THE RAILROAD WEEK IN REVIEW
October 31, 2014

"The US economy [has] turned negative for the first time since 2012, driven by widening credit spreads and big falls in industrial metals prices." Variant Perspectives

The BNSF Shortline Meeting in Fort Worth last week drew some 150 representatives from the nearly 200 Class II, Class III, and switch carriers having direct connections with BNSF. Moreover, BNSF itself was well represented by more than 70 individuals presenting or assisting in the breakout sessions. The meeting theme was Grow, Invest and Serve — entirely appropriate for today's railroad environment.

To set the scene, let's start with BNSF third-quarter revenue units through Week 39 (Sep 29). Total volume dipped 1.0 percent to 2.6 million units as coal dropped 6.4 percent and "Consumer Products" (intermodal and auto) lost 2.5 percent. Grain shed 3.9 percent and non-ferrous waste dropped 13.2 percent. Industrial Products (everything but coal, ag and intermodal) grew a respectable 9.6 percent thanks to double-digit gains in automotive (mainly finished vehicles), sand/gravel (frac sand lives here) petroleum products (crude oil plus STCC 29 refining and drilling by-products). Strip out just the crude oil (short lines are heavy in LPG etc.) and the IP delta drops to 4.6 percent.

Several things are going on here. Conversations with BNSF staffers revealed that the revenue-unit declines in coal and intermodal are a function of velocity, not demand. Dave Freeman, SVP Transportation (the guy who runs the rail ops) and Carl Ice, President and CEO, provided examples of the work at hand to recover velocity (why the Northern Region is the big capex winner, cars-per-week potential with proper velocity). And IP Group VP Dave Garin talked about how unit trains enhance velocity and that "the supply chain will dictate unit trains *vs.* manifest."

Getting back to quarterly carloads, non-Class I connecting roads touch roughly one out of every four non-intermodal revenue units, call it 131,000 loads in Q3. It's also useful to separate crude oil from STCC 29 "petroleum products" because only a few short lines are running trains of crude but many are running everything from asphalt to nat-gas liquids. How to break them apart?

The Quarterly Carload Statistics (QCS) from the STB suggest BNSF has a STCC 29 run rate of roughly 55,000 cars a quarter. Subtract that number from the petrol products line and find that Q3 crude oil was up 44 percent to 95,000 units from 66,000 units year-over-year. So, back out crude oil from the IP numbers above and see that the commodities the short lines handle are up 4.6 percent, not the 9.6 percent shown for the IP group as a whole.

Likewise, separating frac sand, STCC 14413, from the rest of "sand and gravel" is helpful for short lines. This broad category includes both stone and sand, with the latter about half the total.

BNSF reported 82,256 cars of sand/gravel in 3Q2014. That suggests to me about 41,000 cars of frac sand, up 2,000 units or 4.9 percent. Published reports on the rate of increase in wells being drilled are light on specifics; however, the trend seems to be more oil from existing wells and less from new wells. If such is the case, then the decreasing rate of increase for frac sand cars seems reasonable.

Thursday morning's agenda consisted of a number of breakout sessions, six of which were commodity-specific and which I attended. If there's any single place for short lines to pick up new ideas to grow, serve and invest it's in this group of sessions. Ag products, which, including grain, grain mill products and ethanol, are growing RTMs at a faster rate than they are carloads, an indication that short lines will be well-served seeking heavier cars going farther. Blowing plastics into containers for export is a new chemicals transload business because cheap nat gas as the raw material for plastic pellets creates new global markets.

Industrial coal could be another shortline strength. Though less than five percent of BNSF coal carloads, there are myriad uses that fit the carload model. The building products breakout was mostly lumber and panel, though we touched as well on paper, with an emphasis on packaging and forward positioning in shortline-served warehouses. Texas and Oklahoma are leading housing-start markets, suggesting unit trains of center-beams with 2x4s and panels to be unloaded at loop-track grain terminals between grain train arrivals.

Sam Kyei's Economic Outlook is always a crowd-pleaser touching on topics from consumer spending to industrial capex and how they affect railcar loadings. He cites "bothersome headwinds" including slowing global growth, geopolitics, and tightening of monetary policy. All of which fits with reports from other economy watchers.

For example, Variant Perception, a contrarian investment advice house, wrote on Oct 21, "The VP Weekly Growth Index aims to track the health of the US economy in real time and turned negative this week for the first time since 2012. This has been driven by widening credit spreads and big falls in industrial metals prices, which in our models more than offset the good initial jobless claims numbers and the recovery in building permits." And if that isn't a leading indicator for the metals business, I don't know what is, and it has implications for the rest of the IP sector. It certainly explains the small deltas in BNSF's Q3 industrial markets.

At the end of the day, the consensus seems to be the sessions were welcoming and insightful, providing meaningful take-aways for inquiring minds: how to grow the business, where to make meaningful investments in shortline properties, and how to create a value-added service offering in the bargain.

For all the talk of velocity, car-miles per day, and lack of redundancy, channel checks around the shortline industry reveal instances where Class Is are taking the long way round between the shortline interchange and destinations local to the connecting Class I.

Picture, if you will, a triangle A-B-C with the shortline interchange at A, the destination at C, and an intermediate yard at B. Rather than run the direct A-C route, the Class I elects to send the car via B, a major class yard and miles out of route. As a result, volumes increase on already congested routes A-B and B-C, days are added to transit time, and yard dwells (a needless day at B, e.g.) between O-D pairs get worse. And that's just for single-car moves.

Take single O-D pair blocks. A relatively short-haul shipper sends 20-car blocks of material to the same customer several times a week. The cars are pre-blocked in the shortline's outbound consist for delivery to the Class I but they get humped at the intermediate class yard anyway. Yet terminal supers on all the Class Is tell me shortline pre-blocks help cut yard-dwell averages by going straight from the receiving yard to the departure yard. Another instance of saying one thing and doing another to the detriment of transit times, capacity and revenue unit volume, to say nothing of customer satisfaction.

Iowa Pacific Holdings, owner of two railroads in the Permian Basin, the 111-mile Texas-New Mexico Railroad and the 140-mile West Texas and Lubbock Railway, has tapped Tim Hammond for EVP - Operations for these two lines effective November 10. Kurtis Lindsey becomes Director – Permian Basin Logistics, effective immediately, from General Superintendent of Texas – New Mexico Railroad. This new assignment makes Kurtis responsible for customer facility planning on the two railroads as well as managing all aspects of local customer relationships.

Says IAPH President Ed Ellis,"These positions reflect an expansion of our management focus in the Permian Basin and highlight our commitment to customer service and business development. We look forward to the leadership roles Tim and Kurtis will assume with the Iowa Pacific team."

And about time, too. The surge in traffic related to oil shale drilling and crude-by-rail has resulted in a doubling of carloads since 2012, originating just under 40,000 carloads for the 12 months ended September 2014. With new customers coming on line over the next few months, carloads are expected to continue the strong growth trajectory. Congratulations, both.