THE RAILROAD WEEK IN REVIEW

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"Open access is a mixed bag; railroading gets more challenging but with the current networks, I do not see the sky falling." -- Jim McClellan, NS, retired

This week the NIT League takes center stage with its Open Access argument. In a 14-page slide deck for the STB, the League concludes, "Railroads should compete to keep their traffic, meaning most carloads will never be switched." Rubbish. Having a second carrier will push rates down. Good for the shipper near-term, bad for the shipper long-term, bad for the rails every way.

Consider: If I am the incumbent rail, and you are my competitor, and Shipper A forces you onto my railroad to serve him, it'll be because he sees you as the low-cost provider. The only way I can win him back is to undercut you. If rates get low enough, one of us will leave and Shipper A is now back to one railroad -- probably you. And without any competition, you will go back to market-rate pricing and Shipper A will have to find another railroad to offer lower rates than yours. That's why I think there's a point at which incumbent railroads might just walk away.

A friend who's paid to watch this stuff writes,

> I don't disagree with your argument, but from where I sit you're only looking at one side of the picture. The railroad's view of the market is the rate level it thinks it can charge for transportation to the shipper's market. The shipper's view of the market is the price it can sell its product in the market, which includes transportation. When the two don't match, somebody loses.
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> If a railroad is allowed to raise rates based on its view of the "market" without any transportation competition to temper that market view, it may force the shipper (1) to switch markets and transportation modes (thus losing the shipper's business), or (2) to relocate its business (thus losing the shipper's business). If one railroad drops out of competition because the price is too low, the remaining carrier will figure that out and raise prices. Eventually the drop-out railroad's salesperson will return to solicit the business. Competition keeps everybody sharp.

Jim McClellan takes a different tack:

> We have real world open access out there in railroad land -- intermodal and automotive. And we have a great model for open access carload in the CSX-NS Shared Access areas of the Northeast. Much of that traffic comes over western gateways and is thus open at both ends. And margins on all of this open access traffic is lower than other carload traffic -- but still profitable.

More open access means that cost control and service will be key leverage points, as they are in IM and autos. So a mixed bag; railroading gets more challenging but with the current networks, I do not see the sky falling. You correctly point out that when pushed too far, carriers simply opt out so a shipper has to play his cards carefully as well.

"With the old, fragmented networks (think SP in the west) dying railroads would do anything to get carloads. SP was growing ton-miles at a rapid rate but revenues hardly at all. That pretty much guaranteed that service and infrastructure suffered. But then, [railroad owner] Phil Anschutz was not in the game long term. Now executives are taking a longer term view, knowing that in the end you do have to have good track and engines and all those things. So, life could get harder but it is not the end of profitable railroading."

The League argues that any rate above a revenue-variable cost (RVC) ratio of 180 percent is captive. More rubbish. The origin of the 180 percent was a non-scientific compromise (Rails wanted 200 percent RVC, shippers were going for 160 percent) during the negotiations leading up to Staggers in the mid- to late-1970s when many of today's transportation buyers were still in diapers (the actual Staggers Act became law in 1980).

Fast-forward to 2013. We now live in a market-based economy and if moving a carload of plastics 3,000 miles is worth a 200-percent RVC, so be it. Nobody is fussing when moving a carload of rock 100 miles produces a 101-percent RVC. And, if you go back to original ICC legislation, it was pointed out that what you could get for some commodity-OD pairs was not profitable so prices ought to be raised on other commodity-OD pairs where there was room to do so in order to subsidize the losing commodity.

In this context, the 180 number has absolutely no basis in analytic reality other than that each side claimed that if *all* traffic moved at their chosen RVC rate, then the railroads would make enough money to be revenue adequate. Great idea – except – the market doesn't work that way (although the pre-Staggers ICC did).

The market decided that not only would it not allow everything to move at 180 percent, it would require rates to be competitive if they were to move any traffic at all. The result is that *average* RVC numbers are still well below any of the numbers noted above (160 percent, 180 percent, 200 percent). Thus speaks the market. Which really makes RVC is irrelevant – all that is important is what the market says the rate should be and artificially changing the market is no different from any other form of regulation. But it feels better to the regulators and to those another favorite pundit calls socialists wearing capitalist suits.

"Boom Times on the Tracks: Rail Capacity, Spending Soar." Tuesday's *Wall Street Journal* page 1 story on the Railroad Renaissance (thank you, Tony Hatch) could not have been a more timely antidote to the NITL rant. The lead photo is a CSX mixed-train manifest (even though intermodal and crude-by-rail get most of the ink) and the argument is better service, operations keyed to supply chain needs and flexibility are "stealing share" from the trucks.

Truckers know it, too. The article quotes an ATA executive who says, "Trucks are generally more reliable than trains and trucking transportation numbers are not going to be diminished by rail. At the end of the trip, you still normally use a truck. Rails just don't go everywhere."

True enough. However, the *Journal* writer cites examples of railroads winning converts with capacity that is non-existent elsewhere (pipelines), with reliable on-time rates (UPS) and dependable service (Container Store). And we see it everywhere, from UP's Customer Satisfaction survey results, the TSI-Merchandise initiative at CSX, Norfolk Southern's Local Operating Plan Adherence metric to Pan Am Railways' "We'll run the trains, you fill 'em" approach.

The ATA man is talking first-mile, last-mile in his last comment, and the rails are vastly improved there as well. Watco uses its Annual Operating Plan to determine how to meet and exceed customer expectations on time and within budget. Pennsylvania's North Shore Group and the Winchester & Western have customers in Yard Limits so any time can be train time. Short lines and regional carriers are what Norfolk's Chris Spiceland calls "market extenders" and BNSF says its 200 connecting Class II and III roads combined have about as many route-miles as does the Class I itself.

I say let the NIT Leaguers complain to the STB all they want. They will get the rail service they want at a price the market dictates as long as it meets railroad revenue/cost guidelines. And if they don't, they can always call Mr. ATA-man because -- he said it -- railroads don't go everywhere.

Providence & Worcester closed out 2012 with total revenues of $29,960,000, down 7.3 percent from last year's $32,325,000. Freight revenues were off 5.4 percent due mainly to their 11.5 percent decline in conventional carload freight where P&W took heavy hits in mets, chems and ethanol. The 5.0 percent RPU gain to an average of $841 a car helps. P&W's boutique intermodal business (1,178 units, nearly double year-over year) is only 4.2 percent of revs and makes one wonder what the revenue/avoidable expense ratio could possibly be.

Operating expense before capitalized items increased a mere one percent to $36 million for an operating ratio of 120.3 vs. 110.0 a year ago. Comp & benefits remain the big question mark: why is P&W shelling out 55 percent of revs in payroll when the shortline/regional number is closer to 30 percent? Then there's the perpetual $million in trackage rights, most of which is -- I believe -- to Amtrak for the P&W aggregates move from Connecticut to Flushing.

What to do with so-called "capitalized costs" remains a grey area to me. The 2012 number includes $3.6 million for "recoveries due to the 2012 Amtrak agreement" and looks to me more like a one-time item. Be that as it may, ops income was $2.5 million, more than five times what it was a year ago. The OR after cap items is 91.7, a seven point improvement over the 2011 number.

Below the line, other income more than doubled to $2.7 million in fees relating to permanent easement grants over the past three years. Thanks largely to the property deal and the Amtrak-related item above the line, net income was $3.5 million vs $932,000 a year ago. Diluted eps increased to 72 cents from 19 cents. Free cash flow after capex and divs was a negative $778, unchanged year-over-year. The Dec 31 share price of $13.96 indicates an edbita multiple of 11 times.

Florida East Coast, up along side of P&W, is a marked study in contrast. Intermodal dominates, with 65 percent of revs and 77 percent of revenue units. FEC total revenue for the year was $229.6 million, up 18 percent on 7 percent more revenue units. Carload RPU was $786, down 7 percent mainly on mix; intermodal box RPU was up 14 percent to $419. And the reportable personal injury ration was a respectable 0.72 per 200,000 hours worked.

Operating expense gained only 9 percent so operating income jumped 52 percent to $53.0 million. And it is here the contrast with P&W is most marked. FEC runs a 351-mile corridor between Jacksonville and Miami, parallel to I-95. P&W runs its own freight-only lines between Worcester and New London and Worcester and Providence and in southern Connecticut New Haven to roughly Danbury. But it also has rights over Amtrak between Providence and the Borough of Queens in NYC. Total mileage 516 of which 180 miles is on Amtrak -- all but 12 of which runs parallel to I-95. And both FEC and P&W are heavily into aggregates-hauling.

However, FEC has a 78.5 operating ratio compared 91.7 for P&W after the exclusion for capitalized items. P&W spends 55 cents of every revenue dollar on comp & benefits; FEC is at 20 cents. Both roads are spending about 12 percent of sales on diesel fuel. Car hire runs 5 percent on FEC and 3 percent on P&W. Moreover, P&W pays nearly a $million a year in Amtrak trackage rights to haul aggregates to Queens. But what I can’t get over is why P&W continues to have a comp & benefits line that is 55 percent of revs vs a Class II-III average of 30.

Keeping STCCs straight is always a challenge when seeking to run comps on railroad commodity performance. Take CSX, for example. Back on March 6 CFO Frederick Eliasson ran some slides for the JPM Transportation conference citing “week 8” numbers. But when I went to Jason Seidl’s “Trackwork Weekly” report for Week 8, there were some differences.

For example, Jason reports intermodal up 3.3 percent to CSX 4.0 percent, total coal 164,582 units to CSX 179,000 units (yellow bar, top of side 8) and Ag prods down 7 percent to CSX down 3 percent. Jason shows merch ex-ag down 1.1 percent; within the group pure chems were off 2.2 percent with petrol propelling the group up 4.7 percent. The CSX slide 7 bar chart breaks out industrial and const, though I saw no indication of what STCCS are where.

I did some digging in my own files and made a few phone calls to Jacksonville and found there is a variation between the CSX fiscal weeks and the AAR data,which Jason uses. To begin, the AAR data is based on a calendar week Sun-Sat; CSX's fiscal week runs Sat-Fri. As a result, CSX's fiscal first eight weeks of the year run from Dec 29, 2012 through Feb 22, 2013, whereas the AAR's first eight weeks run from Dec 30, 2012 through Feb 23, 2013.

The intermodal variance is tiny at 1,000 units; however, coal gets a bit more complicated. CSX's coal volume of 179K includes coke and iron ore shipments. This is "roughly" comparable to combining the AAR's coal, coke and metallic ores (not all of which is included in the CSX coal category – some of it goes in metals) categories, which totals 182K.

The CSX merchandise carload market includes the ag, industrial and construction sectors. Ag encompasses not only grains and grain products (including ethanol), phosphates & fertilizers, and food & consumer (STCC 20, e.g.). The industrial sector represents the automotive, chemicals and metals markets, and the construction sector is comprised of forest products (STCC 24 and 26) plus minerals, waste, metals and a few others. Frack sand goes in chems.

Collectively, through the first eight weeks of the quarter, these markets were down 2 percent in terms of volume, with revenue up 1 percent on core pricing gains. The CSX notes on slide 9 reflect the major players, with crude-by-rail, phosphates & fertilizers and building products being the positive drivers during this period, with the remaining markets roughly flat to down.

The exercise proves once again that you have to drill down into the published numbers to get at what lives where before you can run any meaningful comps.