THE RAILROAD WEEK IN REVIEW

January 16, 2015

"The Fed's extraordinary efforts to force market risk-taking and inflate financial assets discourage productive risk-taking in the real economy." — Ben Hunt, "Catch-22" story

CSX Chairman Michael Ward unleashed a remarkable number of record results for the 2014 fourth quarter. Revenue increased five percent to $3.2 billion, operating income was up 11 percent to $901 million, and earnings per share share increased 17 percent to 49 cents from 42 cents a year ago. Revenue units increased six percent though RPU was essentially flat, thanks in part to lower fuel surcharges. Ward attributes the record results to "the timely addition of operating resources," meaning locos, crews and fixed plant.

CFO Frederik Eliasson picked up the thread with the financial and commercial highlights. The commodity mix remains 42 percent merch carload, 40 percent intermodal and 18 percent coal and coke. The last group was up 11 percent in the quarter against just six percent for the year, which Chief Commercial Officer Clarence Gooden addressed in the Q&A, saying utility stockpiles are about where they ought to be; however, "If gas prices stay around $3.00, there could be some downside risk in quarters two and three."

Commodity detail is in the quarterly Financial Review, with an added section with pie charts and commentary. The commodity detail section is better than I've seen from any other Class I, and gives you a printed summary for future reference, essential for connecting Class II and III roads planning their portfolios for the best CSX fit.

Merch carload vols including automotive but excluding coal and coke were up five percent in a diversified product mix in which no individual commodity group accounts for more than nine percent, and that's chems, highly skewed by crude oil and frac sand (more on this group anon). The ag sector (ag products, ferts, food) was down a point on mix and markets; the industrial sector (chems, autos, metals) jumped eight percent on chems and metals; the housing sector also saw eight percent more loads in forest products, aggregates and MSW.

Chemicals and minerals were the only double-digit gainers. Minerals is aggregates as noted above, and chems include crude oil, frac sand, and the entire STCC 29 petroleum products group with its LPG, asphalt, and other NGLs. Going by the 52-week YTD carload commodity data from the CSX website, chems increased 2.4 percent and petrol products increased 61.1 percent; both groups combined increased 13.5 percent to 793,000 units, of which petrol products was 27.0 percent, up from 19.0 percent year-over-year.

CSX reports 620,000 units in chems. I suspect the spread has to do with the way CSX assigns commodities in ways that don't exactly parallel the AAR. Frac sand and petroleum products are in chems and ferts are in Ag whereas the AAR puts frac sand in aggregates and ferts in chems. I've asked CSX for a commodity map showing which STCCs go in which buckets to be sure.

However, you can get a sense of what goes where from the QCS tables on the STB website. As of the 2014 second quarter (QCS always lags a couple of quarters), LPG at CSX was the largest-volume STCC 29 at 14,000 units. Crude oil, STCC 13, was more than double that and accelerating at a 60-degree angle while the 29s are half that. Bottom line: merch carloads were up 37,000 units and by my QCS reckoning crude oil could be a big part of that. I'd welcome comments from anybody with a sharper pencil.

But I digress. On the call, Frederik said the outlook is favorable for all commodities except ferts and export coal. Ag expects strong demand and a record harvest, and more food and beverage in boxcars, but ferts could be down on softer global markets. Oil and nat gas E&P will keep metals and chems vols up, auto expects a strong year, housing starts in the southeast plus packaging will boost forest products and aggregates.

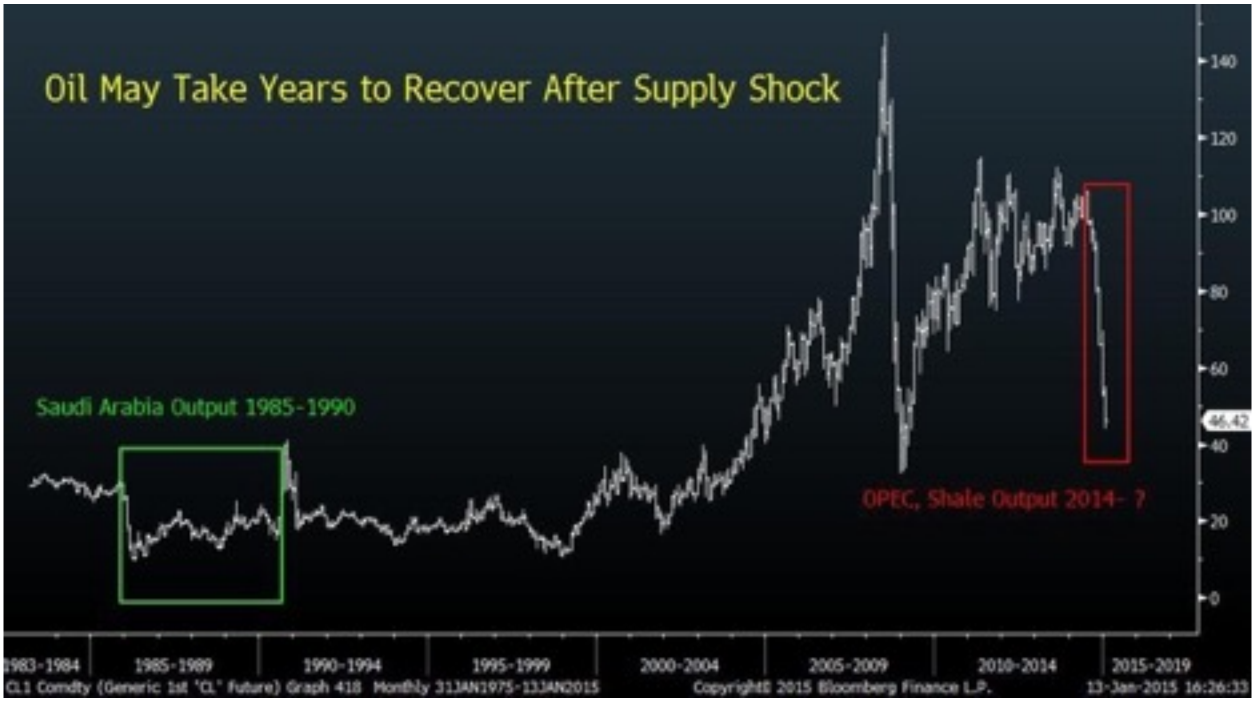
During the Q&A Chief Operating Oscar Munoz fielded a number of question about the network improvements and the effect on train speed and dwell times. He said the incremental resources coming on line will "reestablish the discipline that we've had over the past three or four years around the internal operations of both scheduled and the unscheduled networks. Dwell will be our first focus and the first to benefit from the incremental resources."

Asked about on-time performance, Oscar replied, "Locomotives are the biggest aspect of this. We got 200 in 2014 and will get 250 more in the 2015 first half. Service measures are pretty significantly correlated to the arrival of those locomotives. Crews have been trickling in over the course of the year so we're in pretty decent shape there. We feel pretty good about where we're starting the year and are open for business as fluidity has gotten better across the network."

As for Chicago, Oscar is optimistic. "We've had 11-plus weeks where Chicago has been on what we call a normal alert level and that's good news. We all take our turns in the barrel struggling through various interchange points. But by and large, the entire industry is working very closely and very well. We'll take another look in Week 9 or so, but so far so good."

I came away from the call convinced that CSX is doing all the right things to get back On Plan and that customers will benefit from the "incremental infrastructure" in terms of more predictable traffic patterns and more controllable total transportation costs. Merch carload volumes key to short lines will continue to grow at modest levels and not go the other way.

Crude oil, though only 2-6 percent of Class I revs, has the analyst community in an uproar over the negative effect of low prices on rail volumes. The Bloomberg chart below is one catalyst, showing how West Texas Intermediate, the U.S. oil benchmark, tumbled 69 percent from $31.82 a barrel in November 1985 to $9.75 in April 1986. It took almost five years for prices to recover.



Bloomberg's thesis is that the Saudis at the time flooded the market when it got tired of cutting output to support prices. And it's not likely to repeat the mistake this time around.

> Surging prices in the 1970s led to the development of the North Sea and Alaska oil fields. OPEC members also increased capacity, leaving the Saudis to trim output when demand softened. After the plunge in prices, the Saudis lost their nerve and they resumed the role of swing producer. If they hadn't lost their nerve, we wouldn't be seeing the shale oil boom today and North Sea production would be substantially lower because investment would have been less.

To which a long-time WIR reader who follows this stuff closely for its impact on railroads responds, "Seems like the only thing that can stop this plunge is the low-cost producers' actions. By keeping output the same, they at some point will begin to degrade their own positions. They have only this source of income whereas the developed economies have more to gain from cheap energy than they lose with low prices."

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