THE RAILROAD WEEK IN REVIEW
APRIL 18, 2008

"This company and its employees continue to be focused on delivering superior results for our shareholders.” Michael Ward, CSX

Short lines can do themselves, their customers and their connecting class Is a big favor if they would do two things before asking for a rate. The first has to do with market pricing, the second has to do with service design. As to the first, how much you can charge depends on what the service is worth to the customer and that depends partly on how his supply chain works. For the purpose of this discussion let's restrict ourselves to inbound moves -- materials coming TO a short line customer for use in any process from paving to feeding chickens.

The questions are how much product does it take each year to feed the customer process, where it comes from and the landed cost (price of the product plus transportation to the storage bin or shelf used to feed the process). Knowing the answers to these questions will tell you the market price. Now it's the Class I's turn to tell short line and customer what product (service) they can provide at the market price. However, there's a geographic factor as well. Shorter distances between supplier and customer will generally favor truck over rail in inverse proportion to the amount of material -- the shorter the distance and the smaller the load the greater the truck advantage. But that’s changing.

UBS rail analyst Rick Paterson sees it this way: "Longer hauls have made it easier for western railroads to gain a larger share of their regional freight market than their eastern counterparts, allowing BN & UP to hold 50% of the Class I market share. With rising fuel prices the value proposition over trucking in the US west and Canada stands to improve; however, we think the real story is only 31% market share held by the eastern US railroads, despite covering the largest population demographics in North America.

"Historically, the eastern rails have faced tougher truck competition due to shorter hauls, but that competition is fading fast due to diesel fuel close to $4/gallon and escalating highway congestion. Essentially, the addressable market for eastern rails is expanding as oil moves higher, allowing truck-to-rail conversions as JB Hunt has been able to demonstrate over the last 12 months. Hunt can do it quickly because the same salesperson can sell both over-the-road and intermodal, and it will likely take the overall marketplace longer to emulate this. Long term, it bodes well for both CSX and NS."

It also bodes well for those short line connections that can provide a seamless distribution service. Canned goods coming to New England from the west arrive in Worcester on CSX, are handed off to Providence & Worcester for next-day placement at a distribution facility. Another short line, this one in Pennsylvania, takes boxcars loads from NS and places them for unloading at a distribution center located adjacent to a yard where the switch crew can place or pull almost at will. Just recently the customer unloaded 55 cars in three days at a facility that only has eight car spots. Three switches a day did the trick. Talk about asset utilization!

Three seemingly unrelated tidbits from the WSJ this week could have significant impacts on short lines in the feed and grain business. First, livestock producers (mainly cattle and hogs) are slaughtering more animals than they are adding due to high feed prices. The short-term effect is a slower rate of change in beef and pork prices at the super market. Herds are expected to drop by nearly 4% and as supply tightens shelf prices will start to rise again. It is likely that herds will remain at the lower levels, requiring less rail-delivered feed.

At the same time the paper says "oil's rally has room to run," meaning that for a number of reasons diesel fuel isn't going down any time soon and the four bucks a gallon is going to cut into the trucks' economical day's drive. We see a lot of "truck grain" in the southeast, for example, that cuts into what the feeders bring in by rail. Higher fuel prices will increase the price of a delivered bushel by truck and present an opportunity for short lines to play in the shorter-haul grain markets. But they will have to be aggressive in rates and know where they can make a buck and where they begin to lose out. Big trains of privates quickly turned are the key.

Finally, the Chinese are bidding up the price of potash. As global food demands rise the supplies of K tighten, so much so that a ton of K now fetches nearly $600 a ton, triple what it was a year ago. And as the price of the product goes up so does the value of moving it from where it is to where it is needed. Likewise, CSX in the first quarter was able to raise its fertilizer RPU by 24% yoy (see below). Short lines that have grain and fertilizer moves ought to see better margins in both.

Which brings me to another observation about short line revenue in general. Most short lines, I think it is safe to say, are paid handling allowances or switch fees that are really FAK rates and they never see any of the increases. It appears to me that the handling fee model is broken. In the years since these agreements were signed, the price of fuel and per diem rates have risen dramatically. Handling lines can't set their own fuel surcharges, they are as liable as anybody else for any hazmat incident, and car hire relief is no answer because it shifts that cost back to the class I ops guys who are having a tough enough time coping with costs their own operations incur. The present confluence of continuing high fuel prices and "value pricing" presents a grand reason to rethink the handling fee model. Me? If I had a short line I'd go ISS in a heartbeat.

CSX had the first at-bat for the 1Q08 earnings series and posted respectable yoy gains as well as sequential quarter-to-quarter improvement. I've said in the past that CSX is a "work in progress" as they increase revenues at a faster pace than operating expense, post double-digit ops income gains and improve earnings per share. Total revenue increased 12% yoy with double-digit gains in phos & ferts, metals, ag products (this includes ethanol), chems and coal. Never mind the fact that vols were down in every commodity group but ag and system revenue units were off 2.2% yoy. System RPU gained a robust 14.5% as the CSX "Value through strong pricing" theme continues.

Ops expense was held to an 8% gain as most line items were flat to down, except of course for fuel, up 55% or $157 mm. Gallons of fuel burned actually running trains (the expense line now includes every drop of fuel used everywhere; non-train ops fuel was $36 mm) decreased 4% on a four-tenths of one percent drop in GTMs. Which tells me we're seeing more payload per revenue unit, especially since RTMs were up a point. The spread between revenue gains and expense increase generated a 29% gain in ops income that flowed directly to earnings, aided in part by $55 mm in "other income" that can be attributed to some non-recurring one-time gains. EPS came in at 85 cents, up from 52 cents a year ago, 63%. The share repurchase program contributed nine cents.

The takeaway for short lines is that customers are paying up for improved service. True, the CURE gang and the other usual suspects aren't happy, but then, transportation buyers earn their chops by spending less for more landed product. Trouble is, when the value of the product goes up, so does the place value -- a ton of coal in the furnace is worth more than a ton of coal in the ground. Transportation alone adds that value and needs to be compensated for it. One would wish the forces of re-regulation would go back to econ 101 for a refresher.

I said CSX is a work in progress. On a straight numerical basis revenues and been inching up from a point and change to more than five points quarter-to quarter since 4Q06. Ops expense has moved a point or so at a time, fuel included, though this quarter's six point gain over 4Q06 was the outlier. Ditto ops income and the OR -- a point here and there and trending in the right direction. There was some volatility in EPS -- down 30% quarter-to-quarter then up 36% sequentially. However, over six quarters on a straight percentage gains (no CAGRs here), revenue is up 13%, ops income is up 24%, EPS has improved 13% and the OR is 253 basis points better than it was at the end of 4Q06. Team CSX is on a roll. Let's hope the present distractions diminish directly.

The forces of darkness continue to hover around re-regulation. Given the low approval rating of Congress and the anti-business rhetoric of both Obama and Clinton, I would not see be surprised to see some form of railroad re-regulation and the return of the railroads' sorry pre-Staggers state. Happily, there are others more sanguine than I, JPM's Tom Wadewitz among them.

He writes, "Railroad legislative and regulatory risks are likely to remain moderate and there is narrow support for the Rail Competition Bill. At the present time the Rail Safety and Amtrak bills are top priorities for both the House Transport & Infrastructure and Senate Commerce Committees. As a result of other priorities and also limited support, we believe there is a low probability of the Rail Competition bill moving forward in 2008. Committee membership will likely change significantly in 2009 but gaining broad support could be a difficult task for its supporters.

"On the other hand, Rail Safety and Amtrak Bills are likely to pass in 2008. We expect the Rail Safety Bill to pass the Senate within the next eight weeks. Our sense is that there is sufficient time over the summer to complete the conference process and pass both the Rail Safety and Amtrak bills into law before August. We believe that both of these bills are relatively benign for the freight railroads. We expect very little cost side pressure from limbo time constraints which would be in the final Rail Safety Bill.

"Of greater concern for the rails near-term is the outcome of [certain] STB cases. While the legislative risk appears well contained, we believe that a few cases before the STB merit watching. We believe that an unfavorable ruling by the STB on the "paper barrier" case of UNP vs. Entergy could have broad negative implications. The CSX vs. Dupont "small rate case" is due for a decision in July." Both outcomes could be harmful to the health of shortlines.

Genesee & Wyoming March carloads slid 12.4% yoy and 9.15% yoy for the first quarter. Lumber and forest product volumes fell 24% due to reduced shipments in Oregon and Canada. Farm and food products traffic declined 21%, attributed to lower wheat shipments in Canada. *Northeast Rails & Ports* publisher Chop Hardenbergh notes that the 77 carloads of intermodal represents a decline of 71% from the 264 loads reported for Nov 2006. Prior conversations with GWR management lead me to believe just about all the intermodal business is on the SLR and is largely paper-related. The question remains how long they can stay in this business. (On GWR they count platforms, not boxes, as their revenue units. Ergo 77 double-stacks with no voids is 154 boxes and 264 trailers one per platform could mean biz is only off 42%.)

The* Railroad Week in Review*, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe click on the* Week in Review *tab at www.rblanchard.com. A publication of the Blanchard Company, © 2008. Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned in WIR. Specifics available on e-mail request.