THE RAILROAD WEEK IN REVIEW

October 26, 2012

"This quarter was our busiest of any third quarter in CN's history, averaging over 1.50 billion GTMs per day, up eight percent from last year." -- Keith Kreel, Canadian National COO

Canadian National took in third quarter freight revenues of C$2.5 billion, up eight percent, on 1.3 million revenue units, up three percent. Gross ton-miles increased eight percent, revenue ton-miles grew seven percent even as fuel burn increased just five percent and gross ton-miles per gallon increased two percent. Total ops expense was C$1.5 billion, up ten percent, and operating income was up five percent to C$985 million. The operating ratio crept *up* 1.21 points to 60.6.

Kreel showed how positive deltas in GTMs per train mile, cars per yard-switching hour, terminal dwell, trailing GTMs per horsepower, car-miles per day and train velocity can lower operating expenses and create happy customers into the bargain.

> In September, we set a system-average car velocity record of 217 miles per day. These velocity gains are being achieved while handling record volumes. This quarter was our busiest of any third quarter in CN's history, averaging over 1.50 billion GTMs per day, up eight percent from last year. We've become true supply-chain collaborators, taking ownership of car order fulfillment while, at the same time, being held accountable for achieving improvements in our car velocity.

Chief Commercial Officer J.J. Ruest said petroleum and chemicals revenue increased 14 percent. Crude oil was up, as was refined petrol products, and the remaining economically-sensitive chemicals were unchanged. Metals and Minerals revenue was up five percent, mainly on energy-related products such as frack sand and steel pipes for transmission and drilling. Other finished steel and related products -- iron ore, scrap steel and steel slab -- all took decreases. Not surprisingly, the non-ferrous metals sector -- copper, nickel, aluminum, e.g. -- also took a hit.

Forest products revenue gained two percent. More housing starts propelled dimensional lumber and panel-board up nine percent each; paper revs were off 11 percent. The grain and ferts group saw revs up nine percent thanks in large measure to the new Canpotex contract. U.S. grain was slightly negative because of the drought in the Midwest; Canadian grain was up 11 percent. Intermodal revs increased six percent on seven percent more units, auto revs were up nine percent, mostly from Pacific Rim imports. Coal revs jumped 13 percent on four percent fewer carloads. Met coal was up 12 percent, thermal coal up six percent, and pet coke up 40 percent.

Looking ahead, lumber and panel depend on U.S. housing starts and crude oil will be "a very bright star" in the fourth quarter and a possible double into 2013. Energy-related steel will be strong, other steel won't, and the trend may well continue into 2013. CN has only two commodities in “secular decline” -- U.S. domestic thermal coal and North American paper carloads. But they represent less than four percent of the franchise.

The Canadian grain crop is excellent and the carloads are very strong while the U.S. side is not. Coal will remain an export story and export potash will be a bright spot for CN. So -- at the end of the day, I have to say the carloads are there and short lines that can pick up on Kreel’s operating practices and Ruest’s commercial initiatives will do very well in deed.

Not Norfolk Southern at its best. Tuesday’s call had total revenue dropping seven percent to $2.7 billion as revenue units of 1.8 million slipped one percent and ops expense rose one percent to just under $2 billion. Operating income skidded 22 percent to $731 million and the operating ratio added 5.3 points (!!) to a disappointing 72.9. Below the line, net income plummeted 27 percent while an eight percent decrease in the weighted number of shares held the diluted EPS to minus 22 percent, $1.24; absent the share buy-backs EPS would have fallen 42 percent to $0.92.

The bogeyman was coal, down 14 percent in carloads and 22 percent in freight revenue -- that’s 57,000 units at $2,000 a pop, a cool $114 million or 58 percent of the total $196 million revenue decline. The trend is not encouraging, either. NS coal tonnage YTD is down eight percent from where it was in at this point in 2010. Utility coal is now down 15 percent since then to 65 percent of the total from its 70 percent in 2010; export coal may be up 22 percent in the last two years, but it’s still less than a fifth of the total tonnage hauled. The patterns for neither the 2012 fourth quarter nor 2013 look much changed.

Merchandise units slipped two points and revs a point. Three out of five commodity groups were down in both units and revenue -- ag/consumer/government, metals/construction and paper/clay/forest. Chems and autos were up four and seven percent respectively in units, five and six percent respectively in dollars. Intermodal units increased five percent and revenue was up three percent. RTMs declined four percent, GTMs slipped three percent as did fuel burn.

Some 90 percent of the entire third quarter volume decline came in September as both coal and merchandise volumes materially weakened. Intermodal volumes set a quarterly record high, led by continued gains in highway conversions in the domestic intermodal segment, up 11 percent; add Triple Crown and Premium services and non-international intermodal is up 16 percent, compared to international’s down one percent.

Merch carloads ex-auto declined three percent to 483,900 carloads. Metals & Construction took a seven percent hit as weaker highway and commercial construction activity brought down aggregates volumes by 12 percent. Steel car loadings were off four percent due in part to RG Steel closure at Sparrows Point, Maryland, coupled with a one percent decline in domestic steel production. A lower rig-count in the Marcellus and Utica shale regions caused a 23 percent drop in steel volumes in support of natural gas drilling.

Ag loadings were even with last year. Declines in ethanol and wheat were offset by higher shipments of soybeans and feed. Long haul corn shipments were also lower due to the drought in the Midwest and increased local sourcing in the Southeast, where the crop was better. Chemical vols increased four percent on new crude oil business from the Bakken and Canadian oilfields going to six refineries local to NS. The paper and forest group was down five percent due to lower volumes of pulp and municipal solid waste traffic. These decreases were only partially offset by lumber, up ten percent as housing starts continue to improve in selected markets.

The merch side of the house isn't going to get much better any time soon, either. The outlook for the sector is mixed. Growth in crude oil will help the chemical group while declining materials associated with natural gas drilling, along with a difficult agricultural market due to the Midwest drought this summer, will moderate overall performance in our merchandise business segments.

The bloom is definitely off the ethanol rose and NS could be approaching the doldrums in frack sand. More crude oil trains or domestic intermodal don't do much for short lines; fewer carloads of grain, ferts, aggregates and so forth is a definite drag. And so, where your NS connections are concerned, be nimble, hunker down and turn what cars you get as fast as you can to keep avoidable costs down.

Canadian Pacific brought some pretty impressive numbers to the third quarter conference call. Third quarter revenues came to C$1.4 billion, up eight percent; ops expense went up only six percent, yielding operating income of C$376 million, up 16 percent and an OR of 74.7, down nearly two points. Net income was C$224 million, up 20 percent; diluted EPS was $1.30, up 19 percent, the spread being attributable to a two percent increase in diluted shares.

Revenue units increased three percent to 687,000 loads, with the best percentage gains in Industrial & Consumer, Auto and Intermodal. Sulfur/ferts and Grain took double-digit hits, but coal vols were actually up five percent -- more on this anon. System RPU was up five percent, about par for the course, with auto and industrial products taking the more aggressive hikes. RTMs increased three percent on two percent more GTMs; fuel burn was down three percent and GTMs per gallon of fuel increased a respectable five percent.

The eight percent revenue gain came on three percent price and mix, a like amount on carloads and RTMs and two percent on foreign exchange and fuel surcharge fees. Drilling down to specific commodity groups, grain vols dipped six percent as farmers in Western Canada were sending out fewer cars of grain previously held back, creating a dip in what CP calls "carry-out" stocks. US grain vols are expected to gain on the roll-out of the scheduled grain service that has been so effective in Canada. Q4 promises good production in CP's grain draw territory.

Sulfur/ferts revs fell 20 percent and vols dropped 21 percent. A significant reduction in long-haul export potash traffic resulted in a 30 percent decline in RTMs. Third quarter domestic potash and fertilizer demand was somewhat tentative in reaction to the drought. Strong nutrient replenishment is expected to occur through Q4 and into the 2013 spring season.

Q3 marked the fifth consecutive quarter of double-digit crude-by-rail revenue growth as CP expands its presence in the Bakken oil fields as well as extending its crude-by-rail model to Alberta and Saskatchewan. Frack sand vols are off as drilling activity slows in response to weak natural gas prices. Lastly, U.S. ethanol production was down in Q3 in reaction to drought-induced rise of corn prices but is expected to recover soon. In forest products, lumber was up and paper was down as we've seen elsewhere.

Yes, CP is 70 percent bulk and intermodal, but 64 percent of revs and 63 percent of RTMs are in the merch sector, and that includes grains and ferts. Four out of six CP commodity groups are trending up: chems, grain, metals and stone (frack sand lives here). We know from our experience with Hunter's CN -- and before that the IC -- that he likes to see cars move faster over the road and turn faster at the ends. Short lines can help.

On a personal note, this was the last CP conference call for Kathryn McQuade, my good friend of 20 or so years, who will be taking retirement Nov 1. We first met when she was in the NS finance department and I was working with Jim McClellan in Strategic Planning on the shortline aspects of the Conrail split. We are both William & Mary grads, and though our undergrad years were some time apart, the how-to-think rigor of the W&M experience has served us both well. Thanks, Kathryn.

As we ponder the question of whither the D&H, it is instructive to call upon the institutional knowledge of a railroader who's been following the D&H saga for lo these many. He writes,

> I was heavily involved with the D&H 1989-1992. In that era, D&H should have become a kind of toll-road for the four connections. The fact that CSX, NS, CP, and CN all contributed financially to keeping D&H alive during that period showed their interest. Market forces kept pulling D&H in that direction, spurred along by Walter Rich's NYSW interests.
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> CP charged ahead to buy D&H 1990-91 without fully knowing what they were getting into. For example, I recall a CP marketing guy from Chicago said they were going to "fill Oak Island with containers." He was unaware that the ex-LV Pattenburg Tunnel in western NJ was not cleared for stacks. Then there were the potentially challenging Conrail relationships. "We've looked at that" was their mantra.
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> I have heard D&H officers say that CP invested $200 million in D&H, and that was ten years ago. A lot of that was to "bring it up to CP's standard," and yet somehow the railroad performs service-wise about the same as it did in 1990. Now it comes out that they never made any money on D&H, but I guess we all knew that.

CP has today a very capable operating and marketing staff in the Albany area and they work well with area short lines, particularly in developing new OD pairs for frack sand and other energy-related materials. The central Penna shale business may be experiencing a lull, but it's not going away. I hope CP will stick around to give NS some competition.

Man Bites Dog Dept. Larry Kaufman reports there was recently a minor congressional flap about Berkshire buying two short lines but not going through the requisite STB procedures. It turns out both are subsidiaries of Berkshire Hathaway subsidiaries and hardly common carriers in the strictest sense of the term.

One is the former White City Terminal & Utility Co., reporting mark WCTR, in White City, Oregon and extending 14 miles southwest to the SP (now CORP). Union Tank Car (a division of Marmon Transportation services, now a Berkshire Hathaway Company) bought it in 1974 and renamed it the WCTU. It's not listed as a BNSF short line at www.bnsf.com., so -- if it still exists at all -- it has to be a private industrial switch name.

The other appears to be the remains of the former Wabash near Council Bluffs, Iowa, the CBER or possibly CBEC. The line in question may serve the MidAmerican Energy Company power plant in Council Bluffs, part of Berkshire Hathaway subsidiary MidAmerican Energy Holdings Company. Again, no such railroad appears in any of my lists of short lines names nor is anything like it on either the BNSF or UP website shortline page.

Says Kaufman in his Oct 15 *Argus Rail Business* column, "BNSF clearly is annoyed by Rockefeller's injecting himself into what was a bureaucratic snafu and in his trying to create a *cause celebre*... Claiming to have acted responsibly, BNSF defends its proposed resolution by saying, 'Any legislative call for further regulatory involvement is unnecessary overreach and a waste of taxpayer dollars.' Take that and stop pandering, senator Rockefeller."

But Berkshire is officially becoming a short line owner by having BNSF buy Dennis Prewett's Nebraska Northeastern, a 120-mile ex-CB&Q line running due west out of Sioux City and which the BN sold as part of its 1996 shortline sale program. According to the filing (FD35644, if you must), the line hosts two shuttle loaders and three ethanol plants. "Integrating NENE's operation into the BNSF network would produce a seamless operation for shippers, allowing them to take full advantage of BNSF's exclusive destination network for grain and grain products." Moreover, the transaction gets rid of an awkward interchange in Sioux City and lets BNSF get track speed up to 25 mph from the present ten. Looks like a good deal all round.