THE RAILROAD WEEK IN REVIEW

December 16, 2011

"Hiring in 2011 has added less-experienced staff who take longer to become productive, temporarily deflating productivity metrics." -- Rick Paterson, UBS, on railroad productivity measured in revenue-units per T&E employee

AAR North American commodity carloads year-to-date through December 3 increased 2.1 percent over the same 48-week period in 2011. Intermodal units gained at more than twice that rate -- up 4.9 percent -- bringing the total revenue unit count up 3.3 percent. Short lines as measured by the RailConnect Index covering 399 properties have Week 48 year-to-date carload commodities up by 6.6 percent, three times the Class I increase. Intermodal was up by 10.6 percent, though I tend to discount that as only a handful of short lines have any at all and it skews the carload picture for the Class II and III rails.

Be that as it may, comparing actual volume deltas is instructive. Class I commodity carloads increased by 382,482 units, whereas the shortline commodity carloads increased by 336,396 units -- that's 87 percent of the Class I increase in commodity carloads. Where it's coming from is worth a look, too. AAR grain was down 3.5 percent vs down 3.2 percent on short lines. Class I coal was flat with a 0.1 percent gain; short lines were up 1.7 percent. (I suspect this is largely met coal as the shortline percentage of steam coal carloads is smallish at best.)

Short lines posted a 12.7 percent hike in aggregates (mostly STCC 14, where frack sand falls) vs. the Class Is' 3.5 percent increase. Chemicals (STCC 28 and 49, ex-STCC petroleum products) gained 10.5 percent on short lines against 4.9 percent for the Class Is. These four commodity groups, says RailConnect, represent 51.9 percent of shortline revenue units, so to have three out of four in the up column is good news indeed.

For a closer look at the decline in shortline grain carloads, read what a central plains railroad heavy in wheat writes:

> The drought this summer did extensive damage to the wheat, corn, and soybean crops. We are seeing similar trends that everyone else is seeing with farmers and elevators taking advantage of the carry's in the wheat market. We normally see our wheat move relatively quickly after harvest because the elevators need to make space for the fall harvest but this year it was so poor they didn't have to make any space.
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> The planted wheat acres for 2012 are up 10-15% in our service area. We have reasonable soil moisture at this point; if we have a few more timely rains/snows, it will give our farmers and elevator managers more confidence in the 2012 wheat crop. This will cause a good movement of pre-harvest (Feb-May) wheat movement to make space for new crop wheat.

> We have a very good opportunity for a large wheat harvest but the amount of moisture we receive over the next 3-4 months will dictate how big it is.

As for the Class I outlook, Jason Seidl at Dahlman & Rose writes:

> We believe the railroad industry is well positioned for 2012 based on the following reasons: 1) high fuel prices and tight truckload capacity, 2) the moderate economic growth environment is favorable for the railroads, which typically lose some operating efficiencies during times of high growth, 3) the ability of the railroad industry to continue to price above its cost basis, and 4) the larger carriers can be viewed as defensive plays during periods of macro uncertainty.
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> While we continue to view UNP favorably, the pricing upside from legacy contract renewals may now be partly reflected in the shares. CSX shares, on the other hand, may be somewhat under-owned, as they are up 9% in the last three months (vs 13% for the Class I average – excluding KSU – and 16% for the company's Eastern competitor NSC). The company is well-positioned to benefit from the Maersk contract next year. Investors may recall that CSX won all of Maersk's business on the intermodal lanes that it serves in the East for 2012.

RailAmerica and Genesee & Wyoming (North America only) November carloads both declined year-over-year as RA slipped 2.5 percent (3.4 percent on a same-railroad basis) and GWR was off 1.6 percent (3.8 percent same-railroad). Once again, RA had gains in its smaller-volume commodity groups -- automotive, forest products, farm & food, waste & scrap -- while taking declines in top four groups that make up roughly half its traffic base: coal, ag products including grain, chemicals and paper. RailAmerica carloads were three percent down year-to-date and 2.6 percent behind October.

GWR posted volume gains in three out of the top five commodity groups -- minerals & stone, metals and paper-related -- with declines in coal and “other,”: chiefly NS overhead coal in Ohio. November year-to-date loads were 4.7 percent ahead of 2010 and lagged the October, 2011 car-count by 5.6 percent.

Canadian Pacific has tapped Ed Harris and Tony Ingram for seats on its Board of Directors, effective immediately. This is very positive news. I've felt for a long time that operations was not CP's strong suit. I thought bringing Kathryn McQuade to CP to run the railroad in 2007 would help but that didn't last -- she was tapped CFO in 2008 when the incumbent left. Brock Winter was tapped SVP Ops until April 2010 when Ed Harris was brought out of his CN retirement to be COO and then he left early in 2011.

Throughout all this the operating ratio went from 74.3 for the full year 2007 to 82.4 through 3Q2011 while CN's went from 63.6 to 63.1 in the same period. Clearly changes must be made. A Pershing Square trait in takeovers is to strengthen top management and shed underperforming assets. My channel checks suggest DM&E or D&H are not running particularly well and the energy OD pairs they've been touting are not, IMHO, producing anything like their potential. You can see how they're spending money in the west to improve fluidity; the deplorable track condition on the D&H in the east can only be degrading fluidity and the STB performance metrics.

I'm hopeful that bringing Harris and Ingram -- two of the best operating guys in the biz -- onto the Board will perhaps take some pressure off the Ackman initiative. I am quite at my leisure should you wish to discuss the ramifications further.

Hiring these two guys is a very timely move. First, because of the growing eastern market for crude oil by rail out of the Bakken Formation in Saskatchewan. Over the past three years, CP rail shipments out of the Bakken have grown from a mere 500 cars to more than 13,000 with an eventual potential of 70,000 cars a year. CP is spending more than $90 million to enhance capacity on its U.S. mainline south of Saskatchewan through North Dakota and into Minnesota to handle increased Bakken volumes, including outbound crude oil plus inbound pipe and frack sand shipments. CP needs sharper operating practices to maximize returns.

Also this week CP said it has completed its first year of a three-year program on infrastructure enhancements to upgrade the North Main Line between Winnipeg and Edmonton. The $250 million North Main Line infrastructure program spans roughly 850 miles in three provinces. During the 2011 work season CP completed 155 miles of track enhancements on the North Main Line to increase track speeds and get better asset turns. The North Main Line infrastructure enhancement program includes rail and tie upgrades, new and extended long-train sidings and public crossing upgrades. CP needs to show it can run a smarter railroad with the upgrades.

One can always depend on UBS rail analyst Rick Paterson to drill down into some bit of rail exotica to link operating practices with financial results. This week, Rick looks at four years of productivity gains in terms of revenue units per T&E employee. He concludes:

> CSX (+11%), KCS (+10%), and UP(+6%) have improved, while NS (-5%) and BN (-0.3%) have lagged after starting from a higher base. We were surprised that all five rails weren't solidly in double- digits given the network initiatives (long train, etc.) and infrastructure investments implemented in recent years. A couple of trends are most likely responsible. First, a mix shift as intermodal volumes have grown faster than non-intermodal train-starts.
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> Second, a switch to more proactive – rather than reactive – hiring practices in which employees are brought on in anticipation of need rather than after needs arise. The rails face tough comps in 2011 as furloughed employees who returned to work last year required less training and were more productive faster than new hires. Hiring in 2011 has added less experienced staff who take longer to become productive, temporarily deflating productivity metrics.

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