THE RAILROAD WEEK IN REVIEW

February 1, 2013

"We're seeing very positive customer response in terms of service, consistency and reliability."
-- Jane O'Hagan, Chief Commercial Officer, Canadian Pacific

Canadian Pacific brings up the markers on the 2012 Earnings Season. Revenues increased seven percent (all deltas in this note are in Canadian dollars, not fx-adjusted) to C$1.5 billion on 680,000 revenue units, essentially unchanged, and a six percent RPU gain. Carload revenues including auto but ex-coal were up nine percent on unchanged unit counts; the "industrial and consumer" group saw RTMs jump 29 percent on four percent more units thanks largely to crude-by-rail out of the Bakken.

The operating expense line carries C$317 million in above-the-line charges for stepping back from the PRB expansion of the DM&E (C$265 mm), locomotive turn-back (C$80 mm) and labor restructuring (C$3 mm) to meet GAAP reporting requirements but which just cloud the continuing operations picture. Absent these charges, ops expense increased a mere two percent, producing ops income of C$378 million, up 25 percent year-over year. The operating ratio dropped to 74.8, an improvement of 3.7 points. Diluted EPS ex-charges increased to $1.28, a 15 percent improvement.

Ops expense for comp & benefits and fuel both came down in the quarter as the head-count reductions continued and service improvements meant more cars moved with fewer horsepower hours. Gallons consumed decreased two percent even as GTMs were up one percent and RTMs increased four percent. GTMs per gallon increased three percent. I should also note that trailing-twelve-month share price gain was 50 percent, market cap gain was 53 percent and every dollar increase in retained earnings represented $24 in market cap gain.

Full year freight revenue was up ten percent on three percent more revenue units and seven percent more revenue per unit thanks to changes in length of haul and commodity mix. Operating income ex-items was C$1.3 billion though the OR was 83.3, up two points. Jane suggests that the present crude-by-rail run-rate of 70,000 cars a year could easily double or triple in 2013, propelling double-digit industrial and consumer revenue growth in Q1 alone. She concludes, "Service continues to improve and CP has set the stage for sustainable profitable growth."

The rails as a group had an OK quarter and year, though I would have liked to see stronger merchandise traffic growth. Even including crude-by-rail (which short lines don't see much of) quarterly and full-year merch vols were at best up small single digit or at worst down small digit percentages year-over year.

Take, for example, the four Norfolk Southern merchandise commodity groups: ag/consumer/government, metals/construction, paper/forest products and chemicals. These four groups account for more than than three-quarters of the carload volume NS does with switch carriers, short lines and regionals, based on a chart NS presented at a meeting of short lines some years ago and I have no reason to believe the mix has changed significantly.

NS says roughly 20 percent of NS total carload volume touches short lines with 17 percent coming from the above four commodity groups. Over the past eight quarters total carloads for these four have come down at a half-percent negative CAGR while -- system-wide -- only autos and intermodal are showing any real growth. Moreover, 4Q2012 merch carload RPU was down 0.3% in ag products including ethanol, up 3.4% in metals and construction including frack sand, up 0.4% in paper/clay/forest including lumber for housing starts and up 1.2% in chems including crude-by-rail, which by itself has little line-haul exposure to NS short lines.

In short, the short lines and regionals that depend entirely on handling fees and switching allowances are entirely volume dependent and have no pricing power at all. So as volumes head south, so does their revenue stream. Which goes back to knowing which customers make the best money and do the most to cover not only move-specific costs like T&E labor and diesel fuel but also a larger portion of fixed costs.

The answer is in tracking revenue ton-miles by customer. And if you're getting more dollars per RTM, you can bet NS is too. We're long past the time we can play the any-car, any time game. The Class Is are putting specific costs against specific commodity O-D pairs, and pricing in order to equalize car-contribution per day across the system. The shortline fees are part of the car-miles per day equation; the longer a car stays on the short line the worse the contribution.

Ed Ellis is giving the lie to my thesis that short lines aren't doing much by way of line hauls of crude oil unit trains (see CP above, e.g.). His Texas-New Mexico Railroad, a member of the Iowa Pacific Holdings (IPH) family of railroads, ran its first train Jan 22 out of the recently-completed Genesis Energy crude-oil load-out facility near Wink, Texas. The train was destined for the Texas Gulf Coast and is part of the massive growth in rail carloads resulting from the vast expansion of drilling and production of oil and gas in the Permian Basin of southwest Texas and southeastern New Mexico.

I've watched with great interest over the past few years as Ellis and his team have renewed and revitalized not only the TNMR but also the West Texas & Lubbock. The former was built in 1930 as the Texas-New Mexico Railway Co. to tap the Permian Basin oil fields. TMN was wholly-owned by the Texas & Pacific, and sixty years ago was still running mixed trains over the 112 time-table miles from the T&P main at Monahans, Texas, north to its end-of-line at Lovington, New Mexico.

The line was full-absorbed by the Class I in 1977 and short-lined by T&P successor UP in 1989 in a deal with RailTex, itself absorbed into RailAmerica in 2002. Iowa Pacific Holdings bought the line in 2002 and has over the past three years alone invested approximately $25 million upgrading the property. Newer, heavier rail, better ties, fresh ballast, new turnouts and sidings and even a new locomotive shop are part of the mix. And in August 2012, UP and TNMR opened a new, jointly funded interchange yard in Monahans to facilitate the growth in rail traffic between the two railroads.

A key feature of the yard was tracks set up to handle unit trains. Says Bruce Carswell, Vice President of Permian Basin Logistics at Iowa Pacific, "We worked closely with Genesis to develop their new loading facility in an expeditious and economical fashion. We have several more unit train facilities either already under construction or in the planning stages."

It's all part of what Ed Ellis describes as his "work-out" approach to developing short lines: "We are business development guys who are really only interested in the rail lines that have not *worked out* well for a prior owner or operator. It's been said we should be called the 'Kennel Club' of short lines because we only buy the dogs." The TMNR sure shows well today.

The Pennsylvania Railroad: Building an Empire, 1846-1917, is a weighty 943-page tome packed with lively writing, rare illustrations, excellent research and extensive footnotes sure to keep the railroad historian and enthusiast alike enthralled for hours on end. Author and historian Albert J. Churella visited Philadelphia's Union League last week to talk about the book with a unique focus on Philadelphia's role in the founding and early years of the PRR. Some 100 souls gathered for the Library Hour presentation about what was in 1900 the largest privately-owned business in the world.

Back in 1936 *Forbes* magazine put it this way: "Do not think of the Pennsylvania Railroad as a business enterprise; think of it as a nation." In 1914, the PRR employed more than 200,000 people -- more than double the number of soldiers in the United States Army. The present book, Volume I of a two-book history, ends in 1917 but includes considerable detail on the technological development that the PRR pioneered even beyond that date.

Following Churella's talk, a handful of practicing railroaders and others with railroad interests sat down with the author for a bite of supper and a glass of wine to talk technology and operations (ever hear a historian talk about the high side of a curve?) and what's coming in Volume II. All in all, I'm happy to report the evening was a success as more than a few books went home under the arms of smiling members.