THE RAILROAD WEEK IN REVIEW
SEPTEMBER 11, 2009

"The economics of transportation and infrastructure development doesn't grab voters." Larry Kaufman's "Rail Trends" in Argus Media's Rail Business Report, September 8.

There appears to be a lot of trepidation in Shortline Land about upcoming rail legislation, almost to the exclusion of everything else. Relax. The way the tealeaves are lining up, the focus on health care to the exclusion of everything else makes any new rail-related legislation this year a 50-50 shot at best. In his latest effort for *Rail Trends*, Larry Kaufman writes that House of Representatives Member Jim Oberstar (D-Minn) has his bill lined up and no place to go.

Larry writes, "Oberstar wants to hold colleagues' feet to the fire and probably will go along with a short-term continuing resolution that will maintain current programs and spending levels, but will authorize no new programs or money. The current program was passed two years late and only after several continuing resolutions. Some things never change. As a result, railroads are increasingly hopeful of staying below the radar for the rest of this session of Congress, although they know that legislation that would increase regulation won't go away."

We're now on the cusp of the annual fall meeting season with the UP shortline session two weeks away and the Eastern Region ASLRRA meeting two weeks after that. Early indications are that the UP session will be heavy on business development and operational support while the ASLRRA gathering will, predictably, be all about coping with growing Washington intrusiveness.

As to the latter, I'll leave others to comment. As to the former, however, CEO Jim Young and others of his team have made it very clear on their quarterly conference calls that they are looking for new business that can add significantly to operating income while making more fixed costs variable and thus increase margins. You can get a feel for what UP is doing to run a faster, smarter railroad on The History Channel's "Extreme Trains" series. Though a little overdone, the "Ice Cold Express" episode shows how the Wallula train gets over the UP. There's a lot of repetition and it gives CSX short shrift for its role getting the goods to the eastern markets but still the series gives the uninformed viewer a real sense of what today's railroads can do. Maybe the Members considering railroad re-regulation ought to take a look. See www.history.com/- content/-extreme-trains .

But I digress. If I were a shortline owner at the upcoming Omaha meeting and could ask one question of Young in open session, it would be, "You said in your opening remarks during the second quarter earnings conference call, 'We're pursuing new business opportunities in markets that can benefit from UP's outstanding service product.' Which markets are they and how can UP's shortline partners support your efforts in pursuing these new business opportunities?" This year's UP shortline meeting looks to me more like a conversation than a presentation. What a great opportunity to get the ear of senior management.

There are a few glimmers of a turn-around in the numbers of revenue units traversing the rails. JPM's Tom Wadewitz has "a favorable view on the rail group in general, and we believe gradual improvement in the weekly rail volumes and constructive macroeconomic data points are both potential drivers of upside for the group." As for Union Pacific, Wadewitz' view squares with what I saw on my recent cab ride in California: "We believe UP's operational improvement cost side story and its legacy re-pricing story remain compelling."

Jason Seidl at Dahlman & Rose drills a little deeper. "The deceleration in volume declines continued in week 34 underscoring optimism that the rail sector and the economy as a whole may be inching closer to a light at the end of the tunnel. Volume declines have decelerated in five out of the last seven reported weeks suggesting the emergence of a real positive trend rather than random fluctuations.

"While we are encouraged by the favorable figures and believe that economic stabilization is underway, we caution that a period of somewhat easy year-over-year comparisons lies ahead, stemming from the historic collapse of markets in the last four months of 2008. Total rail volumes decreased 16.2 percent in week 34, vs. declines of 17.1 percent and 18.8 percent in the prior two weeks.

And the short lines yet lag. The RMI RailConnect Index of 341 short lines has revenue units off 29.6 percent and 27.2 percent for Week 35 and year-to-date respectively. The rolling six-week average is minus 28.0 percent while the year-to-date numbers stay stuck at minus 27.1 percent. Chemicals, coal, grain and aggregates, bulk products all, are the four biggest commodity groups by volume and account for 57 percent of short lines' loads.

Altogether these four commodity groups were down 300,000 units year to date -- 1.7 million units vs. 2.1 million a year ago. The Rule of 100 suggests that 300,000 carloads could sustain 3,000 miles of short line railroad operations. The number also represents a revenue loss of $120 million at a nominal $400 per-car allowance or division, enough to keep 24,000 miles of shortline track up to FRA class 2 spec for 25 mph operation.

Three of these four comprise the entire "heat-and-eat" commodity list. Chemicals count because fertilizer belongs here; stone clay and aggregates do not. Coal and grain (including ethanol) are big business for the Class Is and could be the short lines' biggest hope for survival in an economic downturn. *Could* be.

Not so fast on coal, especially eastern coal. UBS Rail Analyst Rick Paterson writes, "US utility coal stockpiles are at record highs and the outlook for coal is bad. Real bad. Coal represented 28 percent of loads (less in revenue terms) hauled in the US last week and future carload volumes will depend on several factors: industrial demand for coal-fired electricity generation, natural gas prices, demand levels for export coal; and utility coal stockpiles.

"The final one, coal inventories, is growing more worrisome. June utility coal stockpiles hit a record high of 198 million tons, well above both 2008 levels and the five-year June average of 136 million, and the cooler than normal summer hasn't helped. While we'd like to put a happy face on this news it's impossible – coal will be a headwind for some time.

"Coal is a lagging cyclical and what we're essentially seeing here is LILO: Last In, Last Out. On the positive side of the ledger we expect total volume growth next year given easy comps and offsetting growth in other traffic types, and even in a no-growth environment we should still see margins and EPS grow due to the resilient pricing story."

Eastern short lines that serve the mines and the users with a Class I or two in the middle are most at risk. For example, Chop Hardenbergh reports this week that the Mount Tom coal-fired electric utility near Manchester NH has switched from rail direct delivery via NS and Pan Am Rail to a rail-truck transload off CSX in West Springfield Mass. Chop writes, "Already two trains have arrived and dumped their contents. From there, a local trucker is moving the coal to Mt. Tom."

That's a lot of trucks. In a state as environmentally sensitive as New Hampshire, it seems odd they would want to put several hundred trucks on the road to provide the fuel that one train can deliver with lower emissions and less wear on the public psyche. I can imagine that neither NS nor PAR is happy about this. And neither is the Western New York & Pennsylvania, operator of the former Erie Southern Tier route across New York State and the logical NS route where Mt Tom coal originates in the Mon Coal Fields south of Pittsburgh.

Railroad analyst Ed Wolfe admonishes investors once again in his *Monthly Macro Watch* to "look for rails with industrial-based franchises over consumer-based (Long CSX, short BNI) and with upcoming catalysts outside the US (GWR, KCS)." As we've noted before, the consumer is retrenching, savings rates are up and consumer credit is shrinking. Now comes UBS head of floor operations Art Cashin with more wariness about the consumer, only this time in a credit context.

He writes, "The July Consumer Credit report was a shocker. The estimate had been for a drop of four or five billion dollars. Instead the Consumer Credit plunged $21.6 billion, the largest drop in history. The June number was revised to a drop of $15.5 billion from the original $10.3 billion. So, the consumer had cut credit exposure in July by a record number and June had been 50 percent worse than originally thought. The consumer represents 70 percent of the U.S. economy and he, or she, looked like they were cutting up the credit cards and heading for a cave for the winter."

Quite possibly. In related notes, Jeffries & Co initiated coverage of JM Smucker (SJM) with a Buy, citing increasing share of market in "center aisle" items like peanut butter (peanuts = plants = fertilizer = materials). And Janney downgraded Best Buy (BBY) to Neutral from Buy thanks to "slow big ticket sales, less credit availability, and weak entertainment software sales"

Need more proof? The "materials ETF," XLB, is one of the better ETF performers, up 34 percent year to date. And given that railroads, especially short lines, do best in materials from copper and steel to the stuff like sulfuric acid and coke that make the finished goods, having the XLB trending up ought to be a good thing. My sense at this point is the materials guys will do OK as we start to make basic goods again whereas domestic and international intermodal will continue to find themselves in the doldrums for the nonce. Like Wolfe says, look for the catalysts. Chemicals and ag products, anyone?

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, ***© 2009. 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.***