# THE RAILROAD WEEK IN REVIEW
## OCTOBER 2, 2009

*"The focus is on new business development. You'll see more feet on the street to get it." — Jack Koraleski, Union Pacific*

**Union Pacific short lines** gathered in Omaha this week for their annual face-to-face. The theme was "Opening Doors and Broadening Horizons" and the consensus is it did just that. That they picked up a few format and presentation themes from other Class I short line meetings says they are past the Not Invented Here syndrome, however we could have done without the infomercials on supply chain management and marketing in a tough economy. But I digress.

Having ASLRRA President Rich Timmons among the first group of speakers was a good idea. His thorough description of all the legislative hurdles in front of the short lines shows just how tough the Feds are making life in the short line business, and to no real public benefit. Most of the requirements are unfunded mandates, meaning they will consume a certain amount of revenue and operating income.

Rich told me over coffee he counts 21 such mandates; nobody will be affected by them all but every shortline will be affected by some. The Hours of Service legislation is particularly nettlesome. ASLRRA has asked for waivers and exemptions for more than 300 properties. The FRA is scheduled to rule on the waiver requests this month and on the exemption requests in November. But until then everybody must follow the rules and inspectors are now in the field scoping out compliance. Take a good look at Rich's slides. They're already on the ASLRRA website; click on the News & Publication tab, then Speeches & Remarks.

UP President Jim Young was under the weather Monday morning so AVP Network and Industrial Development John Newman pinch hit, setting the stage emphasizing UP's commitment to continuing improvement in customer service. Then came Chief Commercial Officer Jack Koreleski to drill down still further into the UP-short line dynamic. There are 175 short lines doing business with UP, he said, and they touch 14 percent of UP revenues and 20 percent of volumes. Putting that in context, UP had sales of $6.7 billion in the first half 2009 and handled 3.7 million revenue units. Short lines, then, contributed to $938 million in sales and moved 740,000 units in the process.

He talked some about right-sizing UP, noting that the railroad has "parked assets" worth some $6 billion and they're bringing back those parked the longest first. The railroad can handle a bit more than 200,000 units a day with the assets and operating disciplines now in place. Volumes dropped below 150,000 units a day in late 2008 and are back to 160,000 by now, though that could still drift south before we're done with 2009.

The good news for short lines is that merchandise carload comps will get better as the year goes on given that 2008's fourth quarter was so dismal. Still, it's doubtful we'll see the 44 million annual revenue units the Class Is posted in 2007 for a very long time. Koraleski's guidance is for short lines to focus on commodity/O-D pairs where trucks will weigh out before they cube out. And if you have trouble selling an idea to a UP commodity group, take it apart, find the objections and address them jointly. Be lane-specific; generalities don't work. UP has not racked up the highest Customer Satisfaction levels in its history by walking away from challenges.

Following Jack there were two sets of three "instructional" breakout sessions with non-UP presenters representing different disciplines. I sat in on “The Evolution of the Supply Chain in the New Economy” and “Marketing Strategies in a Rough Economy.” Neither seemed to deliver what was promised or addressed the topics in a way that gave shortline attendees what they need to do either. To be brutally frank, I was unimpressed with the amount of preparation these guys undertook and I would suggest that next year the UP short line group quiz these non-UP presenters mercilessly as to what they know of the audience before the session.

That is a minor quibble, to be sure, but it left a bad taste in several mouths. The good news is the many, many one-on-one sessions and group breakouts after Monday’s lunch were very well received. I had only one individual session where we talked about product development and lane expansion in food and perishables (not surprising given my recent up close and personal encounter with the Railex train) where every question and concern was more than satisfactorily addressed.

The six commodity-specific sessions ran half an hour each and each was consistent in the way it addressed the role of the commodity in the UP franchise, the extent of shortline involvement and how to get more involved. For example, the paper and lumber group drilled down to truck costs per mile and how they relate to UP volumes and revenue per unit. The coal group surprised me with the extent of shortline contribution -- 18 short lines handling a quarter of UP’s total coal volumes. The downside is that volumes will remain essentially unchanged five years out; the good news is if you’re running coal today the odds are in favor of your running it tomorrow.

Tuesday morning’s discussion of Positive Train Control was a real eye-opener as to the impact of this legislation in terms of rail operations, sheer expense of implementation and what it does to short lines. The bottom line is implementation will cost capacity by slowing things down. The reporting and record-keeping requirement are nothing if not onerous, and the FRA determined the cost benefit ratio to be 15.4 to one -- the rails will spend $15.40 to get $1.00 in benefit.

Three key elements are wayside ratios on every switch stand, compliance consoles on every locomotive and base stations to support them all. UP alone will have to cough up something on the order of $1.5 billion and retrain some 24,000 individuals by the 2015 deadline. UP also figures it has 62 short lines that will need PTC and it must submit to the FRA a plan for their compliance by April 2010. This is a bullet -- nay, an artillery shell -- that cannot be dodged and, when added to following all the new rules Rich talked about, makes playing Short Line an expensive game indeed.

**CSX will sell its Boston-Worcester route** to Massachusetts, allowing expansion of MBTA commuter service in and out of South Station. CSX will retrain freight rights and contribute $500,000 to help pay the state’s liability insurance, plus pay a $7.5 million deductible for any accident where the freight railroad is found to be at fault, resolving a long-festering matter that has kept the parties a part for a year. The *Railway Age* Newswire says the commuter guys also get the CSX Fall River-New Bedford line for expanded regional rail passenger service. How much money is under discussion is “undisclosed,” though the deal also hinged on a commitment by state transportation officials to upgrade some bridges along the routes to allow for double-stack container train operations and to relocate CSX’s operations out of another rail yard in Boston.

CSX did something like this in South Florida when it sold the south end of the Miami Sub to Florida DOT in 1989. Initially, the new Tri-Rail commuter system ran between West Palm Beach and ...67 miles. Since then the line has extended south to the MIA airports and north to Magnolia Park. CSX still serves the freight customers (such as are left) on the former SAL and ACL lines. IMHO the Boston exit serves the same end: move yourself from the high-rent, high risk, high tax district and concentrate activities where you have room. Well done.

**A note from Jon Langenfeld** at RW Baird suggests that freight flows are at an inflection point. He writes, “Truck freight demand has improved sequentially through 3Q. This seasonal build is reflected in our conversations with industry contacts since July. The build is indicative of a freight environment that has moved past the trough. Assuming demand trends remain stable into 1H10, easing comparisons should drive positive meaningfully better year-over-year comparisons through 4Q09, with positive year-over-year growth in 1H10. However, we continue to expect demand trends to remain uneven for the foreseeable future.”

On the rail side, Langenfeld writes, “Railroad volumes have stabilized in 3Q09. Consistent with typical seasonality, each of the four US Class I railroads saw weekly carloads trends improve from July to September, with three of the four (CSX, NS and UP) reaching a peak in weekly carloads for 2009 during 3Q. While we still see modest 3Q consensus risk, given a better-than-expected seasonal build, we expect the rails to beat our lower-end estimates. Of the US Class I rails, CSX and NS had the biggest sequential improvement in terms of “less worse” yoy trends and absolute carloads. BNSF has experienced the weakest sequential trend, which we attribute to weaker coal volumes and the transition of Hub Group's intermodal business to UP from BNSF.”

The report continues with the outlooks for pricing, coal volumes and the regulatory environment. Pricing increases are expected to be in the 3-4% range for the next 14 months; one would expect ISS short lines will want to participate where possible. As for Handling Lines, I’d be very careful to make sure I get the increases I bargained for in the original transaction – I’m getting some feedback there has been some Class I resistance to recognizing same, especially where the present shortline owner is not the original one.

Baird calls coal volumes “a drag in third quarter volumes” relative to other commodities and sees no increases until mid 2010 (the UP told short lines Monday it expects tonnage to be about where it is for *five* years – see above). Finally, re-reg. Lagenfeld writes, “Given the industry’s strategic importance to the nation’s long-term infrastructure constraints, its modest returns on capital, and the rails’ strong allies (union, large shippers, lobbying groups), we do not expect the emerging legislation to be overly onerous and prevent above-inflation pricing over the intermediate term.

**This just in**: The Gabelli Fund has bought 70,000 shares of Providence & Worcester common giving it an ownership position of just over six percent. According to the 13D filed with the SEC, the transaction brings “the aggregate number of securities to 302,448 shares, representing 6.29 percent of the 4,807,702 shares outstanding as reported in the Issuer’s most recent Form 10-Q for the quarterly period ended June 30, 2009.”

This purchase makes Gabelli the second largest institutional holder after Keeley Asset Management with 8.56 percent. Better yet, Mario Gabelli positions himself as a “value investor” and is so bullish on stocks *per se* that he double-teamed with Buffett buddy Charlie Munger at last May’s Berkshire Annual meeting: “It’s a stock picker’s market but I’m not buying the market. I’m picking specific companies.” Good to know he sees something of value in PWX.