THE RAILROAD WEEK IN REVIEW
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"John Mica (R-Florida), Chairman, House Transportation and Infrastructure Committee, has made it clear that he wants to see railroads free to carry the nation's growing freight volumes, unhindered by government." -- Larry Kaufman in Argus Rail Business

Finally, some semblance of reason is coming out of Congress concerning freight transportation in this country. Readers will recall that Mica's predecessor Jim Oberstar (D-Minn) and his pal Jay Rockerfeller (D-WV) over in the Senate, really wanted to put the screws to the rails to pay off their pals in CURE and other so-called "advocacy" groups.

Says Kaufman in his Argus *Rail Business* column of March 14, "Late in last year's congressional session, senator Jay Rockefeller (D-West Virginia) realized his draft legislation that would go a long way toward re-regulating railroads had no chance of passing. Not willing to let the issue die, he urged Surface Transportation Board (STB) chairman Daniel Elliott to undertake the re-regulation task administratively. Elliott agreed to do so." Then came the election and the consequences thereof.

Kaufman continues: "Increasing economic regulation through STB oversight is made more difficult by budget and personnel limitations. Several major proceedings are running late and more appear to be falling behind original schedules. One of the most important is the revision of the Uniform Rail Costing System (URCS), the underlying data base that is used to determine the revenue to variable cost ratio of rail rates. Until URCS is completed, shipper rate complaints and other proceedings face the prospect of administrative delay."

It's bad enough that at best URCS is 12-18 months out of date when it comes out, so arguing a case with it can bear little relationship to reality. The railroads are adapting new accounting systems that can pin specific costs to specific customers and do it by specific carload. Railroads are discovering there are places where legacy costing systems do not fully capture today's realities in real time whereas these new systems do. So until the URCS gets closer to real time, and Eyeris can show real costs, not legacy costs, customers bringing rate cases could be in for tough times. Mica is right: frivolous rate cases hinder the abilty of the rails to do their job. Better to get the URCS working right first.

Meanwhile, the would-be re-regulators in Canada have run into a buzz saw in the formidable form of Canadian National CEO Claude Mongeau. In a press release the company "expressed its serious concerns" about the final report of the Rail Freight Service Review (RFSR) panel that was issued March 18. In a word, CN expressed "disappointment."

Said Mongeau, "CN disagrees with the focus and tenor of the panel's recommendations. Like the dissenting panel member, we are concerned that the panel's recommendations are drifting backward toward more regulation instead of encouraging the current momentum for positive

change," adding that the panel failed to act on the hard facts that were before it, which show that rail service in Canada is actually quite good overall.

The panel, in CN's view, "failed to recognize the significant positive change that has been taking place over the past two years to address key service issues, including improved customer engagement, initiatives to improve the first-mile/last-mile of rail traffic movements, and enhanced supply chain efficiency and transparency."

Moreover, "The panel arbitrarily exceeded the scope of its mandate by opining on railway competition. The panel asserted that the railways' 'market power' is a cause of service problems, while ignoring the clear evidence to the contrary and providing no support for its unsubstantiated claim. The Canada Transportation Act (CTA) already provides extensive safeguards to protect shippers' interests, and we believe a regulatory approach runs the risk of stifling innovation and thwarting the progress that has been achieved in the last two years. Burdensome regulation targeting railways alone is not the solution. Greater supply chain collaboration and more service innovation are what is needed to foster Canada's prosperity."

Canadian Pacific was not amused, either. While commending the Government of Canada "for recognizing commercial principles are the key to improving the overall performance of Canada's world class supply chain," CP cautioned that additional regulation for relationships outside of commercial agreements is completely unwarranted. "Isolating the rail sector will not produce the desired results," said President and Chief Executive Officer Fred Green.

The press release continues, "To offer an independent assessment of the state of regulation relating to Canadian railway service, the government commissioned third-party research which confirmed that the current regulatory regime for rail in Canada is robust and is superior to other frameworks reviewed. While the report suggests negotiated commercial principles are preferred, I am concerned about the application of some of the recommendations involving regulation. The devil will be in the details."

As if the government isn't making life difficult enough, the weather really hammered CP. I had just finished reading their press release when this photo dropped into my e-mail box. As you can see, this is no small snowfall. There were two other shots in the series -- one from the side so that only the roof of the loco is visible, the other of the mouth of a tunnel as a small yellow glow at the base of a mountain and surrounded by snow drifts -- tracks are nowhere in sight. The location is given as Rogers Pass between Revelstoke and Golden. Brrr.

Says CP in the press release, "Since the new year, multiple severe weather events have caused significant disruptions to train operations across our network. Slower train speeds have reduced productivity and asset velocity thereby constraining network capacity and limiting our ability to

meet market demands. The impact of avalanche disruptions are just one factor that increased fivefold this year in our busiest corridor."

For its part, Barclay's, Inc., had this post on on the Schwab streetsmart.com website: "Shares of Canadian Pacific dipped 2.3 percent to $64.19 in late market movement on Tuesday, following guidance from the company concerning Q1 guidance Monday night. Barclays now rates CP shares at Underweight, saying there are better picks in the railroad group. "While the severe weather would normally be discounted as a one-time event, the magnitude of CP's miss reduces confidence in the company's ability to achieve its long-planned operational turnaround."

Still, "As Rails near or exceed all-time highs, the market increasingly wonders how earnings can keep surprising. We think efficiency gains are the answer; these gains are likely to sustain the positive backdrop the shares have enjoyed for several years. Significant capital investments made by the industry following the great recession have had a more profound impact on core productivity than we expected.

"Because we view these gains as core productivity rather than operating leverage, we believe they will be sustained, if not compounded, as volumes recover further. Detailed cost analysis suggests that efficiency gains may be under-appreciated. CSX looks most attractive, CP least attractive: While all rails should benefit from the phenomena discussed in this report, we see the most appealing upside in CSX. We see modest upside in CP, but suspect the shares could underperform other railroads under our coverage."

To which a Wolfe Trahan note adds, "Bad weather and rising fuel should be drags for the entire group in the 2011 first quarter, although we don't expect anything close to the same magnitude of EPS misses for the other rails. Note that CP's volumes are down 5 percent quarter-to-date vs. the other large-cap rails up 5.5 percent on average. CP's train speeds are also down 13 percent in the quarter vs. the other rails down only 3.6 percent on average. We expect more modest EPS misses (less than 5 percent) for the rest of the group, although we still expect positive y/y earnings for each of the other large-cap rails."

As for the world at large, Goldman Sachs has encouraging words about the US economy in its January, 2010 *Outlook*. "US consumers may be further along in repairing their balance sheets than many think. Over the last three years, the savings rate in the US has more than tripled, from 1.7 percent to its current 5.7 percent. This fits neatly with the conclusions of two recent International Monetary Fund (IMF) reports that found that an appropriate savings level, incorporating consumers' need to further reduce debt, was between roughly five and seven percent. In other words, the current level is already close to the median of the IMF range."

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