THE RAILROAD WEEK IN REVIEW
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"The impatient money that is out there sometimes is not consistent with a long cycle business like the railroad where we are making decisions for 20-year assets like locomotives or 30 to 40 years for track."-- Matt Rose, CEO of BNSF Railway, on Bloomberg Television

Bloomberg Television's Betty Liu spoke with Rose earlier this week about the Berkshire deal and why it was good for Burlington Northern Santa Fe. Rose also spoke about oil prices, the coal industry and his observations about China. Some highlights:

"When I first became CEO, the equity markets really wanted to hear your three to seven-year plans. Some wanted as short-term as three years, but there were other people, institutional investors, that were really interested in looking at business plans out to seven years. Today, that has changed. It has become impatient money that is sometimes not consistent with a long cycle business like the railroad where we are making decisions for 20-year assets like locomotives or 30 to 40 years for track.

"The West is where the growth is. That is just the nature of the beast. We have seen a great migration from the North and the East to the West. We also know that the heaviest trade lane is going to be in Asia but we have bottlenecks all over the railroad industry, just like we have bottlenecks in the airport business and highways. We have put together a multibillion plan to fix it by increasing speed and putting in new technology -- things like that.

"I personally don't see the demand to support current oil prices. As of this morning it was just a touch over $80 a barrel, but I don't think that's sustainable. It is probably not going to $60 either, though we tend to lose sight of the relative differences. If oil were to go down to $60, we would say, oh boy, fuel is really cheap. Remember, it was $25 a mere six years ago."

As for coal, "BNSF could survive even if we were to get rid of every coal asset in this country. The problem is the *country* couldn't survive. We rely on affordable, reliable energy in this country and we need to find ways to put less carbon in our environment. But you can't go in and do harm by shutting down a coal-fired generating plant that produces electricity at two or three cents a kilowatt and try to replace it with alternative energy at ten, 15 or even 20 cents a kilowatt.

"Doing so would be the greatest job destroyer that our country has ever seen. Moreover, if you were to look at the state-by-state cost per kilowatt and then put that against unemployment, many of the states with the lowest electricity costs are the states that are doing the best and have the lowest unemployment levels. That's the reason is it is a competitiveness issue." [I wrote a brief treatise on Red State, Blue State, right-to-work or not state in WIR way back in November, 2008. One indicator was the growth of short lines in those states vs. virtual stagnation in the Blue states. -- rhb]

Finally, Rose addressed the Washington situation. "It is hard for members of Congress, and even for the Administration, [to understand the railroad message] because the DOT is really focused on airlines, which they should be. Highways are the second love and the railroads are way down on the list. It's not because they don't love the railroads. It's that they don't appropriate dollars to the railroads and that [politicians tend to] love the people that they appropriate dollars for."

The annual Berkshire Hathaway Letter to Shareholders is always a treasure trove of business insights and the 2009 Letter is no exception. It's available for downloading at

www.berkshirehathaway.com and contains good guidance as to how to run a healthy short line, even if not couched exactly in those terms. Start with the basic rules under "What We Don't Do" on page 4. Not only do these rules speak volumes about how BNSF wound up in the Berkshire fold but they also flag what BNSF short lines can do to fit the Berkshire mold. Here are some excerpts rephrased as admonitions for shortline owners and operators:

Avoid businesses you can't evaluate no matter how exciting their products may be. For shortline owners, that includes the sometime-shippers who talk a great game but whose business premises are shaky. See the MMA paper customers, below.

Never become dependent on the kindness of strangers; arrange your affairs so that any requirements for cash are dwarfed by your own liquidity. Too many short lines fall woefully short here. Look at the Railroad Day on the Hill begathon and the clamor for state rail freight grants. I would argue that any railroad that cannot stay afloat by dint of its own cash flow may be more of a drag on the fraternity than a contributor to the good of the order.

*Be sure decision-making occurs at the operating leve*l; *avoid becoming a monolith that is overrun by committees.* As a Buffett-watcher for more than 20 years and as one who eats his own cooking by holding more Berkshire-B shares than anything else in his IRA, I can safely say Buffett expects this decision-making behavior at the companies he owns. It's a great time for shortline owners to go to BNSF with sound recommendations where the homework has been done and there is reason to expect prompt and fair action.

Keep communications with stakeholders as direct and unabridged as possible. Buffett expects that his own personal values -- openness, integrity, extreme honesty -- be reflected at his companies. There is a scathing account of what happens when somebody reporting to Buffett is less than forthright in Alice Schroeder's *Snowball* biography. Read Chapter 49 re Salomon and the "Sternlight letter." Particularly tasty is the bottom of page 605 beginning, "When Buffett got back to Salomon...he was livid...Buffett's and Munger's attitudes towards management hardened." The remark about personal values above is part of this section.

The saga of the Montreal Maine & Atlantic is instructive because it violates the rules about evaluating businesses and becoming dependent on the kindness of strangers. A news item in the Feb 19 *Bangor Daily News* reports that some of the largest employers in the MMA service area went before the Maine legislature to say that loss of rail service "would devastate the region's economy." At issue was a legislative hearing on a proposed $20 million state bond issue earmarked to buy the 241 miles up for abandonment.

For its part, MMA says it's now down to 9,000 revenue units a year from 15,000 just four years ago. Get out your Rule of 100 calculator and do the math: 9,000 cars a year on 242 miles of track is 37 cars a mile, a third of what you need to run a profitable railroad. Yet the newspaper quotes a paper shipper who says, "Our survival is dependent on getting our products to our customers in the most efficient and cost-effective manner. Increased freight costs would significantly decrease our operating margins, threatening the continued operations of our mills."

None other than the Maine DOT has called the line "questionable" according to the March 2 *Atlantic Northeast Rails & Ports* newsletter from Chop Hardenbergh. The report concluded that -- even though there remain viable rail customers -- the debt load is what's killing the railroad. "A nominally profitable operation could be run by a third party operator as long as current traffic does not decline further and a large debt obligation was not required."

Debt service is not part of the Rule of 100 calculation, nor was it ever meant to be. Maintaining 241 miles of railroad averages about $5,000 per mile per year; it could be more in Northern Maine. But assuming the number fits, that's one-point-two million a year just to keep it at FRA class 2 and 25 mph max speed. On a traffic base of 9,000 cars, track then costs $134 a car. That's no way to run a railroad, and MMA has correctly concluded it can't.

As for the shippers, it's use it or lose it. The railroad is absolute and unforgiving. Stuff wears out and gets used up and has to be replaced. It makes no difference who's writing the checks - the railroad remains a wasting asset and the piper must be paid. A ton of debt only makes it worse.

The Californians are at it again, this time by moving to cut emissions by outlawing corn-based ethanol. The California Air Resources Board (CARB) recently passed a "Low Carbon Fuel Standard" that if enacted would penalize corn-based ethanol and could open the door to the exclusive use of imported Brazilian sugarcane-based ethanol in the California market. Shell International Petroleum Co. is making a major investment in ethanol production to fill this need through a joint venture with Cosan, Brazil's largest ethanol and sugar producer.

The California Energy Commission report dated August 2009 predicts the state will need 1.2 billon gallons of ethanol (enough to fill 40,000 tank cars) for auto fuel blends in 2010, doubling in ten years. The Renewable Fuels Association says Iowa, Nebraska and Illinois are the top three ethanol producing states with just under half the total US capacity. The AAR waybill samples aggregated at www.usraildesktop.com put the combined BNSF and UP ethanol haulage at roughly 160,000 loads a year. Let's say California represents a quarter of the ethanol business on the western roads with the bulk of it out of the Midwest.

With each western Class I road handling more than two million revenue units a year, ethanol volumes are not that big a deal. And if the shift to cane-based ethanol becomes a fact, the Class Is will handle most of it anyway -- unless it comes through the Panama Canal. On the other hand, there are in the three top ethanol states a goodly number of short lines that make a living on ethanol so the drying up of the California corn-based ethanol market could exact a heavy shortline toll.

The Washington scene continues to grab headlines. From UBS rail analyst Rick Paterson comes this cheery note: "The squabbling in Congress and legislative gridlock after the important election in Massachusetts last month should be music to the ears of rail investors. A report by the House of Reps lists 290 bills passed by the House that are now stalled and awaiting deliberations in the Senate. With the White House imploring Congress to prioritize job creation, healthcare reform, and financial regulation, the odds that re-reg happens in 2010 appear increasingly long.

"Where is railroad legislation on the priority list? Nowhere. Freight doesn't vote so passage of the bill won't help legislators facing surging anti-incumbent sentiment into the November mid-term elections. Add the fact that there is no companion bill in the House and an expanded STB will run afoul of the deficit hawks, and this thing is likely toast. What about the next Congress in 2011? Despite being a bi-partisan issue, we're almost certainly going to see more Republicans relative to Democrats, which has historically been positive for the railroad's fortunes on Capital Hill."

As for me, I remain aloof from the artifice in Washington and keep my eye on making money by making customers smile. In this regard, the Washington follies are a severe distraction and best left to those who can function in a dysfunctional town. Let's worry about how to keep the MMA alive without subsidies and let the ethanol lobby be driven away by market forces that favor efficient fuels above special interest subsidies.

Speaking of ethanol, I'm not alone in my disdain. Dennis Gartman, he of The Gartman Letter, has never been much of a fan of ethanol. Last Friday's TGL is particularly terse in this regard. "Ethanol is by many schools of analysis a net 'loser' regarding energy, for it takes more energy to produce ethanol -- when one considers all of the inputs into the production of corn and the creation of ethanol from that corn -- than one gets from the ethanol itself. What are we thinking when we put 'food' into our gas tanks when so many people of the world are hungry and could survive using American corn?

"But ethanol is here to stay despite our antipathy toward it, and we thought we should look at the numbers involved in its production. For example, back in the '05-'06 corn crop year, the US used 1.602 billion bushels of corn in ethanol production. That rose to 2.119 billion in '06-'07; rose to 3.049 billion bushels in '07-'08; rose again to 3.667 billion bushels in '08-'09 and will be 4.3 billion bushels in this crop year. Clearly this is a bull market in corn usage."

Gartman goes on to say that what we really ought to watch is the percentage of the corn crop that goes into ethanol production. "In '05- '06, ethanol production took up 14 percent of the total domestic corn crop. That rose to 20 percent in '06-'07; rose to 23 percent in '07-'08; rose again in '08-'09 to 30 percent and in the current crop year almost a third of the domestically grown corn crop will be used in the production of ethanol!

"About the only 'good' thing we can say is that the steepness of the growth of corn usage in ethanol production is slowing, for we've gone from a 23 percent year-on-year growth in '06-'07 to its highest year-on-year growth of 44 percent in '07-'08 to 'only' 17 percent growth from last year to this. But 17 percent growth when you've nearly tripled the use of corn in the course of five years is still a huge increase.

"This nonsense really has to stop, but it won't. The American public 'believes' in ethanol, and sees this as an 'US vs. Them' scenario, with ethanol's supporters painting this as an American farmer vs. an Arab sheikh circumstance, when nothing could be farther from the truth. Will we be using more corn in the '10- '11 crop year than we used in the '09-'10 crop year to produce ethanol? Of course we will, and we are both embarrassed by that fact and bemused by it. Nonetheless it is the harsh reality of American farm production. How sad.

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