so well in practice.

The simplicity of Form 8900 and 45G is apparent when compared to alternative financing mechanisms attempted in the past to preserve short line infrastructure such as federal grants and loans. If the goal of tax reform is to lower rates so as to encourage real investment, to allow business and the market to decide where and how to best invest the money they earn, and to simplify to code, then the 45G credit has proven in practice to be consistent with those goals.

Fairness

Once the determination has been made that there is a national interest in preserving local freight transportation then the universal application of 45G across the short line industry is the fairest solution for increasing infrastructure investment. The 45G credit is available to corporations and pass-through entity railroads. Railroads without current year tax liability can still realize increased investments by partnering with eligible taxpaying customers and suppliers. To prevent secondary markets in 45G credits, credits can only be assigned once, and they can only be assigned to entities with a direct participation in moving goods by rail and improving track conditions.

Federal grants and loans can be used very effectively to preserve local freight transportation in the national interest. However, such approaches cannot provide the same level of universal application paired with market-driven decision making that is available under 45G.

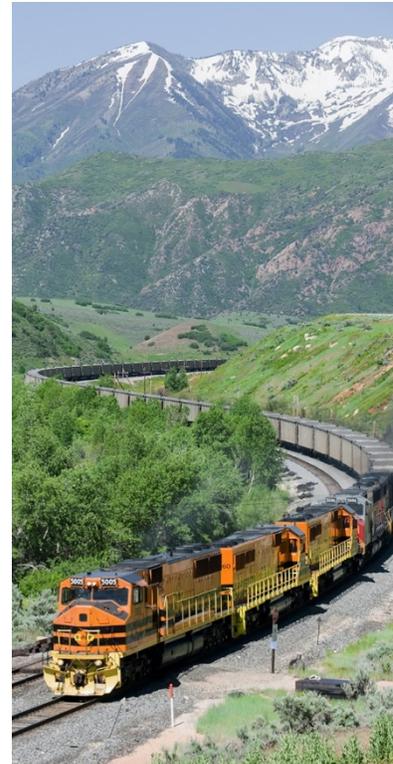


Figure 6 - Utah Railway hauls a unit coal train. Photo: Genesee & Wyoming, Inc.

Capital Investment

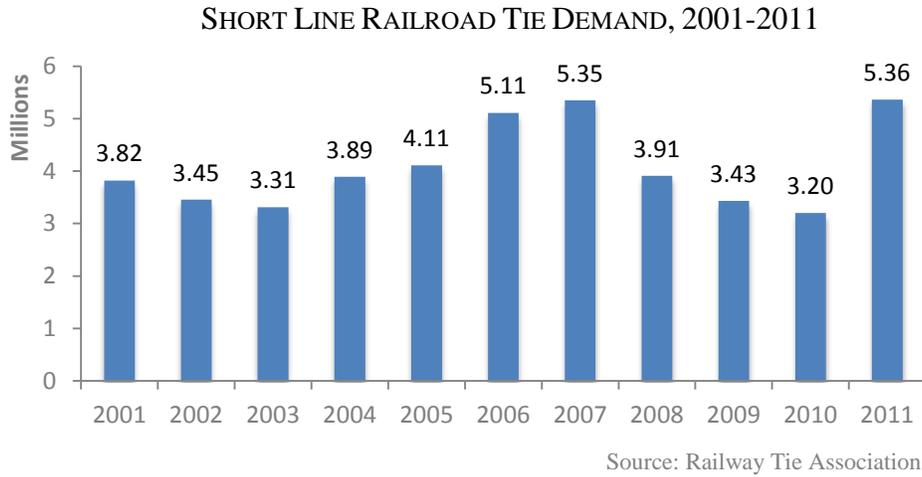
Short line track investment is up dramatically since the credit went into effect in 2005. The best evidence for increased investment comes from tie orders, a leading indicator of rail rehabilitation. Railroad tie replacement is the first and most cost-effective step that can be taken to increase the handling capacity of a railroad. The direct impact of the credit, and the downsides of the biennial legislative tax extenders process can be shown in the following data produced by the Railway Tie Association (RTA).

For over a century the RTA has tracked tie demand and production to model the market for its tie-producing members. Following enactment of the American Taxpayer Relief Act, RTA Executive Director Jim Gauntt reported the following on January 7, 2013:

[T]he 45G... Tax Credit [has] been authorized retroactively for 2012 and extended for 2013... For RTA members this is a game changing piece of legislation for hardwood and softwood tie demand for 2013. Updated with this news, the RTA econometric tie demand forecasting model now suggests that at least 500,000 ties to as many as 1,200,000 million ties will be added to the market demand for 2013. This raises the total 2013 forecast for new wood tie demand to 23.3 million, on the low-end, to an upper-end of 24.0 million. This is an immediate positive for loggers, sawmills, and wood treaters.

The RTA's data shows that short line tie demand remained relatively stable at around 3.6 million ties per year in the four years prior to enactment of Section 45G. In 2005, the first year of the credit, tie demand began a modest uptick. IRS regulations were not issued until 2006, and further statutory changes followed to resolve uncertainty created by those regulations. Only a

modest uptick in tie orders would be expected in 2005 under such uncertain regulatory conditions. As 45G became widely utilized in 2006 and 2007, tie orders were up dramatically to over 5.1 and 5.3 million ties respectively. The expiration of the credit at the end of 2007 combined with the economic downturn to depress tie orders for 2008 and 2009. The continuing recession and a 50-week gap in the effective period during 2010 caused by a delayed extension pushed tie demand below pre-45G levels. In the face of continued depressed economic activity, the extension of 45G in the closing weeks of 2010 is the primary factor contributing to the demand skyrocketing to over 5.3 million ties in 2011.



The projected increase in tie purchases for 2013 translates into between \$22 million and \$54 million in tie purchases, before installation labor costs. For many small sawmills in timber producing states this means the difference between keeping a mill open, and shuttering it temporarily for a lack of business. This has been especially true in recent years as timber demand for housing starts has been depressed.



Figure 7 - Farmrail System, Inc. hauls a train of crude oil from newly opened oil fields in western Oklahoma along lines that once predominately served grain elevators. Photo: Dave Snyder courtesy of Farmrail System, Inc.

Short Line Infrastructure Cost Recovery

Railroad assets have long physical lives. It is common to find short line railroads operating on steel track that was manufactured more than a century before. One recent short line infrastructure effort proposed replacing several miles of steel rails that were made in the same month that Adm. Robert Peary returned successfully from the North Pole (Nov. 1909) and another rail segment made the same month the Red Sox traded Babe Ruth to the Yankees (Jan.

1920). Unfortunately, this steel is far beyond its useful life. While the assets have long useful physical lives, they are extremely expensive in comparison to the revenues of most rail lines.

Questions posed by the Working Groups have asked commenters to describe how companies rely on or take advantage of cost recovery provisions such as accelerated depreciation. In the short line industry, tax depreciation is not, by itself, a reason to invest in track infrastructure. Most short line assets have book lives of several decades and most are depreciated on a seven-year Modified Accelerated Cost Recovery System, or occasionally 10-year straight line methods. Short lines have such significant infrastructure shortfalls that accelerated depreciation makes a poor incentive for investment. Section 45G, by comparison does create investment by stretching investment dollars by 50%, allowing short lines to make more investment.

Changes to depreciation or expensing rules cannot solve this problem

Prior to and after the enactment of Section 45G railroads could utilize safe harbor expensing provisions under Rev. Proc. 2002-65 and expense 75% of track expenditures as maintenance. With the utilization of favorable expensing and accelerated depreciation, short lines were unable to generate cash flow and resources necessary to overcome their infrastructure shortfalls.



Figure 8 - A Watco locomotive hauls wind turbine towers.
Photo: Watco Companies, Inc.

The 45G credit overcomes this obstacle in three ways. First, Congress adopted Section 45G in full recognition that the existing expensing and depreciation was insufficient and must be taken into account by defining qualified expenditures as “expenditures... whether or not chargeable to capital account...” This further recognizes the economic reality that maintaining an existing line at a safe and efficient state of good repair can be a challenging task on limited revenues.

Second, 45G allows railroads with a federal tax liability to use the credit directly, thereby freeing up resources for additional track investment.

Finally, 45G allows railroads without a current year tax liability to partner with a customer, contractor, supplier, or another railroad to pay or incur qualified expenditures and claim the credit if they have an economic interest in transporting goods over the rail line.

Relying on straight expensing won’t result in increased track investment. Under the accelerated depreciation and expensing described above, short lines were unable to overcome the infrastructure shortfalls handicapping their customer’s ability to reach distant and ever extending markets by rail. Many short line railroads operate at minimal profits because they have low revenues and pricing flexibility in comparison to the significant public benefits that they create.

Summary of Observations and Recommendations

The short line railroad industry plays a role in energy extraction, production, and transportation of biofuels, coal, wind turbines, nuclear power equipment, and the extraction and transportation of oil and natural gas from new shale formations that is rapidly moving America towards energy independence. Short lines preserve fuel efficient transportation for thousands of railroad customers that would otherwise be cut off from rail options all together. Section 45G has the following advantages:

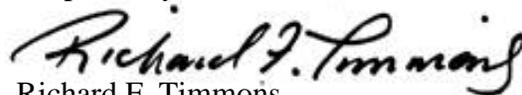
- (1) It is very **simple** and **straightforward**: Form 8900 is a mere 10 lines long;
- (2) It is **fair**: Both corporations and pass-through entities can take advantage of 45G;
- (3) It **supports real infrastructure and capital investment**: By letting small businesses retain more of their revenues, it allows these railroads to address the greatest challenge facing railroads and their customers.

ASLRRA makes the following observations and recommendations as you weigh tax reform:

- (1) Using the 45G credit to “pay for” reductions in the corporate rate would increase taxes on short line railroad infrastructure investment and decrease the level of investment, particularly for the large number of short lines that are pass-through entities. ASLRRA supports reductions in corporate rates, but **corporate rate reductions would not offset the loss of investment caused by eliminating 45G.**
- (2) **Accelerated depreciation and expensing of capital investments does not in itself increase short line infrastructure investment**, particularly investments funded by railroad customers through 45G assignments that would not occur absent 45G.
- (3) The **45G credit is capped, simple, fair, transparent**, and a great facilitator for **real private sector investment** that benefits the public at large. ASLRRA recommends the methodologies utilized by 45G as you look at ways to simplify the tax code.

I thank you for the opportunity to comment on your process and I thank you for your support.

Respectfully,



Richard F. Timmons

President

American Short Line and Regional Railroad Association