THE RAILROAD WEEK IN REVIEW

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"The new company would give shippers the choice of where they can connect with another railroad along its network, bringing an end to the practice of bottleneck pricing." — CP Press Release on NS proposal, November 17

Canadian Pacific on Wednesday released the full text of the letter sent to NS regarding the CP business combination proposal. Addressed to Norfolk Southern CEO Jim Squires, it reads in part, "We believe that combining our two great organizations will allow us to form an integrated transcontinental railroad with the scale and reach to deliver unsurpassed levels of safety and service to our customers and communities while also increasing competition and creating significant shareholder value." The full text is available on the CP website under Investors.

Of critical interest to Norfolk Southern's regional and shortline connections is CP's November 17 press release, "CP Proposes Business Combination to Norfolk Southern," in which it spells out some of CP's thinking re access and routings. [emphasis added]:

> Among the combined company's key innovations is a new approach to terminal access that would change the status quo in U.S. rail transportation. In the event the new company failed to provide adequate service or competitive rates, it would **allow another carrier to operate from a point of connection over the combined company's tracks and into its terminals**, providing an unprecedented alternative to the affected shipper.
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> In addition, the new company would give **shippers the choice of where they can connect with another railroad** along its network, bringing an end to the practice of "bottleneck pricing" to a large number of shippers in the U.S. while further enhancing competition.

For non-Class Is in particular, this suggests that if one has access to both NS and CSX, to cite but one example, and if NS/CP access weren't working properly, one could shift that business to CSX. In short, it could spell the end of paper barriers where NS and CP are concerned.

But there's a caveat, too. CP has really gone quiet on its shortline program. There haven't been any shortline meetings in years. We also know HH was instrumental in CN's buying back several short lines where, according to my sources, the short lines in question were perceived as having high operating ratios. The logic appears to have been, "If they have an OR of 90 and I have an OR of 60, why should I pay them to do work I can do cheaper?"

NS, for its part, has limited its public response to this terse November 17 note on the nscorp.com Investors page:

> Norfolk Southern Corporation confirms that it has received an unsolicited, low-premium, non-binding, highly conditional indication of interest from Canadian Pacific to acquire the Company for $46.72 in cash and a fixed exchange ratio of 0.348 Canadian Pacific shares per Norfolk Southern share, representing a premium of less than 10 percent based on closing prices today.
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> The Company's board of directors, in consultation with its financial and legal advisors, will carefully evaluate and consider this indication of interest in the context of Norfolk Southern's strategic plans… Notably, any consolidation among Class I railroads in North America would face significant regulatory hurdles…The Company's stockholders do not need to take any action at this time.

A friend who has a good feel for rail combinations writes,

> Right now, the network is balanced: two large western roads, two large eastern roads, and two large Canadian roads, each with some US holdings. If a Canadian road or a western road attempts a merger with an eastern road, it unbalances the network and creates a potential competitive advantage. It's not really a monopoly, but it becomes the only road that can go coast to coast — in the present case, Vancouver to Norfolk.
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> So the other railroads would all have to attempt to restructure their networks to compete, which means they would want to merge or take pieces of other lines, etc. And BNSF has vastly more resources (Warren Buffett) than CP, so it could easily outbid CP for NS, and UP could too. At the same time, you have an activist STB that doesn't like the idea of less competition, so even if the merger proposal gets there, you would likely have conditions attached such as "open access" for other carriers that would de-value the merger.

Fuel Surcharge conversations invariably elicit lively exchanges. A long-time WIR reader and veteran of Class I pricing discussions, offers these tidbits:

> We all know railroad fuel surcharges have been a fiasco. It was no secret that the rails were indexing their rates to the truck fuel surcharge and gaining revenue margins against actual fuel expenses. It was also held that carriers could take any rate increase they wanted as long as they didn't actually call the increases "fuel surcharges." The rails then went to a miles-based fuel surcharge which was supposedly more in line with their fuel cost; an interesting case study would be to see how the FSC collected matches up with actual fuel costs.
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> I'd like to see the rails come up with another surcharge scheme, perhaps differentiated by commodity. Some commodities — paper, e.g. —could be directly truck-competitive in their negotiated freight rates with fuel built in. Other commodities may or may not have specific fuel surcharges, spending on the highway norm.

> It would be up to the market managers to determine not only currently competitive rate levels, but also how would they be affected when fuel price goes up or down. They could apply different surcharges to the pricing structures designed to be directly truck competitive, vs. those designed to be barge competitive or source competitive.

Definitely a topic ripe for further discussion. Comments invited.

Day One of RailTrends 2015 did not disappoint. All the usual suspects were there and every presenter left take-aways for enhancing the shortline competitive advantage. The proceedings opened with the usual industry panel. We heard from Sarah Feinberg (FRA and refreshing), Linda Bauer Darr (ASLRRA on accomplishments and what's next). Michael Borque (Rail Association of Canada) and Ed Hamberger (AAR) paint the broad railroad industry picture for their respective countries, and Tom Simpson (Railway Supply Institute) touched on car owner/ lessee equipment concerns.

We then got into the railroad business itself. In no particular order, CN EVP Marketing JJ Ruest showed how individual sales reps, each armed with a full battery of freight offerings from the single carload to intermodal boxes to transloads, can add value to the railroad product and enhance customer (always customers, never shippers, to CN) supply chain economics. Shortliners Rick Webb (Watco), TJ Gallagher (GWR), Kevin Shuba (OmniTrax), and John Fenton (Patriot Rail) showed what made their properties unique in terms of business model and in terms results for customers.

Rodney Case (Oliver Wyman) and Larry Gross (FTR) brought case histories on how changing customer demands are shaping railroad operations and what can be done to bring customer requirements and railroad capabilities into alignment. Don Broughton (Avondale Partners and Tony Hatch (ABH Consulting) covered the Wall Street viewpoint regarding issues and opportunities, with Don zeroing in on the truckload sector and Tony doing the railroad side.

There was no formal discussion of the CP-NS merger proposal, but listening to conversations during the breaks and around the edges, one came away with the impression that the combination is, variously, not needed, a distraction, and a diversion away from other, more pressing matters. The consensus seemed to say NS has the talent and tools at hand to do what Hunter proposes: take points off the operating ratio, streamline rail operations, and Run to Plan. It was quite a day.

WIR takes its annual Thanksgiving Holiday next week. Next up: December 4.