Add PTC, Subtract Tax Credit

Net Result? Fewer Ties Than Forecast Predicts

By Jim Gauntt

This year's mid-summer forecast for tie demand shows a still weakening marketplace. It should be noted that January's baseline forecast placed tie demand at 19.4 million ties. With additional data input, the new forecast from the economic model suggests tie demand right at 19 million for 2010.

Unfortunately, the data through June 2010 show the 12-month rolling total of annual purchases at only 18 million ties. While a rebound may be under way, there are reasons that this recovery will likely be slower and weaker than desired.

Positive Train Control

The first problem to look at is the unfunded federal mandate for installation and operation of Positive Train Control (PTC). PTC is a very complicated and expensive process Class 1s and others must implement that will allow a train to be stopped by a dispatch or other controlling central office if it were to be headed into an unsafe situation. The idea is to help increase safety by providing a central mechanism that could avoid collisions or other accidents.

The cost for Class 1s to implement? Six to seven billion dollars or more between 2009 and 2015. Has the federal government provide any funding for this? Not a penny—at least not yet.

So where does the money come from to do all of this? The railroads have to realign their budgets to do it out-of-pocket. According to industry sources, that tab was around $720 million in 2009. In 2010, it will exceed $1 billion. Over the remaining years of implementation the average out-of-pocket expense, absent some forms of government assistance or tax incentives, would be between $700 million to $1 billion annually. Furthermore, following full implementation the ongoing cost for maintenance for the Class 1s is estimated to remain as high as $700 million annually.

The implications are clear. Other budget desires will suffer. The Association of American Railroads (AAR) reports that this will have the effect of absorbing almost all of the growth capital and capacity-improving technology for the next six years. During this time no one is suggesting that railroads won't invest in their plant so that all operations will be maintained in safe and profitable ways. But the elective items that could provide for that extra bit of capacity or efficiency, for example, will be subject to budget realities now and in the foreseeable future.

Thus, it is hard to see how some purchases of rail, ties and equipment, for example, won't be affected.

Short Line Tax Credit

The second issue is the lack of certainty in the realm of extending the short line tax credit. There is considerable optimism that it will be renewed and be retroactive for 2010 expenditures. However, that has not happened yet. And, it has been very obvious to industry observers over the years that without the certainty of the tax credit in place, short lines and regional roads don't spend as much as they would if they could bank on the credit in advance of purchases.

These items, and others that concern railroad decision makers about the future, no doubt play a role in the weakened demand for ties so far experienced in 2010.

Fundamentally, though, the demand should be higher based on economic growth and should be a positive for tie suppliers going forward. On the other hand, PTC will certainly constrain capital availability for several years to come with the likely effect of dampening demand to some extent.

In one sense, especially given the state of production in the tie industry to date in 2010, softer demand for a short period of time could be an undesired but mixed blessing. But, in fact, the opposite appears to be occurring. With the 12-month rolling total for production through June tallying 16.5 million ties and the rolling total purchases at 18 million, an imbalance is beginning to emerge.

Industry observers suggest that the final total for production in 2010 may settle in between 17 million to 17.3 million ties. Even if production recovers to this level from the 16.5 million being reported as of June, if purchases continue to rebound, any excess inventory in the system will quickly evaporate. This appears to already be occurring. The June inventory-to-sales ratio dropped significantly from 0.98 to 0.90 in only a 30-day span.

Thus, there isn't a lot of room for error if tie purchases were to leap-frog toward 19 million as the forecast suggests. If this demand continues to ramp up quicker than supply can recover, regional shortages could pose issues for all players.

The Railway Tie Association believes that demand continues to improve throughout the summer and early fall. The amount of this surge will likely be measured, though, and not reach forecasted 18.9-19.0 million ties by year end. A more likely scenario is 18.4-18.5 million. This should have the effect of continuing to lower the inventory-to-sales ratio as production attempts to recover at a measured pace. §