THE RAILROAD WEEK IN REVIEW
June 22, 2012

"The index of home builder sentiment is the highest it's been since May, 2007." Dennis Gartman in The Gartman Letter

Still running GP38-2s from EMD? Has Progress Rail got a deal for you. Tony Kruglinski writes in the *Railway Age Newswire* for Friday that the EMD subsidiary of Progress Rail Services has developed a newer, better, more efficient prime mover -- the 710 "ECO" line of diesel engines -- that will fit into the footprint of the original EMD 645E 16-cylinder non-turbocharged engine and use the same main generator. Tony continues,

> The most important reason for remanufacturing these units is simple: The OEM's haven't made four axle locos in volume for more than 26 years and railroads, particularly Class Is, still have a need for low- and medium-horsepower locomotive fleets. Progress believes the re-powering of these units with more fuel efficient 710-series engines makes economic sense when considering the volatility of diesel fuel prices. Application of the 8-710G (8 cylinder) engines can increase fuel efficiency by a significant percentage and result in the locomotive meeting EPA Tier 0+ up to Tier 2 emissions levels. Even better, there are eight fewer cylinders to maintain and ultimately replace!

Progress says the 8-710G3A-T2 engine develops 2,150 brake horsepower, has a continuous tractive effort of 155,000 lbs and that ECO re-powers are now at work on KCS, NS and Amtrak, among others. Tony concludes that these re-powers are running in the $million range, but "Progress/EMD are currently working on less expensive versions of their 710 ECO repowering package to allow railroads to hit return-on-capital targets by investing in these fuel efficient conversions."

Perhaps a bit rich for your mom-and-pop short line; however, they might just fund a place with the multi-railroad owners. Tony says anyone interested in considering the economics of a 710 re-power can email him at tkruglinski@railfin.com for an EMD contact.

Pennsylvania's North Shore Railroad has a new owner. Sort of. Richard Robey, who was selected to operate the former PRR and Reading lines owned by the Southeast Economic Development Authority - Council of Governors Joint Rail Authority (SEDA-COG JRA or JRA for short), back in 1984, formed the North Shore Railroad for that purpose. In the present transaction, Robey sold his interest to his 12-member management team, headed up by Gary Shields, President. So, yes, techically a new owner. But no change in the management team.

Robey's sale of his company was finalized this week at a meeting of the JRA, whose approval was needed based on the operating agreement. Collectively the lines are known as the North

Shore Railroad System and include the Juniata Valley Railroad, Lycoming Valley Railroad, Nittany & Bald Eagle, North Shore Railroad, and Shamokin Valley Railroad. The company also operates the Union County Industrial Railroad, serving portions of Northumberland and Union counties.

I've known and worked with Dick and his team for most of the time they've had the North Shore. It's one of the best combinations of commercial, operating and financial skill sets in the shortline space and this transaction is absolutely the best possible outcome for the JRA, the railroads' customers, Norfolk Southern (the North Shore's sole Class I connection) and the employees themselves. Congratulations, all.

Bakken Crude continues its push into Northern New England and Eastern Canada by rail. Chop Hardenbergh writes in his *Atlantic Northeast Rails & Ports* newsletter that on June 9 an 80-car train of crude oil arrived at the Irving Oil refinery at St John, New Brunswick. The train originated at Newtown, ND and was handed off to the MMA at Farnham, PQ. Chop continues:

> Some 10,000 to 15,000 barrels of oil per day [could move] from the Bakken oil fields to Saint John via rail in early August if a formal deal is reached. Industry sources say Bakken crude is currently priced at about $7 to $10 a barrel less than the benchmark West Texas Intermediate oil. Still, the volume of oil is a drop in the bucket for Irving, which operates the largest refinery in Canada, processing an estimated 300,000 barrels per day. Eastern refineries currently import about 75% of their oil primarily from Venezuela, the Persian Gulf, and the North Sea at a substantially higher cost than product offered by Canadian sources, said Greg Stringham, a vice-president of the Canadian Association of Petroleum Producers.

The BNSF-CSX-Pan Am Rail connection continues with a third train to Waterville, Maine, and forwarded from there onto the New Brunswick Southern (ex-CP) at Mattawamkeag in 50-car blocks due to operating restrictions. A fourth Irving Oil train is expected over the CP-MMA route as of this very moment.

Wolfe Trahan sent out a note on some coal channel checks, this one with a utility burning mainly Illinois Basin coal which comes in 60 percent CSX and 40 percent barge. It seems the utility in question currently has switched "as much as possible" to nat gas, has on hand coal stockpiles "materially above" target levels and has pushed some contractual volumes out into the second half of 2012 and into 2013. The normal annual burn is around five million tons but will be less in 2012, "regardless of this summer's weather." Short lines that may be at risk include RailAmerica's Indiana Southern, the Evansville & Western and the Indiana Rail Road.

Housing starts were the hot topic this week. On Tuesday Deutsche Bank wrote, "We have more evidence that the housing sector has turned the corner and that a modest recovery is underway. The June NAHB index rose one point to 29 after the prior month was revised down a point. " The note cites slightly better NAHB month-to-month numbers, improved sales vols for singlefamily units, and concludes, “We have yet to see any signs of deterioration in the data that would suggest that sales were pulled forward due to the unseasonably warm winter.”

A note out of Cooper Howes says, The NAHB index of home builder sentiment “has been on a steady upward trend since last June, when it recorded the lowest levels of sentiment since 2009, and has risen 16 points since then.” Dennis Gartman writes in *The Gartman Letter* that the index of home builder sentiment is the highest it’s been since May, 2007.

> This index is rather like the ISM reports in that anything below 50 indicates that the economy in question is contracting while anything above 50 means that the economy is expanding, and so 29 is hardly a great number and should not be taken as such, although some have tried to spin it positively. We’ll suggest that it was something less than horrid and we’ll grant that it is better to see the number rising than falling. However, until it’s above 50 let’s keep the cheering for the housing market to the very dullest of roars.

Hernando Cortina, Equity Strategist at Morgan Stanley Smith Barney, was at the Berkshire-Hathaway Annual Meeting in Omaha and came away with “a few thoughts on four investment themes that resonated with me -- growth in US oil production; the improved health of US banks; higher rates for reinsurance; and compelling economics for US railroads.”

> *Why rail economics are very compelling.* Buffett noted the improved competitive position of rails relative to trucking in the past few years, particularly given the price of fuel, as well as the benefits to the environment compared with diesel-powered trucks. Furthermore, railroads are a business with significant barriers to entry, as it is essentially inconceivable for a new entrant to replicate the existing rail infrastructure.
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> William Greene, Morgan Stanley’s freight transport analyst, is similarly bullish on the outlook for rails, arguing that they currently offer attractive value. He notes that despite headwinds from decreased coal volume as utilities increasingly switch to natural gas, rails broadly beat consensus earnings estimates for 2012’s first quarter by a wide margin, driven by strength in merchandise and intermodal transport.
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> Looking forward, rails should either continue to produce good results despite weaker coal shipments or benefit from potentially higher coal volumes if the substitution of natural gas subsides. Given the reduced valuation over the past few months, we view the risk-reward characteristics for rails to be particularly attractive. An additional positive wildcard is the heralded renaissance in US manufacturing—especially in autos—which could add an additional level of traffic to the rail network.

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