THE RAILROAD WEEK IN REVIEW
FEBRUARY 13, 2009

"The state cannot be very great of which the sovereign has leisure to carry on the trade of a wine merchant or apothecary" – Adam Smith, Wealth of Nations

Three useful tidbits from the *Railway Age* Newswire. *AAR Senior Vice President John Gray* says railroads "are planning to maintain a strong level of reinvestment in 2009, as they have for the last several years. Actual investment levels will depend to some extent on how deep the recession goes and how long it lasts, but railroaders know that the have to invest today to have the rail capacity America needs tomorrow."

Recall it was only a few years ago that Wall Street chided roads like NS and BNSF for continuing their investments in capital and personnel while traffic was in a lull. Then-CEO of Norfolk Southern David Goode said in effect it ain't always going to be like this and we want to be ready when our customers are. I was at a BNSF short line meeting in Fort Worth and I remember hearing then-CEO Rob Krebs saying given BNSF's strong free cash flow he was going to invest for the best returns, and the railroad was it.

At the time John Gray was at the UP and had the short line group under his wing. A few weeks after the BNSF meeting I met up with John, a few other UP folk and some short line guys in Denver for a buffalo burger before taking the UP business train back to Omaha in the morning. Over our burgers we talked about capex and capacity expansion. From the theater car we could see where UP was making significant infrastructure improvements against the eventual and inevitable traffic upturn. How nice to say that kind of thinking has perpetuated itself among the Big Six Class Is.

Economic Planning Associates sees 2009 and 2010 as "difficult" years for the freight railcar industry, based on the economic and financial environments as well as EPA's analyses of customer market activities. "It now appears that carbuilders will survive primarily on backlogs this year," EPA said. "The year 2010 will also be weak in terms of assemblies, but improvements in new orders throughout the year will lead to a pickup in future railcar deliveries."

Maybe so. But recall both UP and NS spelled out specific numbers (in the tens of thousands) of railcars stored as part of their fourth quarter earnings presentations. *TRAINS* magazine for March has a news item on trends in Class I railroad locomotive retirement programs, largely driven by the shifts in train size and type. Here again, if you can handle tomorrow's grain, coal and intermodal trains with the power and fleet at hand, why buy new?

Dahlman Rose & Co. Director Equity Research Jason Seidl sees "a glimmer of hope in an otherwise weak rail environment" as some traffic sectors are beginning to show signs of recovery. Seidl noted that Class I overall volumes "continue to remain extremely depressed on severe demand destruction and extended production curtailments, both mine and plants." However, service metrics have been strong. "Overall performance was solid as train speed, cars on line, and dwell time improved 11.0%, 2.3% and 2.8%, respectively' over the past two weeks."

But that's only part of the story. As Peter Drucker reminded us years ago, the purpose of any enterprise is to create customers. Railroads create customers by saving shippers money on the door-to-door transportation of their inventory. They care little about average train speeds, cars on line or yard dwells, being much more concerned with dock-to-dock transit time.

In his pithy paperback, *Mobility*, Dr. Joe Giglio of the Hudson Institute and Northeastern University puts it thus: “Customers will increasingly focus on the complete *door-to-door* trip [italics his]. As far as they are concerned, the individual modes being used will be less important than the total time consumed making the trip.” The more time inventory in rail cars spends in yards between trains or at terminals between modes the less competitive the rail-based service. Better service metrics can help.

Four weeks into the New Year traffic levels are still lagging last year’s levels, though the rate of decline may be easing or, as analyst Ed Wolfe is fond of saying, “less worse.” Specifically, as regards the “industrial” commodities that are the short lines’ livelihood, he writes, “While all eight segments remained negative, all but coal were less worse than recent 6-week averages. Paper/lumber (-18%) volumes showed the most relative improvement while metals (-34%), chemicals (-15%) and minerals/stone (-22%) volumes were less worse.”

Continuing the thread Chris Ceraso at Credit Suisse asks, “Does This Saw-Tooth Go North? Week Four volume declines took another leg down after showing some positive momentum last week. Total volumes for week 4 declined 15.5% year-over-year. This brings the QTD industry-wide carload declines to 15.4%. While the week 4 data show a retracement of sorts, we didn’t drop back to a 20% decline; [a graph of weekly year-over-year declines indicates] we may be establishing a bit of a saw-tooth recovery pattern that may see further improvement in coming weeks (of course, that may just be wishful thinking). Taking mix into account, our volume/mix score shows that CP is the best performer and UNP is the worst so far in 1Q08.”

Recall that among railroad analysts Ceraso is the only one that attempts to measure service delivery and therefore customer value in his reports. His proprietary “composite score” analyzes weekly volume and service performance metrics (AAR cars-on-line, average train speed, terminal dwell) to arrive at a number for each Class I that “provides a unique way to think about the current trends and what they could imply (on both a revenue and cost basis) for each railroad at a given point in the quarter.” If you’re interested in seeing how it works, drop me a note requesting Ceraso’s Jan 30, 2009 letter.

Short lines have suffered along with everybody else, however it’s “more worse,” to borrow Wolfe’s phrase, for them. It is safe to say that most of the 300+ short lines that make up RMI’s weekly RailConnect Index of Shortline Traffic rely on a steady stream of the most economically sensitive commodities from aggregates to wood products. Through Week Four year-to-date revenue units ex-intermodal but including coal[1] were down 20% as every week has been down by that much or more even after Week One’s meager six percent drop.

Moreover, a very large percentage of short lines depend entirely on handling line or switch fees that do not change when the Class I rate for that commodity-OD pair changes, CSX short lines being the exception. So when volume goes down revenue goes down. Worse, short lines are largely fixed cost operations so when volume goes down operating expense remains about the same and the OR heads north. And it’s another reason why I say that stand-alone short lines with fewer than one hundred revenue units per mile per year will not survive over the next five years unless they are absorbed by a

[1] Not all short lines report intermodal the same way. Some count containers, some count platforms. Also the number is skewed by some very big players – Anacostia’s Pacific Harbor Lines for example -- that are virtually 100% intermodal and hardly your typical Class I feeder line. Thus I exclude intermodal to get a gauge of how the merch-driven short lines are faring.

shortline operating company with the volume and revenue depth to take on most of the fixed cost.

We've often touched on short lines' value as alternate routes for Class Is. With the growth of domestic intermodal traffic the Class Is will need two routes between major city pairs – a 60-mph intermodal route and a 40-mph carload route. In the west, BNSF uses the services of the Montana Rail Link's ex-Northern Pacific route as a carload alternative to the higher speed ex-GN road it owns directly. In the east NS has the same thing with the ex-Southern and N&W alternative to the Crescent Corridor. The latter you will recall is ex-Southern Birmingham-Atlanta-Lynchburg-Manassas-Front Royal route. The former is Birmingham-Chattanooga-Knoxville-Roanoke-Front Royal.

Now comes the new "MidAmerica Corridor," a trackage rights agreement between CN and Norfolk Southern and incorporating the West Tennessee Railroad, a short line between Fulton, KY and Corinth, MS. According to the joint NS-CN press release, "the corridor is designed to establish shorter, faster routes for *merchandise* (emphasis added) and coal traffic moving between the Midwest and Southeast." See map at http://www.nscorp.com/nscorphtml/pdf/CN_NS.pdf. The agreement takes CN freight between Chicago and St Louis off the Amtrak (ex-Alton) route via Springfield and puts it on the NS (ex-Wabash) track via Decatur. NS freight between Chicago and its southeastern gateway at Birmingham will use the CN's ex-IC line north of Fulton, KY; St Louis-Fulton traffic will go via Centralia and DuQoin. Both lanes use the WTNN Fulton-Corinth and NS beyond to Birmingham.

The WTNN is an excellent example of a short line that a Class I spun off and later saw value in the property. As you know, CN has recognized this value in some cases by taking the line back from the short line (Chemins de fer du Quebec, e.g.). Here, NS had *leased* the line segment to the WTNN in 2001, which shows some foresight in keeping the alternate route open to NS, not repeating the mistake BN made selling the MRL. By retaining ownership NS can fund the infrastructure upgrades necessary for the increased traffic, leaving the short line's 14,000 car-per-year franchise in place.

Signs of the times. A New York bond salesman writes, "My street vendor coffee guy has officially left the corner of 51st and 6th Ave. My Metro North train to Grand Central has one less car on the train in 2009. I thought about going to the Super Bowl last minute last Thursday because I was offered 40 yard line seats in the lower section at just above cost and Delta had plenty of direct flights from NYC to Tampa for only $425 leaving Friday, coming back whenever I wanted on Monday. Taxis are fighting to pick folks up in NYC. My daughter's playgroup now has two new dads as well as moms. My friend went to the FBR Open this weekend in Arizona and FBR didn't even have a hospitality tent as they tried unsuccessfully to get out of the sponsorship."

And in that context, try this futuristic description of New York City from the opening pages of a 1957 novel: "When he came to Fifth Avenue, he kept his eyes on the windows of the stores he passed. There was nothing he needed or wished to buy; but he liked to see the display of goods, any goods, objects made by men, to be used by men. He enjoyed the sight of a prosperous street; where not more than every fourth one of the stores was out of business, its windows dark and empty." The thread grows darker as the book progresses.

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