THE RAILROAD WEEK IN REVIEW
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"We believe that the greatest concentration of small captive shipments resides in the chemicals segment" – Tom Wadewitz, JPM

Tom Wadewitz of JPM has penned some thoughtful and useful lines on the recent STB announcement that DuPont had won all three of its small shipment rate case disputes with CSX. "Within the three cases, DuPont had disputed CSX's pricing for small shipment volumes which followed seven different routes. STB rejected DuPont's request for lower rates on only one of the seven routes and that was due to a clear barge alternative to shipping rail.

"While the rate reductions ranging from 5% to 40% are significant, volume on these shipments is small and the resulting revenue loss to CSX is only $1 million per case over a five year period for a total of as much as $3 million. The lost revenue is essentially very small relative to the size of CSX but the near sweep by DuPont is likely to drive more cases."

Tom thinks the direct railroad impact is "insignificant" though it may cause some changes in how they price small shipments from captive shippers. For short lines with only one Class I connection the effect could be quite real. Wadewitz again: "We believe that the greatest concentration of small captive shipments resides in the chemicals segment while there is more limited exposure in forest products (much of this traffic is exempt), and metals. Due to greater exposure to the chemicals segment, we believe risk from small shipment cases is greater for CSX and UP."

Happily, CSX uses a junction settlement method for paying its short lines and short lines will share as base rates go up. On UP and others using a handling line allowance for their non-ISS short lines, short lines will see no immediate benefit. And where there are fuel surcharges, how much the short line sees remains a big question for all the Class Is -- except possibly CSX, thanks again to their junction settlement process.

Wadewitz adds, "Captive, small shipments are probably in the range of 8%-16% of total shipments for the major US railroads." Yet "small shipments" can comprise a significant share of a short line's total revenue stream, so once again the shortline effect may be orders of magnitude greater than what the Class Is see. Attention must be paid.

Over at Morgan Stanley, rail analyst Bill Greene writes, "New guidelines should result in more filed cases, but we don't expect a stampede. With relief capped at $1 mm over 5 years, and an average litigation cost of $250k (probably over $500k after consultants and other fees), most shippers can't justify the investment."

Greene adds, "We expect to see a number of appeals to this decision, including attempts to change the methodology. The use of book value to measure returns in the smallest rate cases underscores the importance of the AAR's replacement cost proposal. The STB is aware capacity is a concern, and we'd expect to see a stronger push for a replacement cost framework."

On the other hand, "Given the higher costs and legal liabilities associated with these [hazmat and other nasty stuff] shipments, railroads were likely attempting to recover some of the inherent risk of hauling such shipments. Hazmat transportation, in particular, has been a key area of debate given that railroads cannot possibly charge enough to cover the large legal liability that comes with these

shipments. However, railroads are still bound to carry hazmat due to their common carrier obligation."

So if you have to haul the stuff anyway and can't charge enough to cover the cost of an incident, there's not much incentive left to be in the hazmat-hauling business. Short line buyers (and there are still more than a few out there) are going to look very closely at the commodity OD pairs and if there's significant hazmat exposure the offers may not enjoy the high ebitda multiples of late.

From the sidelines, seekingalpha.com's "Dr Duru" says, "You cannot get much clearer than that. [The STB] has positioned itself squarely on the side of the consumers of rail transportation and has positioned itself as an inflation fighter. This case is particularly interesting because years of de-regulation and industry consolidation have provided railroad companies with enormous pricing power that they have lacked for decades. For example, ABC News quotes the American Chemistry Council as claiming, "two-thirds of U.S. chemical plants that rely on railroads are served by one carrier." QED re captive shippers.

Gurufocus.com is the kind of investment website that is loaded with the things every railroad manager ought to watch very closely. The argument is that one can sharpen one's own business management by watching what the leading money managers are buying, why they are buying, and how well their portfolios are holding up.

Take Warren Buffet's BNSF investment, for example. He is one of five "Guru Holders" that own the stock. Other Guru holdings are Union Pacific (7 Gurus), Norfolk Southern (6), CSX (3), Canadian Pacific (2) and KCS (1). Canadian National was not shown. We also learn from the chart accompanying the story that only BNSF had more Guru buys than sells for the past 12 months and that CSX had four sells to one buy, the poorest performer in this area.

Want to know what Gurus are doing what with BNSF? Put BNI in the stock lookup window and read that Warren Buffett, Tweedy Browne, Ron Muhlenkamp and Steve Mandel are still buying while George Soros has cashed out. Run the same screen for CSX and see that the four sellers included George Soros (out in Sep 2007), who came back as that one buy in March 2008 with 12,000 shares at $48. Interestingly, Carl Icahn sold his 2.7 mm shares in the same period for the same price.

Gurufocus.com tells us Soros views the financial markets as "chaotic" and "the prices of stocks, bonds and currencies depend on the human beings who buy and sell them, and those traders often act out of highly emotional reactions rather than coolly logical calculations." So he's out of BNSF and into CSX. He's also into JOYG and BUCY, which tells us he's playing mining and materials.

Carl Icahn, says gurufocus.com, "buys beaten-down assets that nobody else wants...companies that are not glamorous and usually out of favor. It is even better if the whole industry is out of favor." That certainly is a contrarian view and at odds with Soros' "chaos" sentiment. And neither of these guys' views of the financial markets is going to be much help to the short line owner or the Class I market manager, except insofar as understanding what makes these guys tick. (See also ARII.)

The Buffett view is somewhat saner, to my way of thinking. "Buffett seeks to acquire great companies trading at a discount to their intrinsic value, and to hold them for a long time. He will only invest in businesses that he understands, and always insists on a margin of safety. Buffett wants businesses (a) that he can understand; (b) with favorable long-term prospects; (c) operated by honest and competent people; and (d) available at a very attractive price."

That he's adding to his BNSF holdings supports my thesis that this railroad is probably the best run

of the lot. I say that because everywhere I go on the property I can see Matt Rose's personal vision being carried out. I see fewer of the disconnects between what's said in the analysts meetings and what's being done in the field than I see popping up on other roads. And if the financial results meet the Buffett criteria then there's a model worth emulating.

Which is exactly what the best short lines do very well. At the NS short line meeting one short line president told me how they're running 18,000-ton trains with state-of-the-art train performance monitoring systems. Last week I visited a short line yard that is expanding its transload operations into everything from consumer goods to utility poles to petroleum pipe. One of the things that always struck me about the Santa Fe was that everything had a coat of paint and was clean. Ditto today's BNSF and two short line engine terminals I visited recently.

Concluding the investment theme, gurufocus.com profiles Bruce Berkowitz, a Buffet fan and fund operator generating double-digit returns that are significant multiples of the raw S&P. He values free cash flow (the cash that comes in less what you spend to keep it coming in) as it measures what's in the enterprise owner's hands at the end of the day. As an investor in short lines, I want to see positive free cash flow and if that means taking full advantage of grants and tax credits for capex, so much the better. It's about the only place I will relent from my Rule of 100. Track expense is about a quarter of the ops expense, so fully-funded track rehab and repair makes it a Rule of 75. I like that.

Good News, Bad News for Short Lines Dept. Pan Am Railways and Norfolk Southern have struck an arrangement with the state of NY to pony up $40 mm for a new logistics park in Saratoga County. Billed as "an intermodal and automotive logistics center," the facility will be constructed at the former rail yard located within the towns of Halfmoon, Mechanicville, and Stillwater. This new rail terminal will anchor the western end of Pan Am Southern's Patriot Corridor. Construction is expected to begin in the first quarter 2009 and be complete by April 2010.

New York State will contribute $3 mm, which is part of the good news because it shows New York's continuing support of rail operations. The bad news is that the site is also described in the press release as "the premier distribution point for consumer products and finished automobiles for upstate New York and western New England." According to PAR President David Fink, "This new terminal will add much-needed freight capacity to the Capitol Region, and is critical to the success of our Pan Am Southern joint venture."

I should hope so. CSX has done well growing its perishables business into the Albany area with the Railex and Express Lane services offered in conjunction with the UP. This new park will give the Pan Am Southern joint venture a competing service into the Albany ADI as well as a more competitive Boston service.

My concern is with the shortline side. There may be carload OD pairs with short lines on one end or the other that could wind up a Mechanicville transload instead of rail direct. I can also see this as a threat to the carload network CSX has in the Boston ADI where it takes several serving yards and as many days to go between the main line and the branch line customer location. But asset utilization is key; if cars can turn faster via a transload and at lower total cost to the customer, then so be it.

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