THE RAILROAD WEEK IN REVIEW

November 1, 2013

"It's time to repeat AIMs by customer location to take out still more variable cost." -- Dave Garin, BNSF Group VP, Industrial Products

BNSF expects four things from its shortline and regional railroads. First, take care of customers by providing excellent service. Second, pursue profitable business opportunities that will expand our mutual franchise -- be a mileage multiplier, if you will. Third, focus on keeping loads and empties moving efficiently, thereby helping customers create competitive advantage through a world-class supply chain. Fourth, invest in your property to support the above.

These four tasks formed the core of the October 20-22 Shortline Conference in Irving, Texas. The theme -- Working Together, Growing Together -- was certainly appropriate, and all the presentations, handouts, and individual break-outs worked well to that end. Moreover, the thumb drive that came with the registration contains no less than 20 PDFs of material to support the above four shortline charges.

In a refreshing change from the usual shortline meeting format, the session began, not with senior management's 30,000-foot viewpoint, but with 15 separate and concurrent commodity briefings, Access to Tools workshops, and administrative resource overviews. There was no way to cover them all en toto, but by selectively dropping in and out one could get the general flavor.

In the commodities briefings, for example, I learned that fertilizers, sulfur and ethanol, though reported as chemicals in the weekly STB car counts, are managed in the agricultural commodities group. The bloom may be off the ethanol rose because people are driving more fuel-efficient cars and not driving as far. Cheap natural gas -- both dry and wet -- is bringing manufacturers that had fled overseas in search of lower costs back to the US and Mexico.

The Ag Products breakout session had the best attendance of the lot, which speaks volumes about what's most important to this group. The next biggest crowd was for petroleum. Even though the number of feeder lines directly involved in crude-oil unit trains is small, many are becoming involved in destination terminal operations. A caveat, though: the successful crude-oil terminal needs enough track to hold two trains and enough tankage to hold the contents of a third train.

The Construction Products briefing was sparsely attended, which is unfortunate. Here we're talking about cement for both new housing and petroleum exploration in a market where non-US providers are not able to keep up. Sand for both fracking and industrial use touches myriad markets local to BNSF short lines and -- with Minnesota's aversion to sand-mining -- new sources are opening almost daily. Happily, car supply is less limiting than it was thanks to faster equipment turns, some of which comes from unitizing certain single-car markets.

For me, Service Design & Performance was the most important Access to Tools workshop. I've never seen it done at any shortline meeting, yet understanding how and why the connecting Class I does what it does is vital to any shortline-Class I relationship. The Industrial Products focus in this session was exactly right given the need to manage trade-offs between requirements and restraints -- between the requirements to turn the cars and restraints of customer behavior and yard dwell.

Interline Service Agreement (ISA) adherence is still spotty, adding car-days to cycle times. Based on my own anecdotal information gathered from short line reps at this meeting, the root causes for ISA compliance failure run both ways. Network design may require physical interchange at 0300 but the short line may not go to work until eight, adding hours to shortline dwell at both ends. In other cases, BNSF ops irregularities beyond the interchange may cause failures. Regardless, the short line must always record *any* ISA deviation so that steps may be taken to prevent recurrence. A simple, home-grown Excel spreadsheet can help.

The ISA is designed to support Goal Number Three: Keeping Cars Moving. And we've got to do better. Dick Ebel, AVP for Shortline Development, says shortline dwell time is still six days interchange-on to interchange-off and excludes cars made available ahead of the want date. Moreover, I learned that shortline days do not count in the system car-miles-per-day figure. They truly ought to because not doing so distorts car velocity figures by six days per short line.

Chief Operating Officer Greg Fox said in his after-lunch operations panel that the ISA is not enough. He reiterates that the best way to reduce transit-time variability is to cut the number of times a car is touched between loads. Processing cars to meet customer requirements is key and predictability of local service goes a long way. The AIM (Assess. Improve. Maximize) initiative for local service can work wonders and short lines are encouraged to use it. Repeatedly, in fact, as customers and operating patterns change.

Railroad President Carl Ice took the mike for some concluding remarks at the end of the formal presentation segment of the program. Said he, running a more efficient railroad covers half to two-thirds of rail inflation costs [*call it 2-3 percent a year -- rhb*]. Managing crew starts to the traffic available, using better train handling and power-to-weight ratios to maximize ton-miles per gallon, and value pricing each play a part.

The mix is now half intermodal and a quarter each coal and merchandise. Intermodal will thrive on highway conversions, the outlook for coal is flat-to-down, and -- the crude-oil surge not withstanding -- merchandise carloads are positioned to grow. Carl concludes, "Each of our commodity teams has a plan to grow" some segment of its franchise, which I take to mean the doors are open for increased shortline participation. Moreover, says Carl, "Being part of the Berkshire Hathaway family puts BNSF in a world-class group of companies with a long-term perspective." Can't argue with that.

Genesee & Wyoming posted its third quarter results Friday morning. We're nine months into the first year of combined GWR+RA operations, so the GAAP numbers have to compare what GWR did this quarter with RA in house vs. what it did a year ago by itself. As a result, we're looking at $401 million in 3Q2013 revenues as opposed to $223 million a year ago, an 80 percent increase. Don't make no sense, as the man says.

The combined GWR+RA non-GAAP operating revenue for 3Q2012 was $373 million, so the $401 million recorded this year represents a seven percent gain. Freight revenue, exclusive of no-freight switching ops etc., increased ten percent to $299 million from $272 million. Combined third quarter North American revenue was $319 million, operating income was $77 million, and the operating ratio was 75.9, a bit on the high side but, as you'll see below, it's under control.

I'm picking up the non-GAAP comps from the earnings call slides for a clearer picture of the combined companies. I'm also restricting my carload discussion to North American results, the better to use GWR as a shortline standard. I have another caveat, too. GWR and RA did not use the same commodity groups for everything. For example, RA had overhead coal in "Other," GWR had it in coal; RA combined metallic ores and metals; GWR shows them them individually. There are also revenue moves that originated on one and terminated on the other, so they have to be adjusted out.

RailAmerica recorded 214,357 revenue units in 3Q2012. After these adjustments, RA shows 209,410 units. The 3Q2012 GAAP volume for GWR was 192,168 units. Combine the two and get 401,578 units, up 5.3 percent year-over-year. The big grower, percentage-wise, was Petroleum Products, a group that includes the STCC 291 benzines, ethylenes, and LPG as well as the STCC 131 crude oil, with crude oil the dominant species. The Metals group put on 5,944 more units, the largest numeric increase. Total carload freight, including auto and crude, increased 7.5 percent, a respectable number given what we've been hearing from the Class Is.

Chief Commercial Officer Mike Miller said on the call that infrastructure improvements, overhead efficiencies, enhanced staffing, and better service are contributing to the recapture of some business previously lost to the competition on a few of the inherited RA properties. Citing "pent up demand," Miller sees an increasing number of truck-to-carload conversions as customers get comfortable with a more reliable service product. CEO Jack Hellman says they're investing about $3.4 million in one-time "fix-ups" on the former RA's 45 roads and 7,500 route miles of track and that ought to be done by the end of 2013.