THE RAILROAD WEEK IN REVIEW,
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"The factors that drove our growth over the past five years are still there." -- Wick Moorman, CEO, Norfolk Southern, at the Annual Shareholders Meeting

According to Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co., "Much of the already-passed stimulus is still working its way through the economy. In fact, we could be in a bit of a sweet spot in terms of government action. We are just beginning to see the positive effects of the massive liquidity injections while not yet having to deal with potential consequences such as higher inflation, higher taxes and paying off the resulting increase in federal debt."

However, she warns that more government involvement with the inner workings of businesses could be troublesome. The Fed may have helped prevent a financial catastrophe last fall; will they know where to stop? "We've already seen tepid response from private business to most of the government plans — the TALF (Term Asset-Backed Securities Loan Facility), in particular. Recently, some progress has been made, but business leaders grow more concerned about the 'rules' of business changing at a later date."

In fact, the Treasurer of Indiana, seeing the state coming up short on their Chrysler paper, told the *Wall Street Journal* this week no funds under his control will ever again invest in the secured debt of "General Motors, other manufacturing companies, or those insurance companies who have or will be receiving bailout funds. The risk is too great for any prudent investor to accept." How true. I myself recently sold the paper I owned on some banks taking TARP money.

Sonders again: "New government proposals seem to be going in a direction that could short-circuit an economic recovery. New regulations for credit card companies run against efforts to stabilize lending and the financial system. Raising taxes on offshore profits of U.S.-based companies [could also be de-stabilizing]. In fact, while we believe that we may be experiencing the end of the current recession, the reprieve could be short-lived as the possibility of a 'double dip' remains."

More to the short line railroad point, elsewhere Schwab's Michelle Gibley, Senior Market Analyst, writes, "Banks continue to face a difficult economic environment. Credit card, commercial real estate and commercial/industrial portfolios continue to deteriorate and large measures of write-downs are yet to come. Keep in mind that securities are marked-to-market, while loans are held at their original cost using amortization rules, minus a reserve for losses."

The implications for more bank loans to shaky short lines are not good. Perhaps that's one reason there appears to be an upswing in the number of RRIF loan applications. Surprisingly, the majority of loan applications are not for tracks but for bridges, shops and rolling stock. As to this last, my sense is that there is a tightening of leased-equipment availability, if only because tax-advantaged leases are less attractive when corporate America is not making any taxable profits. Add to that the fact that CIT, GE Credit and others have been shut out of the long-term debt markets for a while and leasing is not a great source of money right now.

RRIF loans for a short line short of equipment ought to be attractive because they provide government money at Treasury rates for a term equal to the first life of the equipment. Moreover, there are rumors making the rounds the stimulus money coming in through some sections of the Recovery Act will be subject to 80/20 matching and that some are looking at RRIF as the 20% match

– who the “some” are is unknown yet, but assuming they are governmental entities.

Meanwhile, word comes that the FRA is running a series of workshops in or near proposed high-speed passenger rail hubs from 20 May to 2 June. These sessions are for direct stakeholders in the process such as state and municipal transport planners, while pointedly excluding lobbyists per the American Recovery and Reinvestment Act (ARRA) proscriptions. Meetings are designed to assist FRA with formulating the rules and tools for submitting proposals for funding high-speed rail projects under the ARRA and the Passenger Rail Investment Acts. The targeted attendance is geared to produce substantive participation and exchange according to the mandates of ARRA.

As a follow up, the FRA plans to hold informational sessions for industry, labor, intergovernmental and other interested parties. Not a bad idea. And while nobody expects a lot of ARRA money to show up on short lines, it’s a given that the rate of railroad traffic growth will accelerate in passenger and domestic intermodal while carload decreases and coal remains about where it is. It’s been remarked that seventy percent of passenger train-miles are run on Class I freight rails, so they will be direct beneficiaries of ARRA spending on passenger corridor improvements. Short lines will be the indirect beneficiaries because such carload business as remains will get a faster ride, adding competitive advantage to the product.

Larry Kaufman writes in JOC that those trying to force rail rates back to greater federal regulation might just be hurting their own cause. He argues, correctly, that rate levels don’t create transportation activity. “Freight transportation is a derived demand business, and lowering rates would not cause one additional car to be shipped if customers have little or no demand for their products. Lowering rates would only serve to reduce rail revenue, leading to lower operating income and less ability to raise capital for needed capacity expansion when economic growth resumes.”

History is on the side of this argument, and it goes back a hundred years to the original ICC legislation. The 5th Edition of *The Railroad - What It Is, What It does,* puts it this way: “Freight rates don’t really change the quantity of goods anybody ships. A reduction in NS freight rates between Harrisburg and Atlanta won’t cause a manufacturer to increase volumes in that lane. Lower railroad rates may cause a shipper to pick NS over Arkansas Best, but the railroad’s customers’ customers are the real determinants as to what volumes move in what lanes.” (Page 290; full disclosure: I wrote most of the Marketing chapter for this Simmons-Boardman re-write).

[As an aside, in a subsequent note Kaufman brings to my attention an example of rates encouraging new O-D pairs: “When a carrier offers shipper market extensions a significantly lower rate might allow a shipper to enter new, more distant markets, and thereby ship more than he/she/it might normally dispatch. I’ve never heard of the opposite - a higher rate causing a shipper to pull back the area of its distribution.”]

Moreover, our experience with high truck fuel prices suggests many shippers shifted to intermodal and, once they saw how well it worked, did not shift back to truck when oil prices dropped. What this tells us is supply chain managers do not shift vendors solely on price -- it’s more a function of how much value the transportation vendor can add to the supply chain process through reduced inventory carrying costs and so on. And so it was that the market value of the commodity was one of the earliest factors the ICC considered in determining “just and reasonable” rates.

Norfolk Southern CEO Wick Moorman reiterated the theme of using the present economic slowdown to build for the future in his remarks at the recent Shareholders Meeting. Excerpts: “April volumes were down more than 25 percent, driven by a further softening in our coal business. Compare that to the last recession we had in 1981-82, when volumes were down ten percent year over year... One positive note in all of this is that our domestic intermodal has held up reasonably well. It was up two percent year over year for the first quarter, evidence that we still see people wanting to convert to intermodal from the highway, which is very promising for the long term.

“When the economy rebounds, and it will, we will be ready to capture the maximum possible benefits. An example is our capital-spending program for this year. We have identified about $125 million in reductions for the year and are planning on making these reductions barring a rapid economic turnaround. However, our revised forecast is still the third highest in our history and will set the stage for future growth as well as keep our property in good operating condition.

“We think it’s more important to manage for the future, because the decisions we make today are the decisions that will be important five years from now. Rail’s future and our potential to help solve our nation’s transportation crisis are as promising today as they have ever been. The factors that drove our growth over the past five years – higher fuel efficiency in a world with rising energy costs along with ever-increasing highway congestion – are still there, along with our superior performance in terms of emissions and sustainability.”

In other words, NS is moving smartly away from the old “that’s the way we’ve always done it” mindset to one of “this is what we must do today to be in business tomorrow.” The network NS took over from Conrail ten years ago was mainly a carload business with some intermodal, however in the period since then NS has transmogrified into a strong domestic intermodal network that has sped up the carload business in the bargain. What’s different now, as opposed to other recessions, is the rails have the tools and attitudes to respond without having to go up the learning curves of those new tools. Says Jim McClellan, former SVP Strategic Planning at NS, “It is a more proactive world out there today with smarter, more aggressive leaders.”

We’re beginning to see commentary on rail traffic patterns YTD halfway though the second quarter. From the north, with a focus on CN and CP, Scotia Capital’s Cherilyn Radbourne observes, “With five weeks of reported traffic data, Q2/09 volumes are tracking well below our expectations, and we see few reasons to expect any meaningful improvement in the near term.

“CN's carload volumes are down 22% YOY to date in Q2/09, which represents a deterioration from Q1/09, when volumes where down 18% YOY. Similarly CP's carload volumes are down 21% YOY to-date in Q2/09 on an as-reported basis, or down 28% YOY pro forma the acquisition of the DM&E, and that too represents a deterioration relative to Q1/09, when volumes were down 17% YOY pro forma.

“From a mix perspective, Q1/09 traffic patterns have persisted in Q2/09, whereby the volume declines at CN have been weighted towards short-haul traffic (positive mix shift) and CP has experienced severe reductions in heavy long-haul traffic (negative mix shift), particularly Canadian metallurgical coal and potash. Q2/09 expenses should benefit from cost reduction efforts implemented during Q1/09, such that we expect Q2/09 EPS to be little changed vs. Q1/09, with revenue and non-fuel expenses down sequentially.”

Canadian National has agreed to sell three Mississippi line segments to Grenada Railway, LLC and Natchez Railway, LLC both non-carrier affiliates of V&S Railway and A&K Railroad Materials. This deal transfers ownership of 252 miles of track and preserves rail service on the two longest of these rail lines for at least the next two years.

The longest piece is a 175-mile segment of the ex-IC main between the Tennessee-Mississippi state line and Jackson via Grenada, but only as far as a point just north of Canton MS where CN serves the

Nissan auto assembly plant. This is the line that served such name trains as the City of New Orleans and the all-Pullman Panama Limited. It is now the Grenada sub and will become the Grenada Railway, along with the 11-mile Water Valley Spur, which peels off at Grenada and goes as far as Coffeeville (it used to go all the way to Jackson, TN). The third segment is the 66-mile Natchez Branch out of Jackson, MS that will become the Natchez Railway.

A check with the V&S website reveals that the company shares leadership with A&K Railroad Materials of Salt Lake City. Francois Hebert, VP for Network Strategies at CN, told me in a telephone interview that V&S was selected on the basis of prior successful transactions where CN sought a local operator as a “last ditch effort” before abandonment.

As to why CN would spin off what appears to be half of a potential directional-running railroad, Hebert says there is more than enough capacity on the more heavily-used ex-Yazoo segment between Memphis and Jackson and they could add more trains on it without breaking a sweat. There was simply not enough volume to support the Granada Sub infrastructure and the Yazoo main, said Hebert, “The management team we selected gave us seven years more revenue thanks to a successful new business drive in Manitoba. We’re looking forward to a repeat performance in Mississippi.”

Arnold McKinnon, Norfolk Southern's second chairman died May 18 at the age of 81. As chief executive officer from 1987 to 1992, was among the first to envision the railroad as an integral link in the global logistics chain. Under his guidance, NS increased productivity and controlled costs, launched the Thoroughbred quality improvement process, and began the development of managers who today are the railroad’s leaders. He accepted the modern Norfolk Southern’s first Harriman Gold Medal Award for employee safety, marking the beginning of a commitment to safety that has seen NS employees earn an unequaled 19 consecutive Harriman awards as the safest workers in the rail industry.

After his retirement as CEO, McKinnon continued service on the NS Board of Directors until 2000, helping guide the company through the early stages of the Conrail transaction that increased the railroad’s size by half and positioned it for long-term growth. In 2007, NS named its headquarters building in Norfolk in his honor.

He joined NS predecessor Southern Railway in 1951 as a law assistant. Among other positions, he was named vice president law in 1971 and executive vice president law and finance in 1981. When Southern consolidated with Norfolk and Western Railway to form Norfolk Southern Corp. in 1982, McKinnon was named executive vice president marketing. He refined the concept of “the railroad as a service organization,” a critical distinction since partial deregulation of the industry had just gone into effect. In 1987, McKinnon was named chairman, president, and chief executive officer. For three years in a row, from 1990 through 1992, *Financial World* magazine named him one of the best chief executives in U.S. industry.

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