THE RAILROAD WEEK IN REVIEW

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“Intermodal once moved at very low rates, but railroads now can increase rates to the point where intermodal makes a reasonable contribution to system fixed costs.” -- Larry Kaufman, Argus Rail Business

Larry Kaufman’s *Rail Trends* column for March 22 makes the point that scheduled service and reliable transit times are making domestic intermodal a very attractive alternative to truckload direct. For the railroads, Kaufman says there is no limit on domestic intermodal growth -- it is not dependent on the vagaries of international ocean traffic nor is it subject to the 180 percent of variable cost mantra.

The reason domestic intermodal is an attractive over-the-road alternative for supply-chain managers is it’s cheaper than truck, as dependable as truck, and nearly as convenient as truck. And when when one is trying to keep capital tied up in inventory -- either raw materials or finished goods -- at a minimum, small quantities are the goal. Get stuff in at the same rate as you use it, get stuff out as fast as you make it.

Thrice-weekly service for a customer that needs three days to load or unload a car is not acceptable supply chain practice any more. On the other hand, having a customer that can turn a car a day in Yard Limits means the serving railroad can place and pull as fast as the car is made empty or released loaded. The message to short lines is this: understand your customer’s raw material and production cycles and match service to help that customer minimize both inbound and outbound inventory.

If the class I marketeers were smart -- and sometimes I have my doubts, like the time the market manager said she couldn’t return my call because her kids were on spring break -- they would empower short lines to solicit -- and *get paid for* -- domestic intermodal loads for their customers needing to deal in less-than-carload lots. Then we’d really be taking trucks off the highway. And to make it even easier, there will be a breakout session on short lines and intermodal marketing at the upcoming ASLRRA Annual Meeting in Orlando May 1-5. Look for Session 505, “Ramping up Your Short Line - Opportunities for Short Lines in Intermodal,” where panelists will discuss current and potential areas of opportunity for short lines to work with Class I carriers to develop new intermodal services and penetrate new markets.

One final thought. Last week I got to sit in on one of Tony Hatch’s “Salons,” essentially informal gabfests over some wine and a superb meal where rail industry leaders can hold forth for a few financial types. Tony’s guest the other evening was retired NS Vice Chairman and Chief Marketing Officer Ike Prillaman and I got to sit in. It was a special treat because before his retirement Ike always had the time to sit and chat about marketing and short line matters over a Coke in his Norfolk office.

Excerpts from Tony’s take: “Ike remains bullish on the rails and on intermodal – and on the “brave new world” of pricing power. The worse appears to be over for coal, at least in terms of near term utility inventories while exports look ever brighter, especially favoring the east. Ike sees a stable domestic market for more than a decade, with more pressure on Central Appalachian coal than western. But it is intermodal that will be the long-term railway star; the greatest growth potential will be in domestic, which should favor the eastern carriers.” A delightful evening. Thanks, Tony and Ike.

Morgan Stanley’s Bill Greene’s recent note on the rail industry outlook is most encouraging. He writes, “Recent traffic results increase our conviction that double-digit industry volume growth is not only possible, but likely in 2010. Current traffic levels imply double-digit carload growth rates are likely in 2010. In fact, in large part our seasonally adjusted straight-line volume forecasts are higher than when we

ran the analysis at the beginning of the month. Moreover, since 2Q enjoys the easiest comps, year-to-date traffic trends should continue to improve for a number of months going forward.

"Norfolk Southern and CSX volumes confirm that continued revisions to volume forecasts and EPS likely in near-term. Their just-released Week 11 volumes confirm that four-week trailing volumes continue to improve sequentially. We reiterate our "Attractive" view on the freight rails thanks to (1) Volumes tracking better than expectations, (2) Operating leverage to recovering volumes, and (3) Sustained momentum on core price. As a result, we continue to favor rails and we highlight Overweight-rated Union Pacific, a Morgan Stanley Best Idea, as our top pick.

The Health Care Bill has now passed and the signs of negative fallout are starting to appear. One of the more onerous signs for short lines is the requirement for firms of more than 50 employees to offer "affordable" coverage or pay a tax. Companies with fewer than 25 employees will get tax credits for providing health insurance as long as the average wage does not exceed $50,000 a year.

Two thirds of the 500+ short lines in the country are in that smaller category and will most likely stay there -- adding the 26th employee changes the rules and adds cost. I've spoken with the managements of several of the more successful short lines and they say health coverage is now well into five-figures per employee per year and they budget for 15 percent annual increases forever. And that was *before* Sunday's squeaker of a vote in favor.

Now lard this in top of what I call "Rich Timmons' Twenty-six Points of Darkness," his PowerPoint ticking off the "ongoing and significant" elements of the FRA Rail Safety Advisory Committee. It's a daunting list and the ASLRRA deserves kudos for its progress coping with it. See it under Speeches and Remarks, "CSX Shortline Caucus" March 10 at www.aslrra.org and note seven items are "done." But there are still miles to go and every one of the not-done items with it an unfunded mandate to spend more money. Money the smaller guys may not have. The Health Care Bill, to quote Caterpillar spokesman Jim Dugan as reported in the WSJ, amounts to "a tax increase that couldn't have come at a worse time."

The Chlorine Institute and the AAR disagree about the "benefits" of PTC. The AAR *Insider* for March 22 challenges Institute's claim that the FRA analysis of the benefits of PTC was flawed and that positive train control systems result in business benefits to the railroads. Says the AAR, "Nothing could be further from the truth" and reiterates the FRA finding that "there are no present business benefits to the railroads. In fact, the cost-benefit carries an inverse relationship of 20 to one." Though it is claimed that most of PTC's alleged business benefits depend on increasing train speed, the fact is that PTC will not increase capacity and train speed; instead, it will likely reduce both.

The AAR continues, "Current PTC technology cannot equal the handling and braking precision of a skilled engineer. In a testing, the stopping distance under PTC far exceeds the distance under normal operations with a skilled engineer. Increased stopping distances will mean reduced average speed and reduced capacity." What it comes down to is the Chlorine Institute's "attacking the FRA's cost-benefit analysis of PTC as a smoke screen to hide the fact that their shipments will raise the cost of rail transportation for all customers." The AAR note says clearly, "The high cost of the PTC mandate is a direct result of the toxic nature of chlorine shipments.

"Instead of bashing the FRA cost benefit analysis, the Chlorine Institute should join AAR in improving the safety and efficiency of rail transportation, as well as reducing the exposure of the American public to toxic-by-inhalation (TIH) hazardous materials, through product substitution and other means of reducing the transportation of TIH." How about substituting Clorox for pure chlorine? I can carry that home from the Super Fresh without a hazmat sign.

The thread of railroads paying their own way continues**.** My friend and correspondent Dan Behr, who toils at the Chicago investment firm of Jordan, Knauff, writes, "Problems invariably accrue if a carrier inherits a screwed-up infrastructure, such as what happened numerous times when short lines bought or

assumed an operation from the Class Is. Too often buyers ended up with a physical plant that needed a lot of help and into which the Class Is were unwilling to invest. And so it was that the the Class Is fully depreciated the PP&E and then jettisoned it when it was time to reinvest, which left the short lines holding the bag."

Then there's the matter of rates. I get so sick and tired of hearing freight shippers complaining about the railroads' freight rates. I mean, if you can't afford a first class ticket to Hawaii on American Airlines, do you complain to the government that the rates are too high based on the percentage of variable cost? If your first choice of transportation provider (that first class seat) is too dear, maybe you need to sit in the back of the bus. And if you're on a branch line with weekly service and that's not enough, you have two choices: build enough volumes to support more frequent local freight service or use a truck.

However, it has to be said that in the original ICC legislation, it was recognized that not every commodity could pay its own way so rates on commodities that could pay their own way -- cover variable costs and them some -- would subsidize those that could not. (For more on what happened and why, see *The Railroad, What It Is, What It Does*, 5th Edition, Chapter 21 beginning on page 289 and which, coincidentally, I wrote.]

The ICC acknowledged that rates could not fall below the cost of service, and this goes directly to the MMA situation. The mere cost of rehabbing the track would add more than a hundred dollars a car to the "cost of service" freight rate. The debt service -- the debt having been incurred to buy the railroad in the first place -- is another "cost of service" and has to be considered. The shipper who feels ill-used by having to pay for the cost of service may just be in the wrong business.

Happily, there remain those loyal souls who do in fact find rail freight service by the carload does indeed offer significant supply-chain benefits. A friend who makes the customer rounds for a Texas short line writes, "I've received word from a shipper they are converting some of their truck movements to rail as they're concerned about the availability of enough trucks and truck drivers to handle their business whenever the economy heats up." My contact says he's already had some conversions while other customers are talking about returning to rail after leaving it five years ago. And he has a third party searching for site for new warehouse. New rail spur activity is picking up and more prospects in sight.

Competitive information is more accessible than one might think. Three current projects come to mind. The first has to do with ethanol going into California: where it goes, were it comes from, what railroads move it in what volumes and at what cost? The second has to do with frack sand into Pennsylvania. I know where it's going but I need to know origins, carriers, costs and volumes. The third has to do with certain paper traffic patterns. I know the origins but not the destinations, volumes or costs. And for all three I want to know trends: the total commodity volume by carrier three years ago to the present, cycle times, equipment types and rates including fuel charges.

I did all three in a couple of afternoons running the databases at usraildesktop.com. Now the ethanol shipper can go to his prospect and show him how he can beat the competition. The frack sand short line can manage inbound traffic so as to maximize use of private equipment, shorten transit times and improve turn times. The paper chase has to do with truck *vs.* rail in certain lanes and where rail offers the most competitive advantage to the shipper. Drop me a note if you'd like to know more about this nifty tool.

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