# THE RAILROAD WEEK IN REVIEW
## MARCH 7, 2008

*"Canada and Mexico are the top two markets for exports from Ohio." -- Daniel Griswold, Cato Institute, WSJ, March 1, 2008*

**As my lead-up to the recent** CSX Short Line meeting, I cited a United Van Lines survey showing that family migration trends favor the southeast over the northeast and Midwest "thanks to a combination of low or no taxes, economic prospects, quality of life and housing prices" (WIR 2/15). Griswold picks up the thread: "The loss of manufacturing jobs in Ohio and elsewhere since 2000 is the result of increased automation and our own domestic slowdown.

"Behind this trend has been a shift of production down South to nonunion, right-to-work states, and up the value chain to more technology-intensive products. After 15 years of expanding trade, U.S. factories today are producing fewer shirts, shoes and lower-end auto-parts, and more pharmaceuticals, chemicals, semiconductors and sophisticated machinery and equipment." Which again supports my argument of two weeks ago that CSX and NS are particularly well-positioned to benefit from the trend and that southeastern short lines stand to gain as well.

As for the northeast, you'll note that among the products and commodities in Griswold's list only the chemicals group shows any promise for the single-carload sector. The pols are right when they say the old-world low-tech manufacturing jobs are leaving Ohio. What those jobholders made can be made faster, better and for less cost elsewhere, often in right-to-work states. Low-rated commodities like aggregates continue to be a shortline staple but only where there is an active commercial construction market combined with an influx of workers requiring places to live and roads to drive on. I submit Florida and Texas as Exhibits I and II.

Shirts, shoes and low-end auto parts get onto the shelves at Wal-Mart by the truckload, both over-the-road and over intermodal ramps in places like Columbus. But to the extent that states like Ohio can replace lost low-tech manufacturing jobs with high-tech knowledge workers (see italics above), then there will still be a demand for aggregates and building materials, coal and chemicals to feed the power plants and myriad STCC 28 and 29 users from plastics to propane. Is that gonna be enough to support the 18 or so short line names in Ohio? Only time will tell, but I'm not holding my breath.

**Continuing the truckload sector thread** from last week, Credit Suisse rail analyst Jason Seidl reports from Boston: "According to Con-way executives, the feeling is that the trucking market has bottomed and should not get materially worse. This seemed to be the general consensus among truckers who also believe the latter half of the year could see a better supply/demand balance (in fact, carriers are either not adding or are reducing capacity in their networks until demand returns). Further strengthening the bottoming-out argument, many truckers stated that shippers are now trying to lock in longer length contracts—a possible indicator that shippers are at the peak of their bargaining power. Our LTL carriers did not think bankruptcies would materially reduce capacity, although several TL carriers (a much more fragmented group) said small carrier bankruptcies could have a modest improvement in capacity."

And Jon Langenfeld at RW Baird writes, "The trucking environment remains challenging with weak demand and pricing pressure, consistent with recent quarters; further rising fuel prices and 1Q weather are likely to pressure truckload earnings. Positively, as we look ahead, current conditions make accelerated capacity reductions imminent, which should support stronger (potentially meaningfully stronger) truck freight rates in 2009."

**Patriot Rail** adds another one. Its seven-mile Sacramento Valley Railroad will do the switching work for BNSF and UP at McClellan Business Park, connecting businesses to larger rail lines, the company announced Tuesday. The 3000-acre park, home of the former McClellan AFB, does about 3500 annual carloads of lumber, petroleum, aggregate and manufactured products.

Marino is following the former RailTex and RailAmerica model of widely dispersed properties. The addition of the Sacrament operation brings Patriot Rail mileage past the 250-mile point. The other properties are the Tennessee Southern Railroad in Tennessee and Alabama, the Butte, Anaconda & Pacific Railway in Montana and the Utah Central Railway in Utah.

**CSX Chairman Michel Ward** told the CNBC gang early Wed AM that TCI has had a series of "flawed, shortsighted ideas" over the past 12 months, and their talk of cutting back on infrastructure capex has raised eyebrows in Congress. Said Ward, "With the coming increase in demand for rail transportation, we'll need the track."

Later in the day, CSX issued a press release saying in part that Ward "testified today in a hearing before the United States House of Representatives Committee on Transportation and Infrastructure, Subcommittee on Railroads, Pipelines, and Hazardous Materials on investment in the rail industry. Mr. Ward's testimony highlighted the company's outstanding record of accomplishment and plans to meet and exceed the expectations of all CSX stakeholders. The Subcommittee's stated purpose in holding the hearing was to examine investment in the railroad industry, including concerns raised by the activities of The Children's Investment Fund (TCI)."

In a note following the event, JPM rail analyst Tom Wadewitz observed, "Unsurprisingly, members of Congress were strongly confrontational with TCI due to concerns regarding prior TCI comments about freezing capex, adding leverage, and sharply raising prices. Testimony from the Administrator of the [FRA] and all three [STB] board members focused on concerns regarding sufficient investment to maintain a safe system and expand capacity so that CSX would be able to handle future growth."

"Congressman Oberstar (Chairman of the full T & I Committee) expressed particular concern that TCI gaining a measure of control through its (and 3G's) five board nominees could lead to a situation similar to when Carl Icahn took over TWA and took actions viewed as damaging to the company… While quick action doesn't seem likely, our sense is that Congress would not hesitate to take action if the TCI / 3G board nominees are voted in and they drive major changes in leverage or investment patterns. In our view, strong action by Congress to block TCI would be a negative factor for CSX stock in particular and to a lesser extent for the broader rail group."

**Thursday's Burlington Northern Santa Fe analyst confab** in Fort Worth held some useful tidbits for short lines doing business with BNSF. The presentation materials are available under the investors tab at www.bnsf.com and it might be helpful to have them available as you read this. To begin, it is rare that short lines are ever even mentioned in analyst meetings but Industrial Products Group VP Dave Garin did just that in his commentary on slide 65. The AIM (Assess, Improve, Maximize the carload market) goes directly to what might be called the "undesignable, unexecutable" single-carload business where everything is a custom move and thee are no batch economies.

This is where short lines excel. Garin's team has been an early proponent of using short lines for gathering and distribution, showing how and where to apply the AIM principles to do the job more efficiently and effectively. In fact I just got off a conference call with short line with a customer needing an additional daily switch because his business has grown so fast. Note too Garin talks about unit trains (slide 66) in terms of "building origin and destination operating capacities."

Now fast-forward in the BNSF slide deck to Rollin Bredenberg's slide 113 on where merch cars spend their time. Short lines are in the G&D (Gathering & Distribution) business so the more they can apply the AIM principles the better. The word PARTnership implies taking PART not only in the revenue sharing side but also in matching their operating practices to those of its class I PARTners.

And to drill down still further on sharpening the carload product, skip to the Best Way Initiative starting with slide 126. Here VP Transportation Greg Fox shows how to eliminate waste, variability and inflexibility from rail operations. Every one of these sins looms large on the typical short line and contributes to the 80% non-line-haul dwell time Bredenberg cites. And Fox' slide 128 on value-stream mapping shows how to do it.

There are many more short line take-aways from these highly informative presentations and you can expect more about them from WIR anon. For now, however, put on your short line thinking cap and do three things: AIM high in daily operations, find ways to shorten the interval between interchange-in and interchange-out, and use value-stream mapping to do all three. Finding nuggets like these make these conference calls with senior management an essential part of running a successful feeder-line railroad.

**There is yet another shoe to drop.** The merch-carload volume trend is decidedly down while the revenue trend is up. This was a recurring theme at the CSX Short Line meeting and did not escape notice during yesterday's BNSF call. To see how widespread this is, I ran a screen on NS using the Quarterly Trends tables at usraildesktop.com. I looked at the period 1Q04 through 3Q07 looking for relative changes in volume, revenue and RPU. I restricted my search to the 11 commodities that (a) are non-intermodal or coal and (b) make up more than 70% of short line volume according to the RMI RailConnect Index.

Comparing 1Q04 with 3Q07 (the first and last quarters available from this AAR waybill sample), I found that only STCCs 14, 26 and 10 posted double digit volume gains; all the rest were in single digits and three showed losses: STCC 01, 29 and not surprisingly 24, off 1%, 2,2% and 11.6% respectively. To sanity-check these findings, I used the RailConnect Index for the first nine months of 2007 and found that indeed the same STCCS were down yoy.

At the same time, revenue gains for the 3+ years were all up handsomely, from 65% in STCC 33 all the way down to a paltry (!!) 26% in STCC oh-one. RPUs increased as much as 56% in STCC 33 down to 15% in STCC 14. We're told by every railroad to expect price increases in the 4-6% range for 2008, and all are agreement that volumes will remain "soft" for at least the first half. So it's beginning to look like the rails are charging more and more for less and less. How long can it last?

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