RAILROAD WEEK IN REVIEW

April 9, 2021

"The ISM Manufacturing Index rose to 64.7% in March, above our forecast of 62.7% and the consensus forecast of 61.8%, marking the highest reading since December 1983. March was the 10th consecutive month in which the headline index was above the 50% break between contraction and expansion." — Barrons, April 5

"Norfolk Southern is taking no position on the merits of the proposal. Norfolk Southern encourages the Board to apply the 2001 merger guidelines to this proposed transaction. The prior rules are antiquated, adopted over forty years ago. The railroad industry has transformed itself since then, and the STB modernized its major merger guidelines in sync with those changes." — CP/KCS comment filing, April 1

"When much of the economy shut down around this time last year, rail volumes plummeted too. We have to take that into account when comparing rail traffic this year to last year. That said, rail traffic has clearly rebounded from last year's depths. Looking ahead, rail volumes are highly correlated with manufacturing output, so recent signs of strength in manufacturing are good signs for railroads too." — AAR Senior Vice President John T. Gray

Canadian Pacific and KCS in their March 22 merger filing stated flatly they intend to proceed not under the Board's current rules for Class I mergers, but instead under the rules in place in 2000 under an accelerated timeline pursuant to a narrow waiver the Board contemplated for a KCS proceeding. Understandably, this raised many red flags among other Class I railroads.

UP's objection to the waiver simply observes, "In 2001, when the Board last revised its rules for major rail mergers, KCS urged the Board to adopt a special waiver so the new rules would not apply to transactions involving KCS. At the time, CP urged the Board to reject KCS's waiver proposal and apply its new rules 'equally to all Class I carriers'...

"[CP] has only now reversed its position because it sees the opportunity to invoke the waiver and thereby avoid full regulatory scrutiny of the proposed CP-KCS transaction." To which UP adds, "KCS does not need a government subsidy in the form of relaxed regulatory obligations to prop up a transaction with one of its Class 1 peers."

Then there's the matter of the Laredo Bridge. The Union Pacific position is that KCS now owns the bridge, which it didn't 20 years ago. KCS also owns the Tex-Mex feeding the bridge from the north as well as Kansas City Southern de Mexico, which provides the southern feed. Further complicating matters, KCS recently obtained a Presidential Permit to construct a second railroad bridge at Laredo.

BNSF objects to the waiver, but takes a more conciliatory view: "Applying the current Class I standards to the proposed CP/KCS merger is not meant to create insurmountable conditions for the applicants or to add unnecessary delay. In fact, it should not result in any prejudice at all. Since announcing the transaction, CP and KCS have made public statements asserting their confidence that the merger will meet both the pre-2001 and the current heightened public interest standards applied by the STB."

A joint filing representing a number of key shipper groups including the NIT League cites potential "competitive consequences" regarding the Kansas City gateway. Though it may well be the CP/KCS combination is an end-to-end merger, that does not mean that there are no anti-competitive possibilities. Both roads connect with BNSF, UP, and NS in KC and with CSX and CN at other points. "Post-merger, KCS and CP could close those gateways for traffic that today has the option to use an alternative Class I carrier."

"This harm is particularly significant for a CP/KCS combination because of its substantial overlap with the Canadian National rail network. The merged CP/KCS could foreclose current KCS/CN routing options." That would include short lines that access KCS via CN. And so the shippers are correct: "If the KCS waiver is not revoked, those consequences could go unaddressed."

Neither CSX nor NS have taken serious exception with the waiver. CSX is prepared to make further comment as the proceedings proceed, but for the nonce "expects the transaction will be reviewed under the 2000 Rules and not the undefined, untested 2001 Rules which do not appear to have application to a consolidation involving KCS."

NS simply proposes that the current merger guidelines be applied because the whole industry has changed and KCS is no longer the runt in the litter. "Winding back the clock to antiquated guidelines would deny the agency the suite of modern tools to gauge and address the broad implications of any major rail merger in the current economic and operational environment."

The view from here is that the waiver will eventually be waived and the merger approved. That said, now is the time for short lines and shippers to look closely at their customers' routings, identify those that could be affected by this transaction, and begin conversations with the Class Is in the route to resolve the issues before they interfere with customers' established supply chains.

Just to add a little fuel to the fire, Tuesday's joint CP/KCS press release tells us that "45 customers, ports, transloads and other stakeholders have filed statements with the STB." That brings the total number of letters in support to the transaction to more than 300. Names mentioned include SSAB, Domtar, Farmers Cooperative of Hanska, Port of New Orleans, and E.J.R. Reload.

The press release continues, "The new supporters stated they expect the combination would, among other things, invigorate transportation competition, expand access to existing and growing markets, and provide new service offerings that would improve transit times and reliability." That's all to the good but, as usual, the devil is in the details.

And this just in: There are some who seem to think that the waiver argument will fail. If it does, it will make the merger much less easy to get approved, and this may attract private equity interest to swoop in and buy KCS directly. Recall it wasn't that long ago that KCS was approached by a private buyer — (WIR 9/11/2020): Kansas City Southern rejects $20 billion takeover offer from a group of investors).

The STB announced April 5 the adoption of a final rule to amend the operating revenue thresholds for classifying rail carriers. The final rule will raise the Class I revenue threshold to $900 million; shortlines become Class II at $40.4 million. The final rule will use 2019 dollars as the baseline for revenue calculations going forward.

This rule-making follows a petition filed by Montana Rail Link, Inc. (MRL), on February 14, 2020, requesting the Board increase the revenue threshold for Class I carriers. MRL contended that it was likely in the near-term to be re-classified as a Class I railroad under the existing threshold – operating revenues of $504,803,294 or more – despite its historical status as a "regional railroad" with a comparatively smaller footprint and revenue base than the current Class Is. As a Class I railroad, MRL would have been subject to additional regulatory requirements, in particular, extensive reporting of financial and economic information.

Before this ruling, the Class II break had been $40 million in revenue and 350 route-miles of railroad; Class IIIs were anything below that number.

AAR North American Week 13 YTD revenue units were two percent fewer than they were in the first three months of 2020. Intermodal was the big plus, naturally — up 13 percent. Coal only lost four percent and automotive slipped two percent. Merchandise carloads — everything else — were off less than two points, which, given everything else that's going on, is not bad.

Among merchandise carloads, grain remains the hero of the day — up 26 percent and representing more than five percent of total revenue units. Non-metallic minerals (phosphate, clay, rock salt) dropped 11 percent and petroleum products including crude oil lost 15 percent. That's a shame as the non-met mins are almost as big as grain and only a few basis points behind grain in percent of total revenue units. A quick glance at the STCC 14 QCS tables suggests phosphate rock is the biggie here and CSX is the dominant player.