RAILROAD WEEK IN REVIEW
April 29, 2016

"We are made to heed what we see and not heed what does not come vividly to mind. -- Nassim Taleb, The Black Swan

This week I had the great pleasure of devoting two and one half days to Light Rail (trolleys, interurbans, and Diesel Multiple-Units). The occasion was the *Railway Age Light Rail 2016* conference in downtown Philadelphia, one of the few US cities where one can see and ride all three light rail modes as well as subways, elevated trains, and classic commuter rail.

Nearly 200 souls representing all disciplines and suppliers were there and the conversation was lively, informative, and entertaining. The eye-opener is the effort, enthusiasm, and talent going into this largely public-sector endeavor, and the appreciative nod to all the disciplines and practices of the "steam railroads" that come together under the light rail rubric.

And of course, if you're going to do a confab like this in Phila, you've got to go ride the system. Here, SEPTA, NJ Transit, PATCO, and the Conrail Shared Assets Operation collaborated beautifully to show off the best of the best, rare mileage included (how about the shop track around the perimeter of the Elmwood trolley shop in a restored PCC?).

The Tuesday afternoon ride over the length of the NJ Transit "River LINE" Camden to Trenton ran over a portion the original Camden & Amboy (the "John Bull" trod here). Eventually the line became part of the PRR, then Big Conrail, and then NJT when NS and CSX split Conrail in 1999. Recall how the merger created three switching zones (North Jersey, Philadelphia, Detroit) where over the years consolidations and re-routes made it impossible to split the properties according to the CSX-NS split scheme.

Thus was born the Conrail Shared Assets Operation (CSAO), charged with the first-mile/last-mile disposition of every car and container entering and leaving these three markets. I mention this because the CSAO is the freight operator on the River LINE, Transit's DMU operation on the old Camden & Amboy, and the trip gave us a good look at what freight's there and what's possible.

Being owned by CSX and NS, the CSAO can forward or receive freight to and from its owners, providing customers a dual access rarely found except in terminal areas like Chicago (think IHB) or Houston (the PTRA). Because the DMUs are technically "light rail" vehicles, the FRA prohibits simultaneous operation of both freight and DMU passenger on the same tracks at the same time. Thus the "temporal separation" scheme, which has DMUs owning the rails 0500-2200 and Conrail out there in the wee hours.

That means Conrail trains are loaded and ready to go at 2200 precisely, and that customers know precisely when their cars will be spotted and pulled, essential for precision supply-chain control. It's a good variety of commodities, too, including all the groups the Parent Roads say they need to replace the lost coal business: steel, aggregates, lumber, paper, both chemical STCCs, crude oil, food stuffs from raw grains to canned goods, and automotive. What a gold mine. And thanks, NJT and Conrail, for giving us a first-class, first-hand look at what is and what's possible.

Canadian National first quarter revenue dropped 4.5 percent, to C$3.0 million, on 1.3 million revenue-units, down 7.2 percent, while revenue-per-unit rose 2.9 percent. Operating expense came down 14.2 percent, leveraging operating income up 14.5 percent, to C$1.2 million; all expense lines were down but D&A and rents, the latter up a point. Net income was up 13 percent.

COO Jim Vena's Slide 6 is a powerful message about how savings over here can create further savings over there. All six metrics improved: the theme throughout the Vena presentation is how this level of execution cascades throughout system. For example, casualty expense down a third thanks in large measure to the added attention paid to running the railroad right. Or fuel burn. Down 9.3 percent on GTMs down 7.1 percent, GTMs/gallon +2.4 percent, and achieving the Holy Grail of one gallon per KGTM. Free cash flow after capex, divs, share repos is a minus C $209 vs. a plus C$366 last year.

Every carload commodity group but forest products and auto lost volume year-over-year; intermodal was unchanged. Crude oil was down 14,000 cars, frac sand down 13,000 cars; the latter's market is shifting more to drilling for nat gas than for shale oil. However, says Chief Commercial Officer J.J. Ruest, even though all drilling may be down, low nat gas prices supported a seven percent carload growth for manufacturers of petrochemical plastics, hydrogen fertilizer and others using nat gas feedstock.

On the call, CFO Luc Jobin said CN expect vols to be down four or five percent for full-year 2016, though, adds CEO Claude Mongeau, "It's incumbent on us to keep pricing that allows us to reinvest in the future and to be disciplined in how we go about things." The outlook calls for CN to continue with its 52-23 carload-intermodal mix, with coal at a diminishing 21 percent and "other" a minuscule four percent.

Ruest says more housing starts in the United States will benefit the lumber group, low nat-gas feedstock prices will benefit plastics and other petrochemical businesses, and auto sales continue to encourage (though not everybody thinks so — see Stephanie Tomboy, below). The system-wide outlook for grain is muted, potash is mixed, and coal is down to three percent of the CN commodity mix, lowest ever. Petrol-based energy's a drag with crude and frack sand less than five percent of total CN loadings.

The message to CN feeder lines is clear: Build on Vena's operations record. As Claude said on the call, do that and carload volume will take care of itself.

Genesee & Wyoming's first quarter results for operations in North America (approximately 80 percent of G&W's annual operating income) saw operating revenues come down 5.6 percent to $299.8 million from $317.6 million, while reported income gained 22.6 percent to $70.0 million. Non-GAAP adjustments ($12.6 million of costs related to the 2015 Freightliner, and I disallow restructuring costs and asset-sale gains) bring NA ops income to $70.2 million, up 23.6 percent.

NA carloads slipped 9.4 percent - by 36,561 units - with the big hits being coal (75 percent of the loss), ag products, minerals/stone, and a few chems rounding out the downside. Overhead remains at a thankfully small four percent of total units. On the call, CFO TJ Gallagher said ag units fell on low grain prices and smaller export volumes (no surprises there); lower frac sand and rock salt numbers offset by some construction aggregates hurt mins/stone; plant closures and trucks took pulp/paper down; and coal is — well, you know the drill.

The revenue deltas for NA ops show losses of $2.6 and $8.9 million respectively for foreign exchange and fuel surcharge fees, with storage fees and other (respectively $2.0 and $5.8 million) partially offsetting. Full-company operating revenues increased 21.6 percent to $482.6 million from $397.0 million. Adjusted income from operations slid 8.2 percent to $79.6 million.

Total GWR reported income from all operations decreased 21.5 percent to $57.0 million, primarily due to a $21.1 million charge related to an Australian iron ore customer entering voluntary administration. (Australian law establishes a system of "voluntary administration," used in circumstances where the company is, or will become at some future time, insolvent.) GAAP net income was up 13.0 percent to $27.0 million.

GWR has set several priorities for 2016: bring Freightliner safety standards up to GWR par; reduce leverage to around 3.4 times adjusted EBITDA from the present 3.7 multiple; close new commercial development opportunities in North America, Europe/UK, and Australia; pursue the 45G tax credit exception; and sustain the acquisition and investment pipeline.

Revisiting NS results, I'm quite impressed with COO Mike Wheeler's comments on taking re-crews down 51 percent. That number makes one wonder what was going on to cause a re-crew number so high it could be cut in half. It would be most helpful if NS would enlarge on the base number of crew-starts being re-crewed and what percentage of total crew-starts that represents.

If we're talking 1,000 starts and have to re-crew 500, that's one thing. If we're talking 10,000 starts and re-crewing 500, that's another matter. And, while we're at it, are we talking only road crew train-starts or are we including yard and local train starts? Either way, I'm sure there's a lot of root-cause analysis being done to find out why trains were re-crewed and what steps to take to prevent recurrence. There may be a better way.

Let's assume most trains finish their runs without re-crews. That being the case, let's do a root-cause analysis of why trains are NOT re-crewed and try to replicate THAT pattern. One place to start is with trip-plan compliance. If more trains move to the receiving yard according to plan than are held out, the common characteristic is not being held out. What's the root cause?

Most likely it's because there's room in the receiving yard. Solution: bigger receiving yards. It's cheaper than 10,000 foot interlocked passing sidings where re-crews cost cab fare, not to mention getting power and crews out of cycle, and pushing up car hire bills. Moreover, as train sizes change and operating patterns morph with them, you can't pick up sidings like so many pieces of Snap-Track. But you'll always need receiving yards.

The UP's Santa Teresa intermodal facility is a good example. Once the UP double-tracked the Sunset, all those trains needed some place to go. Clearly there's not room in downtown El Paso. Collecting them west of town makes sense.

On the revenue side, NS Chief Commercial Officer Alan Shaw says all merch categories but chems are up, with crude oil short-falls being the big chems downer. But when I see the big jump in auto, I get concerned. Stephanie Pomboy of MacroMavens writes that sub-prime loans comprise an increasing share of total car loans, and asks how the 17 million seasonally-adjusted rate of sales (SAAR) can be sustained. She compares the acres of cars in dealer lots to the acres of unsold houses in Las Vegas or Ft Myers housing developments. Is it The Big Short Redux in auto loan CDOs, another financial Black Swan?

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