THE RAILROAD WEEK IN REVIEW
SEPTEMBER 18, 2009

"Economists say that a reduction in the earnings of either utilities or railroads could have ripple effects on their customers." – Railway Age Newswire

"New railroad legislation is likely to come next week," writes Morgan Stanley's Bill Greene in a note issued Wednesday. He continues, "There are three key areas the proposed legislation is likely to address: 1) Provisions to strengthen the STB, giving it more authority, resources and commissioners. 2) Provisions to help increase customer access to the rail networks; and 3) Reforming review process on rail rates and service."

I still think this is a tempest stirred up by a relative teapot of big shippers, particularly those in the chemicals and coal sectors, that have issues of their own from TIH exposure to greenhouse gases from coal-burning electric utilities. The railroads are the least of their problems. Let's take the three topics and see what might be really going on.

"Strengthen the STB" is code for "put in people who will produce rulings that give me what I want." "Help increase customer access" to the rail network is code for open access and forcing one carrier's access to another's bought-and-paid for property. Any shipper who wants access to any railroad can get it -- but at a price. "Reforming the review process" is again code for "results that fit my needs."

The market drives transportation decisions, not what the STB thinks, not what railroad goes where, and surely not rates and service: if you don't like the rates and service, use another vendor. The Staggers Act revitalized the railroad industry and it appears most railroad freight service customers benefited it. Trouble is, few in Congress today appear to have a clue as to what the Staggers Act did, let alone how transportation companies work or how supply chain managers select modes. Worse yet, none of the Members seem to know anything about the Law of Unintended Consequences. Remember the old Chinese curse: May you get what you ask for.

To which the *Railway Age* Newswire adds, "Carbon-reduction legislation approved by the House of Representatives in late June and ready for consideration by the Senate could sharply erode the earnings of coal-fired power generating plants and, by extension, the railroads that deliver their fuel. A Standard & Poor's report suggested that H.R. 2454, the American Clean Energy and Security Act of 2009 ("ACES"), could cut utility earnings by 20 percent. The importance of coal for rail profitability is indicated by the fact that coal accounts for more than 40 percent of rail traffic and around 20 percent of revenues. Economists say that a reduction in the earnings of either utilities or railroads could have ripple effects on their customers, including cuts in capital investment that would affect service and capacity." Harrumph.

The Canadian economy is expected to expand by a modest two percent in the third quarter and 2.4 percent in the fourth, so says the latest forecast from RBC Economics. Improved markets, low borrowing rates and fiscal stimulus have helped. Recoveries in autos and housing will lead the charge. The report also predicts the Canadian economy will tack on another 2.6 percent growth in 2010.

However, "consumer spending is still being weighed down" by the 8.7 percent unemployment rate, which the bank predicts will edge higher by year's end. RBC expects the unemployment rate to fall in early 2010 and, if it does, the consumer may start to buy stuff again.

What Ed Wolfe said about GWR's strength in the industrial as opposed to the consumer sector goes as well for Canada's short lines. Bulk commodities and industrial products from steel to paper dominate. There's a reason the Dow Theory calls transports a leading indicator: you can't sell stuff until you have orders for it and increased orders for future deliver trigger orders for transport services.

UBS picked up the USDA's September 14 crop report and finds "69 percent of the corn crop was in Good or Excellent condition, in line with last week's 69 percent, and above last year's 61 percent." Corn futures prices rose one percent over the past week but are 46 percent below year-ago levels. Soybean prices declined 5 percent over the past week and are down 22 percent from this time last year. Wheat prices declined slightly over the past week and are down 41 percent against last September. Percent.

"Although down from the prior year, we note that corn, soybean and wheat prices remain well above historical averages, and farmers are expected to remain profitable in 2009. That said, we expect farm profitability in 2009 to be lower than in 2008 or 2007 (USDA forecasts net farm income to decline 20 percent YoY in 2009). Reduced farm profitability, coupled with above-trendline farm equipment sales over the past few years, could lead to lower North American ag equipment demand in 2010."

UBS maintains its Neutral ratings on shares of Deere (DE) and Case (CNH) based on a perception of fair value for the companies – "our Neutral ratings on DE and CNH reflect our belief that shares are fairly valued. In the near term, we expect investors to focus on the condition of the 2009 corn crop.

A pair of railroad investor conferences ran back-to-back in New York last week. At Credit Suisse Chris Ceraso hosted a spirited Q&A session on the legislative and business outlooks. Railroad investors expect some form of legislative change or update in 2010. Roughly 28 percent think the probability of this is between 41 percent and 60 percent while 20 percent expect the odds of change to be 80 percent up.

Nearly half expect the rails to raise rates between two percent and four percent. Looking even further out, 47 percent of investors anticipate long-term railroad pricing to be in the two percent to four percent range. Expectations for carload growth in 2010 were in line with what C-S believes the market and the street is pricing in -- 61 percent of respondents anticipate volumes to rise zero percent to five percent relative to 2009.

At Dahlman & Rose, Jason Seidl's main takeaway for rails goes like this: "Railroad executives cautioned that the recovery is likely to be a slow and gradual one. Solid rail pricing continues to underscore the fundamental strength of the major railroads. Capital expenditures should to be largely maintenance-related and cost cutting measures are likely to continue. [The CSX trackwork I saw on my recent cab ride across NY is supports the first; UP's improved locomotive fleet management practices such as I saw on my recent California cab ride supports the second. -- rhb]

"One silver lining that can be seen through the thick clouds of the current recession is that the railroads are likely to emerge leaner and meaner as they have trimmed unnecessary costs and learned what expenditures they can forgo without incurring material detrimental effects to their business. Near term outlook for the rail industry is positive as volumes should begin to show growth in September.

"While this is partly due to easy year over year comps, it is also a result of improving traffic in the automotive, chemicals, agricultural products and steel sectors. As business picks up the railroads are likely to enjoy high incremental margins on the first 10 percent of growth as they should only have to add railcars, and not trains, in response to volume increases." [UP says it can double the size of some trains given the potential of distributed power; BNSF is already doing it. -- rhb]

The Mount Tom coal-fired utility is in Massachusetts, not New Hampshire as I wrote here last week. I confused it with the Bow plant near Manchester, NH, as several readers were quick to note. Let me correct the error thus: Chop Hardenbergh reports in his Atlantic Northeast Rails & Ports newsletter that the Mount Tom coal-fired electric utility near Holyoke, MA is now taking coal through a CSX truck-rail transload in West Springfield rather than rail direct from Pan Am Rail. Chop writes, "Already two trains have arrived and dumped their contents. From there, a local trucker is moving the coal to Mt. Tom."

Interesting. A Google search on "Mt Tom Power Plant" yields up this tidbit: "Coal is delivered by rail cars, which arrive at the station in 80-car trains." At three-plus trucks per carload that's a lot of trucks. In a state as environmentally sensitive as Massachusetts, 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 cannot imagine that the good citizens along US Route 5 and I-91 will be particularly amused once this gets moving. I suspect we've not heard the last of this.

Watco has reached a lease-purchase agreement with the agreed with Iowa Northern & Pacific (INPR), a 210-mile collection of three separate ex-UP lines in southwest Idaho and eastern Oregon. The new carrier, the Boise Valley Railroad (BVRR) will take over operations of the 11-mile Wilder branch running west from a connection of the UP main at Caldwell and 25 miles on the old UP Boise Cutoff running east from Nampa, both of which INPR leases from UP. BVRR also gets overhead rights on UP between Caldwell and Nampa.

There are 84 customers who will be served by the BVRR, several of which are currently customers of Watco's Eastern Idaho Railroad, Great Northwest Railroad and Yellowstone Valley Railroad. Commodities shipped on the branches include potatoes, lumber, fertilizer and fuels. The acquisition fits nicely with other Watco operations in northern Idaho and eastern Washington. IANR is part of Rick Bertell's Rio Grande Pacific.

***Value Line's* Railroad outlook** is not very encouraging on the non-bulk merchandise carload side. What I'm hearing from short lines and shippers bears witness to the fact that rail's competitive advantage is in hauling heavy stuff over long distances without a lot of "railroad events" – classification yards, multiple train starts, changing of power and crews, e.g. – between origin and destination. Unfortunately, this is the exactly opposite of where many short lines live. The question is thus, "How does a single-carload franchise survive in a high-speed, high-density world." Anybody?

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.