THE RAILROAD WEEK IN REVIEW
JULY 4, 2008

"New corridors – Heartland, Crescent, Pan Am Southern, Empire Link – add capacity without mergers."—Wick Moorman, Norfolk Southern CEO

Norfolk Southern held its Seventh Annual Short Line Meeting in Roanoke last weekend and it was all about building the business. I heard less about "protecting the franchise" and more about how to leverage the short line-NS relationships to new levels of competitive advantage for the customer and profitability for the railroads. Nearly 200 individuals representing 90 short lines and holding companies plus a smattering of vendors and consultants were in attendance. Considering that two nights in the Hotel Roanoke plus parking and internet fees comes to about $300, and that many short lines had several representatives in attendance, we can't be doing all that bad.

The highlight for me was the awards dinner Monday night. It was the culmination of the challenge laid out by NS Short Line AVP Rob Robinson at least year's session: put down on this easel the number of new-business carloads you can commit to bringing on line by the end of June, 2008. He called it the 250-squared Challenge – getting each of NS' 250+ short lines to bring in at least 250 carloads. That works out to some 62,500 new loads worth some $75 mm in new revenues to NS at the 2007 average RPU of about $1200.

Awards were given by commodity group and new business levels: 500 to 1,000 new loads and more than 1,000 loads. The list of award-winning short lines was long, which tells me that the number of short lines that can design services to match customer supply chain needs is indeed growing. Another indicator is the number of positive comments I heard during the breaks, receptions and over meals. I did not hear a lot of carping about interchanges and rates but instead there was a lot of praise for NS reaching out to make the relationships work.

A key part of this is doing the homework before asking for a rate or proposing a move. The market manager wants to know why you're asking and what are the market parameters – the competition, the volumes, the assets required and the potential bottom line. As for service design, Customer Service VP Fred Ehlers drilled down into metrics and measures that cover not only train performance but also individual carload trip plan compliance – nothing new here but it needs to be said if only to remind folks that railroads *can* deliver Just in Time performance. As long as the supply chain manager does *his* homework.

To amplify the importance of this theme, let me quote what Tony Hatch had to say about changing supply chain practices in a recent note. "The costs of logistics, after declining since deregulation (of trucks, air and rail) in 1980 when they were 16% of GDP, to a low in 2003 of 8.6%, are steadily heading back up (10% in '07)… The *Financial Times* 6/27 interview with the head of global supply at P&G says the price of fuel compared to the cost of capacity (and capex) is changing – forcing P&G to consider shifting manufacturing sites closer to consumers to cut the transport bill."

Wick Moorman's lunchtime remarks went straight to the point: "We're seeing more of what is being called regional production, the idea that goods should be produced closer to the point of consumption in order to reduce transportation costs." Moreover, truck pricing, highway congestion, high truck fuel costs, increasingly pro-rail public policy at the state level and public-private policy that works all work in favor of rail.

Where does NS want to be in five years? Wick said the focus is on the core business of providing a rail freight service where ample capacity and high quality-of-service levels will drive an operating ratio in the 60s and the ability to add yet more capacity. In this regard, Wick notes that the rail market share in the "Austin to Boston" lane is a mere 5%, compared to 50% in the Chicago to North Jersey lane where "ample capacity and high service levels" dominate. Do I hear another challenge to the short line community? Most likely. Stay tuned.

Changing supply chains and market shifts will take their toll, however. The Montreal, Maine & Atlantic has "trimmed train service" and by the beginning of this week had furloughed 33 employees. In a press release, MMA blamed "the current economy [which] has caused a downturn in paper, lumber and other forest products shipments. The company also cited "extraordinary snow removal and spring flooding expenses." And if that wasn't enough, "Katahdin Paper plans to close its Millinocket, Maine mill (one of two operated by the company) on July 28."

Paper from the Millinocket mill and inbound raw materials account for about 12% of total business. System-wide, paper and forest products account for three out of every five revenue units handled. Take that out of the 40,000 annual revenue units and you're down to 24,000 loads, hardly enough to support the 745 route miles under MMA's control.

I sent the MMA press release to a friend who's been in this business for 40 years and who has seen it all. He writes, "This economy is going to be in turmoil for a long time. The cost of transportation is increasing so folks will find a way to reduce transportation component of their costs. The disruption is partly monetary in origin, so it will pop up everywhere. Insofar as oil prices are just catching up in real terms, that's good for rail although still a tax on the economy. But what happens when inflationary expectations start getting built into interest rates, and the Fed can't pump new money into the system fast enough to keep interest rates down? Stagflation? (Deja vu all over again.)"

My sense is that any railroad with a lot of shorter haul markets and a diverse traffic base is well positioned to survive and, if they play it right, prosper. Many potential customers are still in the learning phase of all this. So are railroad operating and marketing people as we're now beginning to see the players reach out for better asset utilization and line capacity. The Empire Link is one such example.

My correspondent continues: "In an age of uncertainty, you want to have a lot of diversity both in commodities carried and in geography. MMA has neither. The freight business in Maine is in decline and MMA needs to maximize the overall value of the franchise and the job won't be done until the railroad is handling everything that covers its direct and shared cost of capital -- however we agree to measure that."

In attempt to head in that direction, MMA "has launched an international initiative to increase shipments via Searsport, Maine. The Mack Point Terminal is one-to-three days shorter sailing time between Europe and large East Coast ports, is less congested and [has] larger clearances for oversized shipments." That's got to be a long-shot, though. Higher fuel costs are pushing the ocean carriers to running slower and substituting water movement for land movement wherever they can. Just to the north of Searsport, Halifax is losing share as ships just sail on past to major hubs and avoid the expensive inland rail move.

Thus, the intermodal planners will have to adapt to shorter hauls. There are those (yours truly among them) who would say the railroads must re-evaluate strategies adopted in the 1980s--big hub centers, long drays, equipment that maximizes on-rail efficiency at the expense of flexibility, light weight, and so on. Maybe it's time to bring back the sort of trains that Conrail ran to support intermediate markets. There was a pair of Chicago-North Bergen trains that hit the smaller terminals at Selkirk, Dewitt, Rochester, and Buffalo. The service wasn't fast or sexy, but it was dependable and a survivor over many years. Operating Departments have bought reliability by minimizing the number of stops and connections. Now they may be challenged to reconsider.

RW Baird's Jon Langenfeld took a new look at the trucking industry and found that trucking demand is stable, albeit at lower yoy levels, and that pricing is firming. "Over the last two months, truckload capacity has clearly tightened driven by capacity exodus, and truckload pricing has moving higher from trough levels. LTL pricing also stabilizing following 1Q deterioration. Intermodal demand trends positive, benefiting from conversion of truck freight due to lower price point and greater fuel efficiency."

However, Langenfeld does not see significant freight recovery in the near term. "Given the continued risk to the consumer and early signs of weakness in the industrial sector, we expect below-normal seasonal demand patterns in 2H08, likely delaying the freight recovery until 2H09. These trends combined with fuel are likely to pressure forward consensus estimates. As such, most our 2009 estimates are generally near the low end of consensus."

In conclusion, "We see 2Q estimate risk for truckers, though not as widespread as 1Q, given pressure from fuel, partially offset by a firming pricing environment. We expect that 2H08 and 2009 estimate revisions will generally be lower, with the most at risk being the asset-based truckers." Thanks, Jon.

Fuel Tidbit I: Trim Tabs Investment Research (www.trimtabs.com) says, "The one key truth most traders don't understand is that crude will not hit $200 per barrel this time around for one major reason: the global economy will crash and burn before that happens. The US consumes about 21 million barrels of crude per day. At $200 per barrel, just the cost of crude alone would eat up $1.5 trillion annually: which is equal to 23% of the $6.5 trillion of after tax income of all who paid individual income taxes (personal, capital gains, partnership, etc) over the past 12 months. In calendar 2007, at an average cost of $70 per barrel, our crude oil habit cost just over $500 billion, or 8% of take home pay. There is no way crude could reach 23% of take home pay, as consumers both here and everywhere else will be tapped out before that happens."

Fuel Tidbit II: We've all heard the rail efficiency mantra about moving 436 tons one mile on a gallon of diesel fuel. But has anybody done the math? Well, factcheck.com evidently has. "Our CY 2007 calculations, which match the AAR's tally exactly, show the nation's seven major railroad companies moved 1,770,545,245,000 ton-miles of freight and burned 4,062,025,082 gallons of diesel fuel (including freight trains and trains in switching yards, but excluding passenger trains). That works out to an average of 435.88 ton-miles per gallon of fuel." So there.

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