THE RAILROAD WEEK IN REVIEW

March 6, 2015

"If the U.S. economy continues to improve in 2015, we expect earnings of our Powerhouse Five to improve as well." — Berkshire Hathaway Annual Report, page 5

BNSF, one of Berkshire's "Powerhouse Five" industries, in came in for a bit of a scold in the opening pages of the Chairmans Letter. Quoth Mr B:

> During the year, BNSF disappointed many of its customers. These shippers depend on us, and service failures can badly hurt their businesses. BNSF is, by far, Berkshire's most important non-insurance subsidiary and, to improve its performance, we will spend $6 billion on plant and equipment in 2015. That sum is nearly 50 percent more than any other railroad has spent in a single year and is a truly extraordinary amount, whether compared to revenues, earnings or depreciation charges.
>
> Though weather, which was particularly severe last year, will always cause railroads a variety of operating problems, our responsibility is to do whatever it takes to restore our service to industry-leading levels. That can't be done overnight. The extensive work required to increase system capacity sometimes disrupts operations while it is underway. Recently, however, our outsized expenditures are beginning to show results. During the last three months, BNSF's performance metrics have materially improved from last year's figures.

I guess if you exclude intermodal (down 11 percent year-to-date on West Coast labor follies), that's a true statement, particularly for the core shortline merchandise franchise. All-in, YTD revenue units through Feb were off one percent, with intermodal (44 percent of all revenue units) down 11 percent. Coal, 25 percent of total vols, increased 8 percent; auto was up 6 percent, and petroleum products up 2 percent. That leaves merch carloads — where short lines live — up 10 percent, with sand/gravel (includes frac sand) up 28 percent.

Full-year 2014 BNSF revenues increased 6 percent to $23.2 billion, revenue units increased 2 percent, and RPU gained a reasonable 4 percent. Merch carloads, including crude oil and frac sand, were up 5 percent, though average RPU was off 2 percent. The operating ratio came at 69.9, highest of the Big Six North American Class Is.

The Berkshire 10-K paints the BNSF results picture with the broadest of brushes, yet acknowledges the short lines' role thus: "BNSF efficiently serves many smaller markets by working closely with approximately 200 shortline partners. BNSF has also entered into marketing agreements with other rail carriers, expanding the marketing reach for each railroad and their customers." Please note the use of the term, "partners."

Whereas virtually all Class I quarterly reports provide year-over-year revenues, units and RPU by commodity group, the BNSF portion of the Berkshire 10-K goes only this far:

> Revenues from consumer products in 2014 were $7.0 billion, and were relatively unchanged from 2013. In 2014, unit volume and average revenues per car were relatively flat versus 2013. Revenues from industrial products increased $508 million (9 percent) to $6.2 billion. The increase was primarily due to increases in overall unit volume, and to a lesser extent, changes in rates and product mix.
>
> Revenues from agricultural products in 2014 increased $584 million (16 percent) to approximately $4.2 billion. The increase was primarily attributable to increased volume, rates and product mix changes. Also, agricultural products volume in 2013 was negatively affected by the drought conditions in 2012. In 2014, coal revenues of $5.0 billion were essentially unchanged from 2013, as a 2 percent increase in year-to-date unit volume was offset by a 2 percent decline in average rates.

I worked these numbers backwards to approximate 2013 revs by commodity group and came within 4 percent of the 10-K totals. Then I took 2014 week 52 AAR carload data and sorted the commodities into the annual's industrial, ag, coal and consumer groups. The resulting RPUs are in line with the percentages quoted above.

Operating expense gained 6 percent in 2014 and operating income grew 5 percent. Below the line, net income was up just 2 percent to $3.9 million as both interest payments and taxes took bigger bites than a year ago.

CSX held its 26th Annual Short Line Workshop at Amelia Island, Florida March 1-3. More than 275 individuals representing 185 short lines as well as some 200-plus CSX staffers were there. The event also, sadly, marked the last Workshop under Len Kellermann's able leadership, as he will be retiring from CSX after 33 years of Service on April 30.

Thus it was a double shame the weather gods conspired to dump enough ice on PHL airport Sunday to shut the place down. Ergo I missed out in the proceedings entirely. However, having the agenda at hand, and having been to most of the preceding 25 Workshops, I have a good idea of what was discussed. Some highlights:

Monday's operations panel featured two CSX Division Managers, the CSX head of Customer Service Operations, and two short line leaders. If past experience is any guide, my sense is there was considerable emphasis on how to move cars faster at lower cost and with greater perceived value to the customer. The panel, appropriately enough, was bookended by Ops EVP Cindy Sanborn, CFO Fredrik Eliasson (only CSX trots out the CFO for short lines but everybody ought to) and EVP Commercial Clarence Gooden, who I hope touched on car-miles per day as a critical competitive metric.

The Tuesday break-out sessions covered the entire spectrum of the CSX commodity groups, from ag products and fertilizer to forest products, chemicals, metals, and minerals, every one in a different break-out room and offering insight as to what works and why. Because CSX quarterlies use a more detailed commodity list than its peers, one can easily put the remarks here in the context of the quarterlies with no loss of transparency.

As it happens, Fredrik Eliassson was also at this week's JPM transports conference and from his slides I was able to glean several tidbits about what CSX sees thus far and for beyond in 2015. For the first seven weeks of the year total vols are up 3.9 percent. Intermodal was up just 2.9 percent; carloads including coal were up 4.5 percent — an encouraging sign as carload growth usually lags intermodal.

Here's where it gets interesting. Fredrik rightly says merch carload growth in the industrial and construction sectors beat out intermodal YTD, proving that faster, more reliable merch trains can demand more aggressive RPUs. What he didn't say was that carloads ex-coal, petrol products, and crude increased just 3.2 percent. Petrol products plus crude oil increased 34.4 percent and aggregates including frac sand increased 22.7 percent, making these two groups the leading growers for all of CSX. But we're cautioned that pace isn't likely to continue.

Which brings me back to the plain vanilla carload business. Fredrik shows that same-store pricing is running ahead of rail inflation and more same-store money means more money to be invested in the things that improve car-miles per day and shorten yard dwells. And though the NW Ohio Hub is an intermodal tool, having it there also speeds up the entire network, improving equipment product productivity and creating higher quality in the eye of the customer. That's always worth more money. That from Fredrik with my comments. However…

For all the encouraging words about carload volumes and outlooks, you still have to move the cars, and CSX isn't doing as well as one might like. Trains speeds are essentially unchanged from last year's first quarter and average yard dwells are up an hour to 28 hours from 27 hours a year ago. Particularly egregious are Selkirk, Toledo, Montgomery, Russell, and Nashville, all running more than 40 hours. So, while everything Fredrik says about pricing and performance is true, achieving these ends will be tough with speed and dwell trends like these.

Which brings me to an on-going conversation I'm having with Oliver Wyman's Jason Kuehn and Rod Case. Their argument is that railroad operations are planned and executed on a cost-avoidance model whereas a model that zeroes in on network fluidity and customer service is more appropriate. Says Jason,

> In recent years the OR has really been driven from the revenue side more than the cost side. My thinking is that if railroads could extract more train capacity from the existing infrastructure, revenue would continue to grow faster than expenses, which would improve the OR again. But if you add track miles [or locos or crews], you will also drive up operating

> expenses on the MofW side in addition to the incremental train costs. In short, increasing train capacity on the existing infrastructure greatly improves capital efficiency."

Which raises the question do we really need more locos and T&E crews or do we need to run what we have better? Maybe, says Jason, we need to schedule paths, not trains, and assign trains to paths on a first-come basis. That'll fix the grain guys who sit on cars and then bitch about cycle times. To be continued; reader input is eagerly solicited.