RAILROAD WEEK IN REVIEW

November 24, 2017

"You can travel from nuts to normal in the blink of an eye." — Stephanie Pomboy

The oil futures market may be flashing a warning for those of us in the frac sand support business. Hedge Fund Telemetry, an investment advisory firm known for its work with market sentiment as well as various technical indicators, sees shale producers as the "shock absorbers" for the global oil market given their new ability to export oil outside the US. As a result, the shale industry has transformed the U.S. market from the swing consumer to the swing producer as China and EM nations increasingly experience demand growth. For now.

Writing in *The Daily Hack* on realvision.com, HFT says there are limitations to the E&P (exploration and production) guys' ability to continue to grow production at the current rates. Even if the current rig count begins to flatten, producers have concentrated on production at all costs, targeting the best acreage in response to the depressed oil price. Those areas have already been exploited, land prices have risen, and the structural cost curve for shale is shifting upwards.

Combine that with what industry watchers see as flattening world-wide demand for oil, we may be approaching the point where we have too much oil chasing too little demand. India and China, for example, are mandating a huge increase in electric vehicle production. World-wide there is increasing use of renewables such as water, wind (see below), and nat gas for power plants. As a result, the present 2% per year petroleum demand growth rate could be cut in half in as little as three years.

My take from all this is that commodity support for shale-oil drillers may have a limited shelf life, like crude-by-rail and even coal. That being the case, the railroads ought to take what they can get without over-investing in infrastructure, and be prepared to see a seismic market shift to the down side over the next 3-5 years.

Regarding missed opportunities for Class Is (WIR Nov 17), a friend who's played both the Class I and shortline holding company sides of the aisle asks, "Is short line consolidation into a few holding companies good for the industry? For shippers?" The question is whether the present collection of more than 200 non-affiliate short lines is a bug or a feature.

I suspect it's a bit of both. The present Class Is all began as amalgams of short, regional services and look at them now. Even after the initial consolidation, shipments very often went over several roads between OD pairs. Mergers fixed that. A carload of paper out of Maine bound for Birmingham had to use the B&M, the D&H, the PRR and the Southern. Today that car would go Pan Am Rail-NS and that's it.

But, as shortline holding companies grow through acquisitions, we could be at the point where several short lines stuck together could cobble a through route to compete with a Norfolk Southern or a Union Pacific. Genesee & Wyoming, for example, can route a car between Columbus and Rochester on their own lines, with a short NS gap around Pittsburgh. What if they could close that gap with an area acquisition?

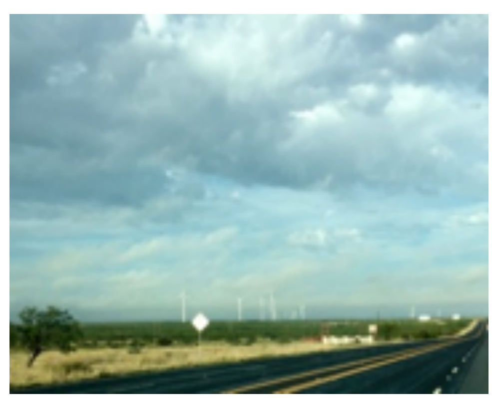
OmniTRAX can route frac sand from its own origin on the Illinois Railway in central Illinois to its Central Texas & Colorado River Railroad west of Fort Worth. Will BNSF do that as an overhead or FAK move if they neither market nor equip the move? Or what about a plastics move in leased equipment off Watco's Timber Rock Railroad in East Texas to a manufacturer on Gulf & Ohio's Lancaster & Chester in South Carolina? The possibilities boggle the mind.

Another reader who's been on both the Class I and shortline sides of the aisle says he thinks the shortlines will own the carload business going forward. However, "Shortlines can pitch, but Class 1s may not catch. The short lines must step up and take the lead. They have to be prepared to supply the cars, take the lead in pricing, and press for the schedules that will allow the business to succeed."

Maybe so, but the future of the carload franchise is presently 100% dependent on Class Is' willingness to take what's offered. Right now, they're turning away a lot; my listing of missed opportunities (WIR Nov 17) only shows a small portion of the shortline complaints I've amassed. As it is, carload lacks a competitive advantage for anything with a time value or where the Class I supplies the cars. That said, short lines that can fill a specific niche have a future.

UBS rail analyst Tom Wadewitz has published a detailed note on the railroad coal situation. In general he sees utility coal burn weakness continuing in spite of periodic weather-driven demand peaks. Tom posits, for example, "The large October divergence between electricity demand and coal burn indicates there was some share shift to other generation types."

Tom says nat gas prices are high enough (north of $3) to support continued coal burn, but then again it depends on the weather, and, like the grain business, having to peg your fortunes on something you can't control can be risky business indeed. He also mentions wind power's potential for eating into UP's utility coal business in Texas for example. I'll second that.



Wind power is very much in evidence in western Texas. On a driving tour of the Permian basin around Midland, one can see rows and rows of wind mills from the road; this scene is about 20 miles south of Midland, Texas not far from UP's ex-T&P main. From the air, it's even more dramatic, as you can see from this shot taken from an American Airlines jet during climb-out from Midland.

As utility coal languishes, says Tom, export coal tonnage through both Baltimore and Newport News/Norfolk has increased dramatically of late. He adds, "We believe Baltimore is 50-50 met/thermal, while Virginia is 85-15 met/thermal." The met coal price mark is now roughly $190/ton, down from $300 not that long ago, and "the current price should encourage continued U.S. Appalachian metallurgical coal exports through Maryland and Virginia ports."

This has to be positive for a number of eastern short lines such as Watco's Kanawha River Railroad, Corman's Pennsylvania Lines, the Reading & Northern, the Buckingham Branch, and North Shore's Lycoming Valley. Here again, there is no guarantee that it will last, being dependent on the demands of off-shore markets and the politics therein. However, Peabody Coal got a boost from Moody's last week, which upgraded its debt — including the new 270-million revolving credit facility due 2020, to Ba3 from B1, one notch up on the non-investment grade scale, and that's a positive.

According to PFL Storage, CSX' newest move to get rid of track access and storage in transit services is "causing havoc" for customers local to CSX. "This has put car owners that utilized these CSX services in the past to look for alternative means, and has created opportunities for adjacent short lines." Moreover, as cars leave storage during the October-November "shoulder months," short lines ought to have space to absorb the cars formerly stored on CSX.

PFL predicts that this winter seems to be shaping up to be a cold and snowy one. "La Nina-like conditions are developing, calling for colder temperatures and increased snowfall in the northern parts of the country and into Canada." So now's a good time to start negotiating next year's storage strategies with fleet managers. And make sure your Class I connections know you have space.

WIR takes its annual Thanksgiving break next week while I am on the road hobnobbing with my fellow wizards Nov 29-Dec 5. I will tell all Dec 8.