THE RAILROAD WEEK IN REVIEW

June 24, 2011

"The U.S. economy is suffering from a lack of demand and borrowing, not a shortage of funds or liquidity." Wall Street Journal, June 22, 2011

The STB's regulatory witch hunt a lasted a day and a half this week and, by my reckoning, accomplished little. I managed to avoid being there in person, opting instead to spend a delightful afternoon boating on Long Island Sound. However, my good friend Tony Hatch, who always has a good ear for Washington doings, was there. He writes:

> **Shoot-out at the STB Corral**. Day One [Wednesday]was a big, hot looooong day in Washington as the Clantons of rail re-reg and the Earps of the railway industry all gathered in one room for hearings on rail competition and access (what I have been calling "re-reg lite"). The testimony and Q&A went on for nine hours with but one short break (at 2:30); no coffee or water or even air conditioning. In the end, nothing definitive had been established.
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> The rails took this very seriously, with testimony not only from the AAR and ASLRRA but also three Class One rail chairmen (UP, KCS, CSX) – and another who showed up for moral support (NS). The rail case was solid and backed up by facts on ROIC (improving but still inadequate by the STB's own measurement) which, has been record, through-the-Great-Recession and continuing capex.
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> The Q&A was the most interesting part and the exchange revealed an interesting truth. The issue for those shippers who want to see change ("reform") is all about price. Service was constantly described as good (to better) and "efficient." I believe that weakens their case, certainly compared with the past efforts where there was a service component to the complaint. The group representing the interests of those shippers supporting changed regs got away with calling rail pricing power, new since 2004, "collusion – either implicit or explicit."
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> All three STB Commissioners participated fully in the Q&A, including the Chairman, Dan Elliott, newcomer & Vice-Chairman Ann Begeman and Commissioner Frank Mulvey. The last-named asked most of the hard, fact-based analytical questions and while fair, seemed to me to be testing the shipper position for more than anecdotal evidence. [I kinda expected that, if based only on some one-on-one chats with him and his staff over the years -- rhb]
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> Senator Rockefeller made a surprise visit to argue for his case for re-reg and perhaps to pressure the STB – in part an acknowledgement that legislative efforts are DOA. He mentioned the consolidation into four Class One railways, awkward what with KCS Chairman Mike Haverty in the front row, having given one of the most forceful defenses of the status quo.

Day Two, according to the myriad reports out there, seemed calmer. Perhaps Rick Paterson at UBS sums it up best:

> The shippers want open access (don't think that's gonna happen) and a more tolerable – from a time and cost perspective – rate case process (possible in some form), while the rails, predictably, prefer the status quo and argued for replacement cost-based return metrics. Advocates for extreme change haven't put forth specific and practical solutions, and from Chairman Elliott's questioning, it appears the STB will likely focus its efforts on either access issues or rate case procedures.
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> The elephant in the room is the lack of clarity around congressional intent. Key Senate Democrats favor tougher regulation, but key House Republicans are opposed to it. Given this standoff, we expect a relatively unseasoned STB caught in the middle to do something that pretty closely approximates nothing; certainly with regard to impacting railroad earnings power anytime soon.

My take-away for the short lines is keep your heads down. I sense a lot of posturing on the shipper side especially and that's dangerous. I've said before that open access can drive off the incumbent, leaving the industry captive once again, and that forced trackage rights can drive investment away from the shared route. In either event, short lines along the way are harmed.

Meanwhile, one can't really say rail traffic volumes are what one might call robust. The AAR through Week 24 (June 18) says carload business is up 2.8 percent -- about even with GDP thus far -- and intermodal up 7.3 percent and representing two out of every five Class I revenue units. Which is fine until one starts looking at margins, where new (to the railroads) activity-based costing systems like the EyeProfit tool from Eyeris (CP calls theirs "Polaris") are getting traction. These are the measures that put every cost against a specific customer or commodity-OD pair, and that includes -- for intermodal, especially -- terminal costs.

The carload sector faces similar challenges. Single-commodity scheduled trains running point-point with no intermediate yards can and do charge premium rates for premium and produce good margins. At the other end of the scale, single-car moves from many points to many points with four or five train starts plus intermediate yards are tough on equipment utilization, track capacity and margins. Not good news for the sixty percent of short lines in this space.

And so is that RMI's RailConnect Index shows a similar trend with short lines. The carload sector represents 92.5 percent of revenue units with the remaining 7.5 percent intermodal units on a handful of special-purpose short lines specializing in water-borne containers. Carloads are up 7.8 percent year-over-year, with coal, grain, chemicals and aggregates making up more than half the total units. Drilling down still further, fertilizers are in the chemicals group and frack sand for the oil and gas exploration business is in aggregates, which means my "heat and eat" thesis is still holding up.

Genesee & Wyoming and RailAmerica's May traffic (remember, we're only doing North American vols for GWR and excluding Australia keep apples-to-apples) reports were uninspiring. At RailAmerica, the May total of 69,776 units was down 1.7 percent year-over-year, down 3.2 percent from April, 2011 and down 1.7 percent for total year-over-year carloads. The good news is four of the five largest commodities - ag products, chemicals, non-metallic minerals and paper products -- were all up year-over year, with all but chemicals up by double-digits. And of these five, all but paper count as heat-and-eat.

Genesee & Wyoming made out a little better, but still not a barn-burner. North American revenue units for May came in at 63,028 -- up 2.3 percent over May, 2010, down 3.8 percent from April, 2011. The year-to-date total volume was up 5.8 percent over the same period in 2010. Three of the top five volume contributors were up -- minerals and stone, paper-related and "other," largely NS overhead coal in Ohio -- were up while coal and metals drifted south.

The heat-and-eat theme is not as pronounced here and in one regard may be a liability. Overhead traffic comes and goes depending on the traffic volumes and system capacity of the road sponsoring the overhead traffic, in this case NS overhead coal. This is -- if I recall correctly -- mostly steam coal for electrical power generation, where first quarter tonnage still lags the 2009 number by six percent or two million tons. Export coal tonnage, on the other had, is 1.5 times what is was in the 2009 first quarter, meaning that the Ohio overhead coal business, while paying the rent, does not appear to be a growth business.

How about a short line unit train of coal out on one of the busiest lines in the UK? It's the Weardale Railway and I found out about it when Iowa Pacific president Ed Ellis responded to my WIR request for shuttle train stories. In a nutshell, two UK affiliates of Iowa Pacific, Weardale Railways CIC and Rail Management Services, Ltd. (RMS), have begun handling coal from a new transload terminal at Wolsingham in County Durham to the Tata Steelworks in Scunthorpe, North Lincolnshire.

This is a great "rail renaissance" (thanks, Tony) story. The line was originally built by the Stockton & Darlington Railway in 1847 to transport limestone to the ironwork of Teesside, and by 1895 had been extended to its final terminus of Wearhead. Although the passenger service was withdrawn in 1953 (apart from a limited summer Sunday service between 1988 and 1992), the line was retained for freight use transporting bulk cement from the Blue Circle works at Eastgate. This ceased in 1993, so the line was mothballed and threatened with lifting.

Fast forward to 2011 and coal produced at UK Coal's Park Wall North mine is trucked a short distance to the transload facility. Once loaded, trains operated by Colas Rail transport coal to the Tata steelworks at Scunthorpe. (Prior to opening the transload terminal, the coal was being handled by truck for the entire movement.) Weardale Railway owns both the terminal and the railway line by which trains access the transload terminal from the national network at Bishop Auckland, approximately 15 miles away. RMS provides switching and related services at the terminal.

Closing thought. Stir the results of the STB Shoot-out, the ho-hum carload vols and the shaky economy into one big pot and you get Caution Stew. If I were a Class I commercial officer, I'd be looking to maximize revenues on moves where I can have decent margins and rapid equipment turn times -- see CP's Long Train Strategy and the RPU results at NS. If I were a short line owner I'd be concerned about dwell times, contribution per carload, asset turns and being rewarded with larger divisions for improving these metrics month-to-month.

And though I don't often comment on the passenger side, Don Phillips' *Trains* column for August, 2011 has insights that bear as well on the freight side as regards government intervention where it has no business intervening. The context is the congressional hearings on privatizing Amtrak.

> How strange that many of Amtrak's alleged "sins" are the result of congressional action, or inaction, or the fact that Amtrak is forced to try to be a commercial enterprise while still living within federal contracting and procurement rules. It's a tactic that amounts to this: Force people to act a certain way, wait for them to do it in order to survive, and then condemn them for doing so.

So you re-regulate the freight rails, they start limiting service options for marginally profitable commodity O-D pairs, and single-car shippers on branch lines -- to cite one possibility -- find themselves with less than adequate service. They complain to the STB and here we go again. It's no way to run a railroad.