THE RAILROAD WEEK IN REVIEW
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"The U.S. oil-and-gas industry focus is now on finding ways to get more out of the shale formations it has already tapped. — Wall Street Journal, September 15, 2014

I wrote last week about strategic planning and having the right assets in place for business that has yet to materialize. What it boils down to is a matter of having a reliable intelligence network. The military intelligence parallel is inescapable, the only difference being you're looking for information that will allow you to stay ahead of your customers whereas military intelligence keeps you ahead of your enemy. And the stock market, being a leading indicator of economic activity, is a good place to start.

In railroad intelligence, it is well to keep in mind the old stock trader's mantra, "The trend is your friend." Take the energy sector, for example, and the nat gas side of the frack sand business in particular. The *Journal* tells us the rate of new wells being drilled is slowing, yet more gas is coming from existing wells and that rate of increase shows no sign of slowing. For example, Cabot Oil & Gas (NYSE: COG) last year drilled what the Journal calls "the best gas well in the United Stales" in northeastern Pennsylvania, drilling longer horizontal legs, fracking as it went.

The question now becomes whether more horizontal drilling and less vertical drilling means more or less sand on the rails, and whether there is a market for all that's being produced. On Monday the U.S. Energy information Administration (EIA) said gas inventories as of September 5 were half again what they had been in March and prices dropped five percent immediately on the announcement. Moreover, the EIA says gas production will increase another five percent this year. Yet, given the COG experience in Penna, does that mean more gas from fewer wells?

Enter strategic planing for railroads. More gas from wells already drilled means fewer new wells and that could lead to less frack sand and pipe to, say, the eastern Marcellus, where COG is particularly active. Norfolk Southern and its shortline network dominate the dry gas areas of eastern Pennsylvania and have to plan train starts, crew starts, and track capacity according to what customers say is coming at them. Or do they?

COG in its September 3 investor presentation material puts 2014 production growth guidance at roughly 35 percent year-over year and another 20-30 percent in 2015. Reserves grew at a heady 42 percent last year for a 26 percent CAGR over three years. But that's just reserves, not what's coming out of the ground. Wall Street looks at the latter and prices shares accordingly, and COG shares have not been among the more robust performers.

Charles Schwab gives COG an F rating based on fundamentals, valuation, and price performance, among others. Ned Davis Research rates COG "neutral" based partly on the relatively high price-earnings ratio (37 vs 25 for the E&P sector). And the MarketEdge technical analysis site says to avoid COG because buyers are sending prices lower according to the 200-day and 50-day moving averages.

Earnings estimates are coming down, too, showing declines over the past 90 days for this quarter, next quarter, this year and next year. Moreover, MarketEdge shows declining share prices in the utilities, energy, exploration and materials ETFs. In other words, the Street is taking COG's rosy outlook with a wait-and-see attitude.

That's why railroad planners will want to look closely at not only what their energy exploration and production customers are projecting, but also at how Wall Street receives those projections. Track once put down can't easily be picked up; train & engine personnel once hired and qualified can't easily be moved. Locos and cars are somewhat more fungible, though increasing train speeds and more miles per car-day give you more RTMs for the same asset base, and being needlessly long equipment is best to be avoided.

The image in the strategic planner's crystal ball is only as good as the market intelligence behind it. So when train speeds lag for lack of power, crews, or track space, it's because actual traffic volumes showing up were not forecast, and — as year-over-year performance metrics have proven once again — you can't run a railroad on surprises. Short lines, as market extensions of their connecting Class I networks, have an essential role in keeping the clouds from the strategic planner's crystal ball.

Not to be seen as picking on COG, I must add that many companies in the energy and E&P ETFs — HAL, COP, SLB, EOG, e.g. — are lagging the general market, indicating a general lack of appetite for energy shares. A recent post at the *Oil & Shale Gas Discovery News* website, oilshalegas.com, tells us a horizontal well in the Marcellus can cost $3-5 million and low nat gas prices (under $4 per million BTU) can discourage new drilling activity. The writer expects Marcellus to "come alive again" in 2015, but the stock market isn't buying it. Neither should the railroads.

Coals to Newcastle redux. Apropos of my last week's comments about coal moving in odd directions, fellow pundit Larry Kaufman writes,

> Based on some seemingly strange traffic flows 30 to 40 years ago, I wonder if there may not be a unique reason for the increase in coal to Newcastle. For example, there was a time in the 70s when the anti-railroad interests tried to make an issue of importing Polish coal for less than it cost to mine domestic coal. Just a bit of checking revealed that the Polish coal was being used for ballast in break-bulk ship that lacked other cargo.
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> With the ship operators paying for coal as ballast, the coal producer was able to beat the price out of Norfolk and Newport News. If you were a coal-burning utility, all that mattered to you was that you got your coal for less than U.S. mines could produce and ship it. So much

for the utilities' effort to con people into believing U.S. producers were gouging and needed to continue to be regulated. I wonder if something like that is at play here. Also, I would not be at all surprised if the sulfur content was not a factor in this seemingly backward movement.

Florida East Coast Railway (FECR) has pushed its all-rail intermodal service north to Charlotte, North Carolina, under the Piedmont Express brand name. FEC operates intermodal ramps at six locations on the east coast of Florida, including on-dock at the Port of Miami, west of Miami at Hialeah, and adjacent to the docks at the new (WIR July 18) Port Everglades facility hard by the Fort Lauderdale Airport.

The Piedmont Express is a two-day ramp-to-ramp service running five days a week. Customers can select from a variety of pickup and delivery options, including door-to-door, ramp-to-door, and ramp-to-ramp. Says FEC President Jim Hertwig, "On average, for every four southbound shipments arriving in South Florida, there is only one northbound shipment. This imbalance can be challenging; however, FECR's Piedmont Express in FECR containers provides a cost-effective option for customers in the Carolinas."

Best of all, FEC runs a scheduled service. Click on the Customers tab at www.fecrwy.com, then the Intermodal Customer button, followed by the Train Schedule button and see origin, destination days of operation, cut-off and departure times for half a dozen trains a day in each direction. Moreover, FEC runs mixed trains, with merchandise and autos in the same consists with the intermodal platforms, meaning carload customers can manage the Florida end of their supply chain with a much sharper pencil.

This coming Tuesday Norfolk Southern will hold its 2014 Investor and Financial Analyst Conference at the Airport Marriott in Cleveland. The program is billed as a comprehensive overview of the company's operating, financial, and strategic initiatives. Best of all, attendees will be treated to an office car trip out to Bellevue Yard to see the expansion first-hand. NS will webcast the morning's presentations 0745-1130 and the Bellevue section 1300-1430 on the Investors page at www.nscorp.com or dial 877-869-3847 for the audio.

Following the live broadcast, an audio replay will be available for 60 days by dialing 877-660-6853 and access number 13591242. The replay will also be archived on the company's website and available for download to a portable audio player or computer as an MP3 - or podcast – file. Both the archived replay and the MP3 file will be located under the Investors section of the website. (Happily, I will be there; watch this space next week for what I saw.)