THE RAILROAD WEEK IN REVIEW

May 28, 2010

"Without rails, it fails." -- Mark Murawski, transportation planner for the Lycoming County (Pennsylvania) Planning Commission

"It," in this case, is the Marcellus Shale natural gas field that covers western Pennsylvania, southern New York, Eastern Ohio and all of West Virginia. In the past two years a total of 1,245 new natural gas wells have been sunk in Pennsylvania alone and there are another 900 permits outstanding. Putting that in railroad context we're talking about roughly 40,000 loads already and nearly that much to come if every permit gets a well.

Do the math. The drilling process involves "hydraulic fracturing," a process in which drillers pump large amounts of water mixed with "frac" (short for fracturing) sand and other fluids into the shale formation under high pressure to fracture the shale around the well, which allows the natural gas to flow freely to the well bore. The amount of frac sand typically required for hydraulic fracturing in just one well can run in excess of 4 million pounds or 20 railcars' worth and can come from points as close as southern New Jersey or as far away as western Canada.

In addition to the sand there's the drilling equipment itself, the miles of pipe of varying diameter, cement and other materials, none of which is typically found locally. Setting up just one well site requires 100 truckloads of drilling equipment and all must come from afar. Wells can be from 3,000 to 7,000 feet deep and have lateral lines of horizontal drilling that can extend another 8,000 feet from the vertical core.

For example, a 6,000-foot deep well with one 5,000-foot lateral line will need 11,000 linear feet of pipe or 200 segments. Area short lines tell me they get about 160 pieces of 55-foot pipe, depending on diameter, in each open-top gondola car so our sample well needs one and a quarter carloads.

Thus the 1,245 wells sunk over two years have conservatively consumed in round numbers 25,000 loads of sand, 12,000 loads of drilling equipment and 2,000 loads of casing pipe. You get to 40,000 carloads pretty quickly at this rate. And we haven't even mentioned the cement and the transmission pipe. Like the man says, "Without the rails, Marcellus fails."

The occasion for Murawski's remarks was the 2010 Pennsylvania Freight Seminar, an annual affair of the Pennsylvania Rail Freight Advisory Committee. More than 150 souls representing Class I, II and III railroads, railroad customers and suppliers, legislators and state staffers had signed up for the day and a half program.

On Day One, after a hearty welcome from Eric Madden, Deputy Secretary for the Pennsylvania DOT Department of Aviation and Rail Freight, we heard from speaker panels on railroads as supply chain partners, the governmental goings on in DC and Harrisburg and railroad legal matters from FELA to gensets. It was Friday morning that we lit into the Marcellus panel and

Mark Murowski led off with his "rails or it fails" thesis. As noted above the numbers are truly daunting. And the limited highway network in western Pennsylvania doesn't help. The effective well-service radius for a railhead is about 75 miles, so the closer to the well-head the railroad can set up its transload the better. An area that big comprises a lot of 75-mile radius circles so it's easy to see why without the railroads, there would be no massive Marcellus Shale development.

Four Pennsylvania short lines -- the Lycoming Valley, the Reading & Northern, the Wellsboro & Corning, and the Penn Lines of the R.J. Corman Railroad Group -- are the present shortline players. And, New York's Western New York & Pennsylvania is just waiting in the wings for New York to get its permitting act together so it can begin opening transloads along its 200 miles of ex-Erie Lackawanna main line between Hornell, N.Y. and Meadville, Pa. Norfolk Southern is the prime Class I beneficiary with 90 percent of the loads; Canadian Pacific handles the other 10 percent.

Business is coming back to the rails, and at a pace that can be absorbed by the assets on hand. Easy year-over-year comps will come to an end in the third quarter, so the double-digit pace will slow, as will the month-to-month volume deltas. All this and more came out at the third annual *Wolfe-Trahan Global Transportation Conference* in New York City this week. Tuesday was mainly truckers and logistics support firms; Wednesday was more rail-oriented.

Ed Wolfe set the tone for the day, saying that in their recent proprietary shipper study, 58 percent of respondents said they expect to make sourcing changes over the next five years, with 18 percent pulling back to Mexico (positive for KCS and UP) from more distant points and another 12 percent plan to move sourcing back to the US or Canada (positive for everybody). The outlook for continuing growth in rail volumes continues, though perhaps at a less torrid pace as the easy comps with 2009 traffic levels come to an end in the third quarter.

Each of the railroad speakers addressed these points in one way or another. We heard first from UP's CFO Rob Knight who sounded what became a recurring theme among rails: adding merchandise cars to existing trains without increasing operating costs much beyond incremental fuel. Pat Ottensmeyer, Chief Marketing Officer for KCS, said cross-border business with Mexico is up 53 percent in the past year with intermodal truckload conversions offering the best growth opportunities.

Norfolk Southern CEO Wick Moorman said April 2010 revenue units were up 25 percent year-over-year and May looks about the same. The key to NS future revenue growth lies in the six "corridors" that open up new markets for all commodity lanes but chiefly domestic intermodal. Derrick Smith, VP of Financial Planning and Analysis at CSX, cites particular strength in the coal rebound, swinging to eight percent up year-over-year thus far in Q2 from 13 percent down in the first quarter. Export coal volumes double what they were a year ago. He reiterated the theme of more volumes for less incremental cost, saying Q2 volumes were up 13 percent on five percent more crew-starts.

The shortline and regional railroad forum was most revealing, giving listeners a level of insight as to why these players do what they do. Genesee & Wyoming CEO Jack Hellman was first, saying their network is right-sized for handling 80,000 cars per month. They have been cutting

expenses at the same rate as revenue declines to push the operating ratio into the mid-70s. The priority going forward is to add new revenues without commensurate increase in expense.

Indiana Rail Road President Tom Hoback said earnings have increased at a rate of 13.8 percent per year for 20 years and he expects to maintain this pace for at least another five years as coal and industrial products make up 65-70 percent of the business base. INRD ran its first train to the new Peabody mine Wednesday (see page 72, April 2010 *Trains*).

RailAmerica President John Giles calls his company a "work in progress," saying what was an $85 million (sales) company when they bought out the previous owners in 2006 is now a $135 million company on less volume, fewer railroad names, lower head-counts and a smaller asset base. Carloads are up 16 percent on ten percent less fuel and five percent lower transportation expense per gross ton-mile.

Watco President Rick Webb wrapped up the session by positioning his company as a study in service diversity with 58 percent of sales in the transportation division and its 22 railroad names, 36 percent of sales in mechanical support, mainly car repair and maintenance, and the remaining six percent in transloading and warehousing. The commodity spread is largely devoid of consumer products; metals and minerals, chemicals and agriculture account for 83 percent of revenue units. Year-to-date carloads for 2010 are up 40 percent to 56,000 units; anticipated revenues for calendar 2010 approach $320 million.

During the Q&A is was pretty much agreed that new carloads (ex-unit trains) can be added to existing train starts with little incremental cost, that running better smarter railroads may mean some furloughed T&E folks will not be able to come back in that craft, and that the terminal access provisions of the STB Reauthorization Bill would allow the Class Is to come in and cherry-pick their best customers.

As for acquisitions, there are fewer distressed sellers even with the economic downturn because operating capacity and flexibility allowed even the shortest of short lines to reduce outlays at the same or better pace than the revenue fall-off. Clearly, core competencies paid off as assets were sold off or conserved. GWR's Hellman said incremental carload margins could be 50 percent or more and INRD's Hoback said they're cascading out old power with newer units that can deliver the same or more total horses with fewer units.

Next up: Canadian Pacific's Investors Day in Calgary next week, complete with train ride over the mountains. I expect it will be highly informative and enjoyable. Film at 11.

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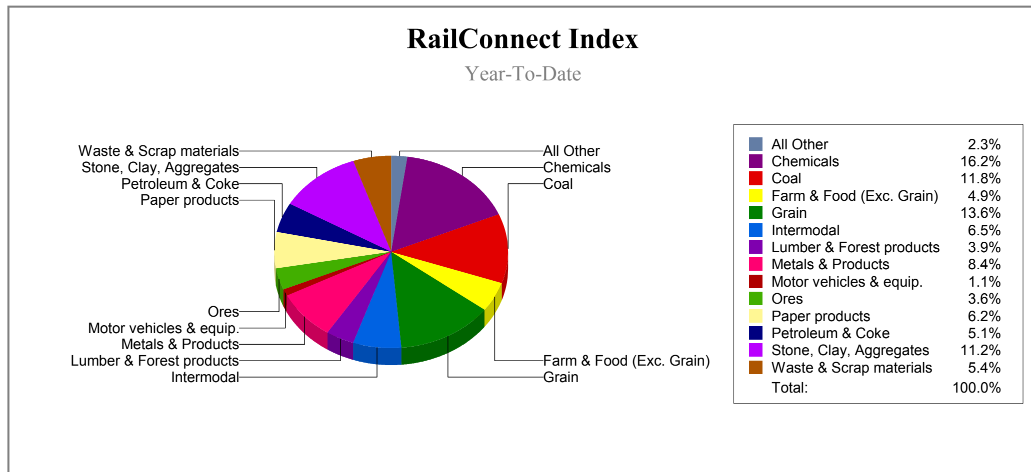
RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 5/22/2010

Week Number: 20

Carloads Handled	Current Week			Year-To-Date		
	2010	2009	% Change	2010	2009	% Change
Coal	10,341	12,629	-18.12%	225,190	261,646	-13.93%
Grain	11,522	10,487	9.87%	258,729	223,631	15.69%
Farm & Food (Exc. Grain)	4,577	5,042	-9.22%	92,686	97,589	-5.02%
Ores	3,448	1,524	126.25%	69,671	30,883	125.60%
Stone, Clay, Aggregates	12,747	11,571	10.16%	212,958	187,032	13.86%
Lumber & Forest products	3,863	3,680	4.97%	73,538	68,824	6.85%
Paper products	5,698	5,562	2.45%	117,558	119,387	-1.53%
Waste & Scrap materials	5,797	4,113	40.94%	102,914	84,220	22.20%
Chemicals	15,661	13,619	14.99%	309,954	296,207	4.64%
Petroleum & Coke	5,325	3,586	48.49%	96,616	85,761	12.66%
Metals & Products	8,769	5,958	47.18%	160,209	123,420	29.81%
Motor vehicles & equip.	1,314	1,011	29.97%	21,638	18,149	19.22%
Intermodal	4,859	6,761	-28.13%	124,060	145,279	-14.61%
All Other	1,991	1,048	89.98%	43,469	28,807	50.90%
Total	**95,912**	**86,591**	**10.76%**	**1,909,190**	**1,770,835**	**7.81%**



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Note: Ex-intermodal, which is mostly international containers to and from ports, short lines are up roughly 9 percent year-to-date. Class Is ex-intermodal are up 10 percent.