THE RAILROAD WEEK IN REVIEW

February 24, 2012

"Short lines have been instrumental in retaining rail infrastructure and freight rail service in areas where it may otherwise have disappeared." -- Cliff Mackay, President and CEO, Railway Association of Canada

The RAC's *2011 Rail Trends* booklet is out. It's all about 2010 and -- given the fact that 2011 numbers are freshest in mind -- the present booklet lets the reader see clearly what's driving what. I'm particularly pleased the see the emphasis he puts on revenue ton-miles, "the most widely-used measurement of workload in the railway industry."

Canadian railroads racked up 239 billion ton-miles in 2010, a 13.4 percent year-over-year increase and just three percent short of the 248 billion ton-mile record in 2007. It is instructive to note, however, that revenue units peaked in 2005 at 4.07 million units compared to 3.63 million units in 2010 as railroads generated more revenue tons per revenue unit. Intermodal was 2010's largest single commodity sector at just under a quarter of total revenue units. Minerals came in second with 703,270 units followed by ag products (462,445 units) and fuel and chemicals (419,905 units, essentially STCC 28, 29). [*A quick perusal of the AAR's FY 2011 Canadian Carloads report shows the same groups in about the same orders of magnitude. -- rhb*]

Operating expense for 2010 per RTM actually decreased 3.2 percent year-over-year even with the 10.5 percent jump in the per-gallon price of diesel fuel. Total operating expense increased 10.5 percent -- 2.9 points less than the RTM increase. Unfortunately, the RAC does not publish operating ratios. If they did we would see the relative changes in RTMs and operating expense driving lower operating ratios.

The take-away from Mackay's message for short lines is the need to start tracking RTMs and more particularly RTMs and operating expense per RTM by customer. Just this week I was on a short line with a customer taking relatively small volumes of low-rated commodities at the end of a five-mile branch of excepted track. There is no doubt where this customer would score if his RTMs and expense per RTM were ranked with others on the same short line. To be continued.

Total North American revenue units increased 2.5 percent in January, according to the AAR. Back out intermodal, and conventional carloads including coal eked out a gain of 0.3 percent. The big losers were grain (-11.0 percent) and chemicals (-5.9 percent) while coal more or less held its own at minus one percent. The double-digit increases were in Group 5, crushed stone, sand and gravel, where frac sand (STCC 14413) lives, up 13.7 percent; Group 13, petroleum products (think crude by rail), up 16.3 percent; and Group 17, finished vehicles and parts, up 10.8 percent.

RMI's Week 4 *RailConnect Index* is comprised of 403 shortline names and has total vols flat -- down 0.09 percent. Take out intermodal, and carloads, including coal, are off 1.7 percent. Coal was off 16 percent -- quite a spread from the Class Is' coal down one percent -- and grain skidded 20 percent to the AAR's 11 percent. Like the AAR, short lines did well in the aggregates group that includes frac sand -- up 13 percent -- and lumber, also up 13 percent to the AAR's nine percent.

As for coal specifically, the Street has been a beehive of activity saying utilities' nat-gas switching is going to clobber the railroads' coal business. Peter Nesvold at Jefferies writes,

> The energy industry has seen periods of very low gas prices in the late 1990s, 2001/2002 and 2008/2009. Each time, the amount of natural gas fuel switching was materially less than many had originally forecast. Many efficient combined cycle gas plants in the Southeast that compete against expensive Central App consuming coal plants have already switched since 2009. Going forward, it will be much more difficult to displace low cost Powder River Basin or Illinois Basin coal.
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> Finally, many misunderstand that "peaker" gas plants cannot for the most part be used to displace base load coal plants. While some industry forecasts are more bearish, we believe that the impact to coal demand from switching could be roughly 15 to 20 million tons in 2012 if nat gas prices stay at very low levels. (This is before other dynamics such as hydro and weather are factored in.)

On the other hand, Rick Paterson at UBS maintains, "We'll admit that the outlook for coal has likely removed much of the upside to our estimate for low-teens EPS growth this year, but we think the bears need to put coal tonnage in better perspective before panic selling at 12x NTM EPS, a level which has proven to be consistently profitable for long-term investors."

And a shortline operator who does business in the Illinois coal basin writes,

> I've been getting a lot of questions by financial folks and others about why more coal-fired utilities aren't converting to natural gas. There are a couple of good reasons. First, it takes capital to retrofit boilers to burn gas and lead times make it hard to complete this process quickly, not to mention the regulatory approvals required. But more importantly, what will the price of natural gas be in five or ten years? Will any gas producers sign long-term contracts with price guarantees? Our experience has been no, they will not.

RailAmerica's January carloads increased four percent year-over-year (three percent on a same-railroad basis), posting year-over-year gains in six out of 11 commodity groups and "Other." Looking strictly at the largest commodity groups -- those that comprise 80 percent of RA's total revenue unit volume -- we see double-digit gains in waste and scrap, metallic ore and minerals, and a middling ag products gain.

Coal took a double-digit hit thanks to lower power-generating requirements at a midwest plant while chemicals, non-metallic minerals and paper all took smallish losses. Coal is still the largest single commodity for RA at 17 percent of total loads (down from 20 percent a year ago). Paper products, non-met minerals and chemicals also came down slightly as percentages of the whole. Metallic ores and minerals took up some of the slack, increasing to 8.1 percent of total units from 7.3 percent. Total units increased 1.2 percent over December.

Genesee & Wyoming's January North American carloads were off 11 percent year-over year (same-railroad down 14 percent) with particular weakness in coal, coke and other (mainly overhead coal) in the Illinois, New York/Pennsylvania, Ohio and Mountain West Regions. Partly offsetting these losses, chemicals increased 16 percent and Metals increased 22 percent. All the above commodities together with paper comprise 76 percent of GWR's total volume base. All-in, Jan revenue units dipped nine percent sequentially from December.

There's a reason I drill down into commodity revenue changes in WIR, and it has to do with how short lines relate their own franchises to those of the connecting Class Is. If you read, for example, that Norfolk Southern's Metals and Construction Group was the strongest performer in the non-automotive merchandise sector, you want to know what's driving it. Moreover, you want to know where the weaknesses are so you can build on the strong and downplay the weak.

Chief Commercial Officer Don Seale's slide 12 from his fourth quarter 2011 slide set shows "strong demand for natural gas drilling" and "increased steel production." Your short line doesn't have any gas drilling, but it does have metal fabrication businesses that bring in coiled steel and manufactures structural shapes. Your assignment: find out how many carloads of coiled steel and structural shapes NS handled in each of the past four quarters so you can gauge the relative importance of each to NS.

The most direct way to get what you need is to use the QCS page on Usraildesktop.com and search by STCC (up to five places), railroad and time period. Here's what you'll find: the big metals group STCC for NS is really 331 -- primary metals -- and by inference within that group 33 123 32, coiled steel -- which seems to make sense with 65-70,000 loads a quarter. STCC 34, fabricated metal products, seems to be concentrated in 34 299 industry wide; 342 for NS is only 9-10,000 loads a quarter.

Clearly, primary metals is where NS makes its market, not in fabricated metals, and now you have your answer. Best of all, the commodity is big enough and heavy enough not to be easily divertable to truck and fits with Seale's predictions for "stronger domestic steel."