RAILROAD WEEK IN REVIEW

March 23, 2018

"The Chinese think strategically for the long term, and so should the United States. – Wall Street Journal editorial, March 21

As I ponder the reasons that railroad revenues seem to be increasing faster than are revenue units, I conclude that in large part it's due to the changing price of diesel fuel. Trying to recover at least part of the increasing cost of fuel through Fuel Surcharges (FSC) exaggerates the top line and does nothing for the bottom line. What follows is based on an email discussion with a number of railroad practitioners.

Buying fuel is an operating expense, just like labor, repair parts, car hire and so on down the expense side of the income statement, and pricing must reflect same. Every quarter I try to see what the OR would be without FSC.

Take CSX. The full-year reported OR change including FSC revs was a couple of points better than it was with FSC not counted as revenue. Part of the reason is FCS collected in 2017 was double the 2016 number. This in turn makes the operating income even stronger — up 15% — when combined with a real revenue increase and a drop in reported operating expense.

FSC Adjusted YTD	2017	2016	Chg
Revs	$ 11,408	$ 11,069	3.1%
FSC	$ 256	$ 153	67.3%
Ops Exp	$ 7,416	$ 7,680	-3.4%
adj Ops Inc	$ 3,736	$ 3,236	15.5%
Adj OR	65.0%	69.4%	(4.38)
Reported OR	64.8%	66.9%	(2.15)

I've heard it argued that truckers use fuel surcharges, and for that reason so should the railroads. I disagree. If something's not right, just because "everybody" does it doesn't make it right. (Moreover, I don't think the truckers' OR is under as much scrutiny as the railroads' and so has less effect on opinion and thus on Buy or Sell ratings.)

Fuel surcharges aren't part of the base rate-making process. Fuel burn is a variable cost (If you don't move a car you don't incur the cost) so affects the RVC ratio for every move. That's why I look at the OR without FSC in the numerator. Disaggregating a basic cost element and calling it a surcharge is a de facto rate increase and a dishonest means to obscure total costs in reporting metrics.

Fact is, the freight rate offered typically contains three elements. First, a base rate that is operating cost plus desired rate of return on capital employed driven by cost and economic analysis. Second, a cost inflator that is just the AAR's Rail Cost Adjustment Factor (RCAF). Third, the FSC — a weekly percentage adjustment to the base rate and determined by the the change in the price of DOE's weekly Retail On-Highway Diesel Prices. Not very clear.

Railroad pricing thus needs to have more transparency and added service component pricing. For example, logistics services (transloading, bulk transfer, hot and cold liquid storage, staging inbound autos by dealer, e.g.) reach beyond the simple movement of the rail car on a service by service basis. And there are many instances where customers are prepared to have additional fees for such logistics services. Airlines and logistics companies have made a fortune and grown their businesses by balancing transparent fee structures and customers' willingness to add extras to the base fare/service. Fuel does not qualify as an add-on.

Rail is the only transportation offer that is fully integrated – Infrastructure to operations to sales. If we can ever stabilize service, we can become a powerhouse on "resilient capacity" in a time of declining level of service on the nation's highways. Yet here we are hauling fewer revenue units than in 2006 on a smaller network and fewer Class I operators. Which is why the STB is having hearings on service failures and taking a closer look at their own Designated Service guidelines.

One observer with long experience in service deign and failure prevention writes, "If I had $100 million to invest in railway revenue growth, I would be putting it against resilience in key corridors. More than two-thirds of all service failures (trains not making trip plans) arise from unplanned train stoppages and caused by lack of resiliency." Here's the kicker, he says:

> Kazakstan has almost zero crew change offs per day with a railway the size of CP Rail; their primary loco fleet consists of GE EVOs and their cars run on Timken roller bearings. US tech with European levels of performance. It is a choice.

And I think it's time we quit worrying about recovering fuel cost to create an unnatural boost to revenue and start looking for carloads and ancillary services that can add an honest dollar to the top line, add resiliency, and create customers.

Demand for railcar storage space is slowing down as stored cars are being put back into service, according to PFL Petroleum. Mexico is a big reason. Refiners are now running tests and could see a sudden surge in car demand, assuming everything goes according to plan. More specifically, BP and Exxon are rapidly increasing their infrastructure in Mexico, with Exxon ordering new fuel trucks.

Exxon and BP are increasing retail outlets, and other mainstream players — Chevron and Glencore, e.g. — are establishing their presence in the market. I suspect KCS and UP will be the main beneficiaries among US Class Is. In LPG markets, supply deals are firming up as supply jockeying continues. Moreover, loaded LPG rail car storage is anticipated to be active over the next couple of weeks as these transactions are finalized.

PFL further advises that now's the time for fleet managers to reposition and combine fleets as needed by geography. Ergo some heavily-used storage sites could lose volumes to other more lightly-used locations closer to the action. Short lines in particular are in a great position to renegotiate their lessor-contracts for return on lease locations, and reap the rewards in terms of track access fees, car-cleaning, and other work performed at their facilities.

The Surface Transportation Board on March 16 sent letters to all eight North American Class I railroad CEOs asking for detailed comment on the service outlook for their railroads "in the near term and for the balance of 2018." Specific areas of concern are loco availability, employee resources, local service performance, customer demand, and capacity restraints.

According to Reuters, shipper response to the Board's action is welcome and timely. Complaints have been quite specific and finger-pointing. A sampling: National Grain and Feed Association President Randall Gordon says BNSF grain trains bound for the PNW are taking delays; loco and crew shortages cause service delays in the greater Houston service area. A Union Pacific train due to leave Nebraska on March 1 had to wait at least five days for a locomotive.

CSX service lapses forced oilseed plants to cut output, and Norfolk Southern had trains that were sitting idle for up to a week at a time. Adding insult to injury, Gordon also cites "dramatically higher and in some cases new" penalties and fees assessed by CSX and Norfolk Southern.

The Alliance of Automobile Manufacturers — which represents BMW, Ford, General Motors and other automakers — told the STB in a letter earlier this week that vehicle deliveries had been delayed by a "serious shortage" of rail cars in February and March.

A March 15 notice on the STB website says they will hold meetings to "gather feedback on the adequacy of the Board's current regulations regarding emergency service and service inadequacies," saying the hearings will last through June. The Board wants to know whether regulations allowing the STB to impose changes on railroads to improve service go far enough.

Says STB spokesman Dennis Watson, "The Board is interested in exploring through informal discussions whether and how the agency's current directed service regulations need to be modified to offer a more meaningful path of relief."

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