Whither, independent short lines?

As the number of rail operators continues to shrink, what's next for the little guys?

A Maryland Midland freight rounds a curve near Sabillasville, Md., on June 11, 2006. The Midland is the latest independent short line to become part of a holding company — the railroad will become part of the Genesee & Wyoming family. Alex Mayes

In a matter of months we've seen Canadian Pacific Railway move to buy the Dakota, Minnesota & Eastern Railroad; the Canadian National acquisition of the Elgin, Joliet & Eastern; and Genesee & Wyoming's bid to take a controlling interest in the Maryland Midland. Meanwhile Fortress Investment Group took RailAmerica private eight years after RailAmerica itself double in size with its 1999 purchase of RailTex. Florida East Coast has also moved into the Fortress fold, with RailAmerica taking the top management posts [see page 15]. What's going on here?

Consolidation is what's going on. The railroads' drastic downsizing since the mid-1970s has slowed almost to a halt. There are roughly 550 shortline and regional railroads in the U.S. and Canada, and though the number of names remains more or less constant, the number of operating companies is shrinking. It's an industry going through an evolution that dates back three decades.

By the mid-1970s, the railroads were in going-out-of-business mode. Congress created the U.S. Railway Association to plan for the future of rail lines in the Northeast, and the group's Final System Plan of July 1975 was an effort to control how fast and in what order the railroad lines that needed killing exited the field. Then came Conrail in 1976 and Staggers in 1980, providing an environment that was conducive to strategic changes in the rail network. And though many industry observers still use Staggers as a start date for the shortline buildup, truth be told, Staggers is only part of the story.

The present shortline community came into existence gradually in a continuum of change that took place as the Interstate Commerce Commission and its successor, the Surface Transportation Board, eased rules for transferring branchline operations and ownership to short lines, communities, and even shippers. Many of the 500-plus shortline names now dotting the landscape came into existence over the past 20 years, largely as a result of the Staggers Act, but it's been a gradual change.

Fast-forward 28 years, and today's Class Is are running better than ever, with the short lines as both contributors and beneficiaries. In 2006, the last full year available at this writing, they handled anywhere from 10 to 14 percent of all Class-I revenue loads (carloads and containers), freeing up Class-I capital budgets for more capacity and more revenue. However, as the Class Is become better marketers and operators, many of the initial reasons for creating new short lines are no longer valid.

Short lines are not necessarily the low-cost providers of yore. Practically everybody has two-person crews, and nobody who has any sense runs an FRA Class-1 (10-mph) main line. Used locomotives, assuming they're available, start a $250,000 a pop, five times what they were 20 years ago. It costs upwards of $5,000 per mile per year to keep FRA Class-2 (25-mph) track up to par. A gallon of diesel fuel is six times what it was not that long ago. Costs like those — and myriad others — hit smaller railroads and their tighter budgets harder than the big guys.

Though Staggers deregulated the railroads' commercial side, new federal regulations — licensing of locomotive engineers, drug testing, hazardous materials training, bridge-worker safety rules, hours of service limitations, operational tests, etc., have added considerably to shortline operating and administrative costs. Moreover, as Class Is adopt better operating disciplines, adhering to the market's need for faster railcar turnaround times, there is a greater need for close control over all aspects of the transportation product from car supply to empty placement to loaded release to placement at destination.

And so the shortline phenomenon may be coming full circle. The CPR-DM&E transaction is a good example. DM&E got its start in 1986 as the Chicago & North Western began shedding light-density branches. A year earlier, Soo Line bought the Milwaukee Road, including its coveted routes between Chicago, Kansas City, and Minneapolis. So it's fitting that CPR is buying the combined DM&E and sister Iowa, Chicago & Eastern (formerly the I&M Rail Link) because, as CPR President and CEO Fred Green said last November, "We know the railroad because we used to own it."

Canadian National's shortline acquisition program is noteworthy because it's acquiring lines that at one time might have been called redundant. CN bought the Duluth, Missabe & Iron Range from Great Lakes Transportation in May 2004 for the parallel line north out of Duluth, Minn., sparing itself the expense of double-tracking its own parallel ex-Duluth, Winnipeg & Pacific line. Earlier, in November 2003, CN acquired BC Rail for reasons of operating efficiency, and is now moving on the Elgin, Joliet & Eastern. The motivator for that deal was CN getting through Chicago faster, establishing a new Chicago intermodal hub, and hooking up its former Wisconsin Central, Illinois Central, and Grand Trunk Western lines. The "Outer Belt" also connects directly with the other big six Class Is, plus other short lines. In sum, CN has invested $7.5 billion on acquisitions, and there may be others on the way.

Other recent shortline consolidations include the former North American RailNet, whose six lines were sold off variously to OmniTrax (Illinois, Georgia, Kansas), Watco (Idaho), and Savage Industries (Alberta). CN bought back this last group; CN originally spun them off to Canada's RaiLink holding company, but decided it wanted them back. RailTex was one of the original consolidators, having built up a stable of 25 properties by the mid 1990s. By the time RailAmerica bought RailTex, the former had already grown to include 19 names from four in its five years of existence.

Colorful lashups like this one, visiting suburban Minneapolis, are common on Canadian National's U.S. lines; expect more color with CN's purchase of EJ&E. Steve Glischinski

By the end of 2005 RailAmerica was home to 43 names, having owned at one time or another as many as 65 names, selling off the poor performers to second- and third-tier buyers. The tale is in the financials, where RailAmerica grew through acquisitions. Same-store (railroads owned a year or more) sales increases were always modest compared to total revenues, which grew to $424 million in 2005 from $47 million in 1999. However, as the number of acquisitions grew smaller, so did the year-over-year increase in revenues from the company's top performers.

Early last year the private-equity guys came calling in the form of the Fortress Investment Group. Fortress took RailAmerica private and installed a new management team to, as RailAmerica President John Giles likes to say, "Understand, improve, and integrate so we can turn this group into a high-performance portfolio of rail properties." Many talking heads were convinced that we would see more lines spun off right out of the box. Not only has that not happened, but in a matter of months, Fortress added the Florida East Coast to its holdings, saying in its STB filing that it plans to use the best management practices of each to the benefit of the other.

It's pretty safe to say that the rate of Class-I shortline spinoffs has slowed. We're more likely to see leases or joint ventures in the model of Norfolk Southern's recent Michigan Central spinoff than outright sales, and the number of small, independent properties will continue to shrink as big operators buy more of the strong performers and smaller short lines face abandonment.

Just how drastic the change is will also be a result of future developments; the rail competition bill now working its way through the House [see January 2008 "news"] would hit short lines particularly hard. Change has been a constant in the shortline game since it really got going in 1980, and it's happening now more rapidly than it has since those early days. Stay tuned. — *Roy Blanchard*

>> Faces of the fallen flags

Maryland Midland | EJ&E | DM&E | BCRAIL | DM&IR

From left: Maryland Midland at Union Bridge, Md.; EJ&E at Rondout, Ill.; DM&E at The Arches, Minn.; BC Rail at North Vancouver, B.C.; DM&IR at Wales, Minn. MM, Alex Mayes; EJ&E, Sayre C. Kos; BC Rail, John C. Benson; DM&E and DM&IR, Andy Cummings

NS pulls the plug on Ontario operations

Loss of auto-parts business brings an end to century-old access to southern Ontario, dating to Wabash

NS train 328 passes CN's Hamilton, Ont., yard. No. 328 ran until late 2006; NS says it will stop all Ontario service. Stephen C. Host

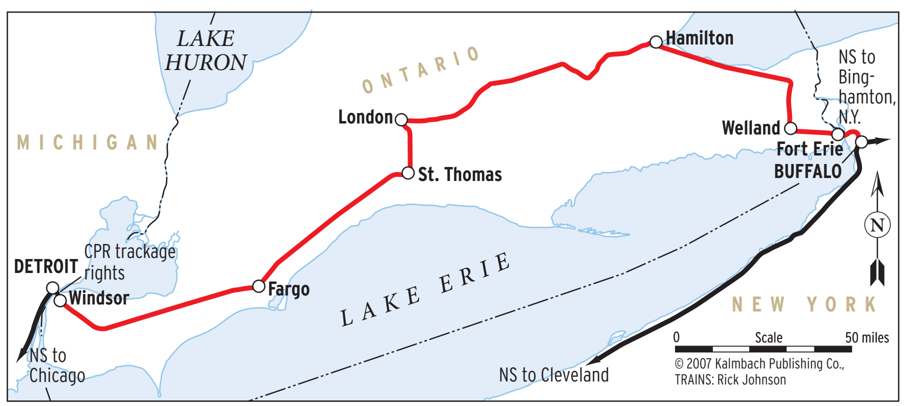
You might not think of the heartland of Ontario when you think of Norfolk Southern, but for over a century, NS and its predecessors have served the region. However, according to NS officials, that service, conducted over Canadian National trackage rights, was to end in December 2007.

In recent years, the primary reason Norfolk Southern continued to serve Ontario was the Ford auto assembly plant in St. Thomas, where it historically has built Crown Victoria and Mercury Marquis sedans, and more recently has built Hummers. Ford required just-in-time delivery of parts from its Buffalo, N.Y., stamping plant. That plant was the primary support for St. Thomas-Buffalo trains. But NS also had access to serve any customers along the route, pursuant to the agreement predecessor Wabash signed in 1897 with CN predecessor Grand Trunk Pacific. That led to grain cars moving from Ontario elevators and interchange traffic from short line St. Thomas & Eastern.

Wabash negotiated the agreement as a shortcut between Detroit and Buffalo, and NS continued to run to St. Thomas from both directions until 2004, when it abolished its train from Detroit. Service on the west end continued in the form of a local through Canadian Pacific Railway's Detroit River Tunnel from Detroit to Windsor to serve customers there.

Ford announced its first cutbacks at the St. Thomas plant in 2005. In 2006 the shutdowns accelerated and workers were idled an average of one to two weeks per month, which in turn led NS to cut back to as-required trains. By the fall of 2006 NS lost the Hummer-frame traffic, adding to its losses. In December 2006, NS abolished service to the plant; the last NS trackage-rights train to St. Thomas ran on Dec. 30, 2006. It consisted of a run of parts cars into the Ford plant in the morning and light power back to Buffalo in the afternoon.

Since then, all that's remained of NS's Ontario operations has been the locals to Windsor and Fort Erie. NS was to annul those locals effective Dec. 1. However, the railroad continues to offer service through CN interchange to customers located along the line. — *Stephen C. Host*



STB gives Tongue River Railroad a highball

Almost a quarter century after it was first proposed, would-be Montana coal route gets key approval

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