THE RAILROAD WEEK IN REVIEW

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"Improved asset turns improve service, lower capital exposure, and drive revenues higher." — Hunter Harrison, CEO, Canadian Pacific

Hunter Harrison opens the Canadian Pacific Investor Day proceedings by chiding the analyst community for missing his message. He puts up a chart of analyst quotes and one by one shows where CP beat the projections. A pretty powerful opening, I'd say, and HH went on to talk about execution to plan and the rewards to stakeholders attributable thereto.

The first hit is on his *where we're going* slide: "I'm happy to tell you we have an understanding on the sale of the D&H. Cannot reveal who's on the other side, but it's something that was in our original plan and now it's come together." The analyst notes I've seen suggest it's GWR, but I'm not so sure. Slide 61 (see the Investors page at www.cpr.ca) shows the D&H network consisting of solid and dotted lines into the heart of the Marcellus where NS is the dominant Class I player and I can't see NS letting another player between them and the drill sites.

NS inherited those CP connections as a result of the Conrail split. Recall the USRA Final System Plan for the Northeast gave the D&H rights into Northern New Jersey, Philadelphia and Washington, creating what one wag called the Delaware & Hudson & Susquehanna & Potomac. Fast forward to today and CP is the only other Class I in the eastern Marcellus, interchanging frack sand and pipe and other goodies with several short lines. NS is the logical successor.

Then there's New England. CN owns access to the Connecticut River Line and Maine through the New England Central and St. Lawrence & Atlantic, now GWR properties. On the other hand, CP has a significant New England franchise thanks to its Pan Am Rail and Vermont Rail connections. Handing all that over to GWR could raise significant anti-competitive issues, ergo my money is on NS as the acquirer.

The balance of the program goes to increasing velocity, sharper capital deployment, getting the right people in the right jobs. The charts and graphs are impressive, and that's to be expected, but they drive home the theme of increasing revenue, taking more points out of the ops ratio, and improving operating income, with velocity and revenue *per train* the biggest drivers.

This is pure Hunter, and a mantra I've heard consistently ever since I heard him talk about the benefits of increased velocity at the Illinois Central 25 years ago. The message to shippers and short lines alike is to turn the cars and rake in the benefits. Which leads me to…

NEARS, the North East Association of Railroad Shippers, and their Fall meeting focus on Capacity. The message is, to pick up on Hunter's theme, the faster you run the trains, the more capacity you get. And that's not just a Class I story. The NEARS shortline panel featured three short lines, each of which had repurposed facilities built for one thing, steel-making, e.g., into energy-support or distribution services or agricultural products transloads. In every case, the speakers showed how the new facilities let them turn cars faster and generate more revenue at lower cost.

This drives home a critical message to the frack sand guys in particular. We all know how drillers like to use those covered hoppers for storage and that $100,000 in demurrage isn't even a rounding error. Yet, having 40 cars in a 40 car yard for 40 days clogs up the railroad the same way sending too many cars to Conway, North Platte, Alliance or Waycross clogs up those Class Is. So even as CSX expands the Northwest Ohio intermodal terminal and NS expands Bellevue for carloads, so must short lines increase capacity to increase velocity. Or get rid of those covered hoppers in storage service.

Both NS and CSX presented on what steps they're taking to add capacity, and the common thread is increasing velocity. Yes, there are still wobbles as the yards and mains are being reconfigured. I heard horror stories of cars going past their destinations two or three times before landing where they needed to be. Clearly a function of lack of yard space, says I, and my Class I contacts agree. And until that yard or track space is added, we'll still have hold-outs, but at least a process is in place to eliminate them.

With nearly 200 souls in the room, roughly a third beneficial owners and logistical service providers, a third equipment lessors, and a third railroads, there was ample opportunity for lively discussions, and I was party to more than a few. Kudos go the NEARS committee that assembled the program. The topic is certainly timely; the presenters and panelists were all admirably equipped to show How Things Work. And the common theme is velocity. Well done.

Kansas City Southern and Union Pacific may see a light at the end of the Mexican Rail Reform tunnel. The *Journal of Commerce* reported Oct 1 that The Mexican Senate will likely consider rail reform legislation this month, allowing the concessions previously granted to the US operators and their Mexico-based partners to remain in effect. Doing otherwise would open the trackage to third-party operators that could lead to serious supply-chain disruptions.

However, says JOC, the reform legislation will likely call for creation of an STB-like regulatory agency. As is, rail customers in Mexico have no means to pursue rate relief, and that could have been behind the initial move to change the rules. However, Stifel's John Larkin writes that an STB-like regulator could crimp the pricing power the US concessionaires have enjoyed. "Captive shippers will now have the ability to seek rate relief from the government. The railroads will often have to follow directives to reduce rates when the regulatory body deems it appropriate, and the rails will likely price less aggressively to avoid such situations."

While the earnings outlook for UP will not take a serious hit, I'm afraid Larkin is right where KCS is concerned. "The potential regulation is another example of the endless hurdles faced in realizing the strong growth opportunities in and out of Mexico. While outsized growth is possible, many opportunities have been eliminated and others have been pushed back." As a result, the aggressive growth rates KCS has cited in the past may be in jeopardy.

WIR reader Bill Burt, a long-time friend and fellow short line advocate, is also an excellent student of railroad history, especially in New York, Pennsylvania, and Ohio. He writes to fill in some crucial details surrounding my Nickel Plate Road and Bellevue commentary (WIR 9/26):

> N&W did not acquire the NKP to obtain the DL&W connection into the Northeast. A merger of Erie and Lackawanna (and possibly D&H) had been publicly discussed since 1956, and by the time N&W-NKP surfaced, there was no possibility that DL&W would continue to function as NKP's eastern connection, in competition with the Erie main line.
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> For NKP management, the N&W merger was a way to sell the railroad for the highest price. They had fought off DL&W's advances from 1948 to 1955 but then had to figure out where to land. Nickel Plate High Speed Service (12 hours 20 minutes best time from Chicago to Buffalo, in 1962, coupled to a 12-hour Lackawanna schedule to NY) vanished.
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> Inevitably, the merger changed NKP and WAB from top-notch competitors in east-west corridors to north-south appendages of N&W. The results were disappointing at first, but N&W's $60 million a year profits covered a lot of disappointments. In its search for business N&W focused on automotive and carload, which were a lot more reliably profitable than (dying) fast freight and intermodal, and this emphasis paid off in time. The NY-Chicago corridor had too many railroads in 1964, so you can make the case that N&W simply acted as the undertaker.
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> For obvious reasons the N&W-SOU merger made north-south routes more compelling, and Bellevue has been the winner. As I think NS noted in a recent document, planning for expansion at Bellevue began when the hump yard was first designed in the early Sixties--a sterling example of forward thinking.

Thanks, Bill.