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"Asian coal prices and infrastructure issues in Australia and China help sustain the re-emerging US export coal story." – Tony Hatch

Unless I am mistaken, coal is not a big commodity among western short lines whereas in the east there are many short lines that make a significant living off the stuff. I recently finished my June 2008 *TRAINS* cover story on the short lines of Pennsylvania and without breaking a sweat I found four short lines doing thousands of carloads just in Pennsylvania.

Spreading out from Pennsylvania's Monongahela fields, one finds coal origins on the Ohio Central and even into southern Indiana where RailAmerica's Indiana Southern lists seven bituminous coal origins. So it was of no little interest that "A positive Call on Coal" in Monday's *Barron's On-Line* caught my eye.

The argument is that US bituminous coal stockpiles "continue to decline as Eastern coal is being exported out of the country." Moreover, US steam coal quality has decreased as lower-vol, higher-ash PRB coal replaces Central Appalachian (CAPP) coal in electric power stations further and further into the east. CAPP mine productivity is also off, down as much as 27% in eastern Kentucky since 2001.

That's the bad news. The good news, says *Barron's*, is that these negatives create a demand for 150-200 mm tons of "replacement coal." (Figure a million tons is 100 trains of 100 cars each with a 100-ton payload.) But wait – there's more. The writer figures there "an additional 300 gigawatts of new coal-fired generation to be built by 2012 increasing steam coal demand by another 20-25%."

To be sure, CSX and NS dominate the Central App map, however coal still accounts for about 12% of short line carloads. I found in my Pennsylvania story there was room for a hefty combination of single-car and unit train business. If we're talking 100 mm new tons that's 10,000 new 100-car trains. They have to start somewhere and it might as well be on the Fallen Flag & Eastern.

Tony Hatch, a good friend, fellow pundit and sometime fellow traveler, has been making the rounds lately observing the passing scene. His latest note offers up some helpful insights on the four quarters just past and the implications for the future. Though he writes mainly for the investment and Class I community, there are always nuggets for the astute student of the carload side of the house.

He begins by recounting the upbeat Q4 and FY 2007 reports with earnings beating estimates handsomely. What's changed is that "rails have pricing power and their role in the supply chain has significantly changed." [System RPU was up 5% against a 1% volume drop with intermodal taking a hit but bulk carloads –coal, agriculture, chems, some metals – did not fare badly. Merch RPUs were up double digits on four of the Big Six. – rhb]

Tony again: "The future is actually looking brighter. Even if we can't forecast a hockey stick for the second half, it is clear that some kind of trough in freight volume will be reached relatively soon. The rails are surviving this test quite well, thank you, and the rail industry will emerge from the [present] challenges in a stronger position than they have been in modern history. We will see this in a consistent pattern of improving returns, and ultimately, multiples. [Something Oscar Munoz mentioned in his CSX short line talk – see WIR 2/22.]

“World events intrude on rails in bulks as the commodity boom roils both the world markets and governments. Asian coal prices and infrastructure issues in Australia and China help sustain the re-emerging US export coal story. As oil creeps back up toward $100/bbl, Canadian oil sands investment continues to boom. In short, the short term, a-cyclical bulks like coal and grain, the staples of old railroading, will continue to bolster rail volumes and results while international intermodal, forest products and autos languish.”

Tony concludes with a nod to the relationship between capex and transportation demand. “In the recession that started this century, railway capex was forced down for several years – after several years of sharp increases. Those rails that too closely matched the poor short-term outlook with their capex budget (combined, perhaps, with historic under-spending) found themselves in a fluidity crisis when that volume wave struck in 2003.

“While the more affected systems appear to have caught up after massive expenditures of capital and systems work, they surely left billions on the table in cash flow when they turned business away. That lesson has certainly been learned by today’s new rail managements, if not by all of their stakeholders, and they have put their money where their beliefs are.” Thanks, Tony.

Morgan Stanley’s Truckload Index report tells us there is still excess truckload (TL) capacity out there. Lead analyst Bill Greene writes, “Efforts to reduce TL supply showed signs of progress in 4Q07, but improvement in the supply side of our index has now stalled. We hear that more carriers lack the discipline to park or remove trucks from the fleet and instead are focusing on incremental revenue. As a result, TL demand is reaccelerating after passing the seasonal trough and remains surprisingly robust.

“Although demand is now above 2006 levels, we realize this is mostly timing-related due to a large retail inventory correction in 1Q06. More important is the lack of improvement in supply trends. Supply remains abundant and without further efforts to shrink fleet size, the TL industry will struggle to recover. If carriers don't reduce supply on their own accord, we may need to wait for external forces, such as a strong rebound in freight demand or additional carrier bankruptcies, to force the TL market back into balance.”

The TL players include names like Swift, Schneider, Werner, Heartland and JB Hunt. They run mainly dock-to-dock on irregular schedules, are high turnover (replacing all drivers at least once a year) and spend more than 40% of revenues on comp and benefits. Typical loads are in the 20,000 lb range and they have concentrated customer bases of 10-30 big names. By way of comparison, national LTL carriers pay out 65% of revenues in comp and benefits and ORs are in the high 90s.

Greene again: “TL carriers face a dilemma much like the rails did before they went to scheduled operations.” Long dwell times and customer car retention meant you needed more cars to do the same work. My suspicion is that highway congestion and hours-of-service restrictions may be putting truckers in the position of needing more vehicles and drivers to do the same work. The rails speed up, creating better value even as the trucks slow down diminishing their value. How about some short line feedback on what their customers are saying about truck vs. rail?

Meanwhile, over at Bear Stearns Ed Wolfe sees an increase in truckload carrier bankruptcies. “Throughout 2007 and thus far in 2008 trucker bankruptcies have trended upwards reaching a level [where we may begin to see significant] capacity exiting the industry. This should, in another quarter or two, lead to tighter trucking capacity and eventually higher rates.

"Currently we believe that freight and fuel are each worse than they were in the 2001-02 period; however both the used truck market and the insurance markets remain better than they were in that same period. We expect that in the weaker winter months and as well as 2Q:08 trucker bankruptcies should increase as truckers face cash registration and licensing fees totaling about $2,000 to $3,000 per truck into a continuing difficult and likely seasonally slower freight period."

I'm not as concerned about the LTL carriers as they don't really bite into the classic "boxcar" (single-carload, non-unit train) business that is the short lines' livelihood. It's the one-cab TL guys who will "drive for fuel" more than the established name-brand carriers that are the short lines' biggest threat. The bankruptcy theme may slow the past years' trends where as soon as one small-potatoes owner-operator goes out of business two spring up Hydra-like in his absence.

As we saw at the recent CSX short line meeting, this is a very good time to be in the short line railroad business. Yes, we have to deal with what ASLRRA President Rich Timmons calls "New Realities" of a more restrictive and potentially limiting legislative and regulatory environment. But after talking with a significant number of short line owners, operators and marketing reps I come away with the sense that too often the focus is first "what can I get out of the government?"

Those who think this way ought to look again at the CSX Core Values spelled out in the lower right hand corner of the program that was in their Welcome Packet. "It starts with the customer" is Core Value Number One for good reason. We are a service business and without shippers and Class Is we'd have no business at all.

Rail Freight Assistance Program grants, RRIF loans and Public Private Partnerships cannot take the place of aggressively selling your services and getting the Right Results the Right Way (CSX Core Value Number Five). Timmons closes his "New Realities" presentation with six bullet points that are essential to succeeding in what can be at a times a very trying environment. The real message is that Knowing the Customer comes first and if you get this part right the regulatory and legislative shifts become just so much noise. The New Realities are -- in reality – more about running a smarter railroad in tune with today's Class I dynamics than about the old single-load boxcar model of yore.

Here's one example of how it begins with the customer. Chop Hardenbergh's excellent regional letter, *Atlantic Northeast Rails & Ports*, carries a note in its Feb 26 *Bulletin* about how Bay Colony Railroad increased revenue units six-fold to the 8000 mark in its more than two decades of local service. Bernie Reagan, SVP Marketing for the railroad, writes, "Shortly before Bay Colony start-up in June 1982, Conrail added a surcharge of $500/car on all light-density lines on their system. This had the desired effect of greatly lowering [operating] losses on [its] light-density lines.

"Bay Colony took over the lines from Conrail in June 1982 and quickly realized that traffic levels were only about half what they had expected – about 1200 carloads in that first year. I was hired to deal with the problem and began work in October 1982. Bay Colony never has imposed a surcharge for anything and traffic has grown steadily from 1200 cars in 1983 to 8000 cars in 2007. The only remaining original customers are Gallo and Ventura; such turnover is common in business and is the reason why it is important to have an active marketing program." Thanks Chop; thanks, Bernie.

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