THE RAILROAD WEEK IN REVIEW
December 4, 2009

"Strategy 1: Reduce use of transportation. Strategy 2: seek less costly transportation alternatives." -- Jim McClellan, Norfolk Southern (retired).

In the last WIR before Thanksgiving (WIR 11/20) there was a thread about changes in shopping habits brought about by the internet and sharpened supply chains. In this regard, my good friend Charles McSwain, late of CSX wrote, "The platform is changing and this is the perfect time for railroads to get into the mix of new products that will support the new economy.

"Railroaders can't just sit back and wish that things get better. They need to develop the new products that provide value for lots of companies that are desperate for a cost-competitive edge in a very tough marketplace. This does not mean cheapening the old [railroad] product, it means finding new ways to insert themselves in much larger multi-multi-modal platforms that create value and new market share." At this point I asked, "Anybody want to continue the thread?"

Well, another good friend, Jim Giblin-- an old hand at managing transportation and supply chains -- took up the offer and sent this thoughtful commentary, reprinted in its entirety with permission:

Dear Roy: Continuing the thread from WIR 11-20-09, page 3, finding new ways for railroads to insert themselves into shippers' supply chains, is more easily said than done, especially if the shipper is not using rail today. During the past few years I've examined the impact of using rail carload service of some kind for various shippers' supply chains. Here are some relevant observations from that experience.

First, while most railroad salespeople are competent and well qualified to sell their service to current rail users, most of them are also woefully unprepared to sell to non-rail users. This is a completely different marketplace that few railroad salespeople have much experience in or with. Second, many large companies today have virtually no experience with, or institutional memory of, shipping by rail. (The blind are selling to the even more blind.)

Third, trucks really are far more user-friendly compared with rail service, both carload and intermodal. (This simple fact has implications far too numerous and significant to fully discuss here.) Fourth, railroaders need to stop confusing price with cost. Most companies can expect to incur additional overhead and administrative costs (some substantial) when converting from existing truck transport to rail carload service. This has included the hiring of additional staff to manage the rail program as well as increased inventory carrying costs resulting from larger shipment sizes and longer transit times. In short, railroad salespeople need to look at the total cost impact to a customer's supply chain and not just focus on the lower rail rate. Jim Giblin

Jim has it exactly right. But there's another bit of blame to pass around: to the transportation buyer who thinks that spending less today than he did last year and getting more transportation for the dollar than he did last year is the best route to professional advancement. He's used to haggling for rates and feels cheated when a vendor tells him, "That's the price; take it or leave it."

I'll never forget the guy who proudly told me he could save a dollar a ton on a 20-ton truckload shipment just by calling around among his trucker buddies to get a good rate. I asked him how long that would take. He said about an hour. I figured he makes about $40,000 a year or roughly $20 an hour. So by spending an hour calling around he saved his boss...nothing.

It's this kind of thinking the rail guys and gals have to walk away from. Here's the rate, if it doesn't work, have a nice day. There's no sale here so there's no sense wasting any more time on this prospect. Go have another cup of coffee and get to your next call.

Another Jim, McCllellan by name, has been making the rounds with a great intermodal presentation that contains some important observations for the carload guys -- especially those with short lines where it's almost all carload business. Here are some warning shots, especially when taken in the context of Giblin, above, and the Nov 10 Morgan Stanley report on the US Consumer and Retail.

First, "Railroading 101." The ideal railroad service offering is for high numbers of cars moving between the same O-D pairs. That's why unit trains work so well, whether bulk products, intermodal or the Railex perishables train. But we live in a fragmented world with lots of origins and lots of destinations -- good for trucks, bad for trains. Custom service vs. batch service, in other words, where rail is "an inconvenient mode" and "historically convenience has trumped efficiency." Like my guy who could haggle for a dollar -- even though it didn't make economic sense in the larger picture, he felt he was doing *something* and it was more convenient than fighting with that intransigent so-and-so from the railroad.

McClellan asks rhetorically, "Are the best days for transportation behind us?" He cites two trends in logistics strategies that just happen to run parallel to the M-S study mentioned above. "Strategy 1: Reduce use of transportation and Strategy 2: seek less costly transportation alternatives." These two strategies boil down to matching inventory to sales, keeping supply chains short in both time and distance, and using the *most efficient (*lowest all-in cost from manufacturing point to shopping basket, not just freight prices) means at hand.

This could be, says McClellan, "a *huge* boon for intermodal and carload to transloads could benefit as well." Absolutely. Look at the Railex model. Perishables are packed in refrigerated boxcars more by temperature requirements than by beneficial owners or STCC, gathered into carloads at two west coast origins and sent in non-stop unit trains via UP and CSX to one destination. On arrival, the goods are sorted by destination store and trucked directly there. It's convenient, dependable, efficient and growing.

Reinforcing this theme a note from Tony Hatch: "For all of the anecdotal talk of rails losing share back to truckers on price (again, on the margin, for those few shippers truly playing the spot market), the best evidence came from the [IANA meeting] public forum – 65% of the shippers expected to increase rail share in 2010. Clearly carbon is one reason (see Home Depot, which spoke strongly about their plans, and Wal-Mart, Pepsi, P&G, etc), as are expectations of consistently higher fuel prices, the rise in rail service, etc."

CSX announced that David Brown, 50, will become Executive VP and Chief Operating Officer upon the retirement of Tony Ingram, effective December 31, 2009. Mr. Ingram is generally given credit for operationally turning around CSX since his arrival from competitor NS in March 2004. Mr. Brown previously served as VP and Chief Transportation Officer of CSX and has nearly 30 years of experience in railroading. Prior to arriving at CSX, he spent 25 years with NSC in various operating roles, and has been viewed as Mr. Ingram's obvious successor since arriving from NS two years after Mr. Ingram in May 2006. Succeeding Mr. Brown as VP and Chief Transportation Officer will be Cindy Sanborn, formerly VP-Northern region.

Rick Paterson of UBS called on Mr. Brown the other day and writes, "When asked the key question: What's going to change? The answer was, predictably—Nothing. No surprises there given Brown has worked with Ingram for the last three years at CSX and about 15 years prior to that at Norfolk Southern. It was also the right answer, in our view, given Ingram successfully turned the CSX ship around after a lost decade, operationally."

Rick concludes, “A key role of the COO is to motivate, lead, and engender operational discipline across a dispersed and unionized work force. Brown has been performing exactly that function as Chief Transportation Officer and regards CSX’s work force as equivalent to NS in terms of training, commitment, and productivity. Overtaking NS as the safest Class I railroad is expected within four years, aiding margins.”

JP Morgan’s Tom Wadewitz sees other efficiencies. “We believe one of the key factors enabling productivity gains for CSX is the ability to expand train length both in the unit train network and also in the carload network. CSX’s TSI program should contribute to productivity through increasing the length of coal and grain trains where shippers have the capability to handle longer trains. With an average size of around 80 - 85 cars (~5,000 ft trains) for its merchandise trains, we believe that CSX can increase length by 10% -20% without bumping up against network capacity constraints.”

Good point. CSX predecessor lines for the most part were not Big Train railroads that ran on tight schedules and where asset turns ruled the day. CEO Michael Ward has made fixing the limitations that he inherited a top priority and his bringing Tony and David over from NS has gone a long way toward achieving this goal. I’m personally pleased to learn David got the job. And thanks, Tony, for your continued focus on the Leadership, Discipline and Execution pyramid you used so effectively in all your analyst presentations. It was a delight to see the proof of that particular pudding in the field.

Rail Traffic slipped again in Week 46, down 5.3 percent, though the rate of decline is slowing. The real question is the rate of decline compared to what. Credit Suisse analyst Chris Ceraso publishes a chart of weekly carload changes vs. the previous year and his 2008 is most revealing. Through 2008’s Week 35 volumes were off a point or so each week but tanked to minus seven points by Week 38, coming back to minus one in Week 40 and than taking the final plunge to minus nine percent in Week 46. So here we are in Week 46 of 2009 and we’re down five points from 2008 and that was off nine points from 2007’s Week 46. YTD revenue units remain down 17 percent year-over-year.

RMI’s RailConnect index for short lines still shows YTD carloads off 26 percent, right about where they’ve been for the past six weeks. Like the Class Is, there is some sequential improvement -- if you consider down less this week than last an improvement. And again, the question is, down compared to what? Week 46 for 2008 was down nine percent from the previous year, so the 2009 number is off a whopping 25 percent over two years. That’s why I’m not very encouraged about organic shortline growth any time soon and remain convinced the only way to grow revenue is to buy it through acquisitions.