

# THE RAILROAD WEEK IN REVIEW

## JULY 17, 2009

*“The selection by President Obama of Dan Elliott and Joe Szabo to head major transportation regulatory agencies is tribute to the political influence of the UTU, which flows from the UTU PAC.” UTU International President Mike Futhey in a July 8, 2009 statement.*

**I’m reminded of a line** in the movie “Shakespeare in Love” where Lord Wessex (Colin Firth) tells Viola DeLessups (Gwyneth Paltrow) that she is to be his bride. He says her father has agreed to give him a large sum for doing so: “He has bought me for you. You may show your pleasure.” For its part, the UTU statement says in effect to the President, “We have bought the Presidency for you. You may show your pleasure.” Thus hath the President done in his appointments of Szabo and Elliott.

Here’s the UTU statement in full: “President Obama’s nomination Monday of Daniel R. Elliott III to chair the Surface Transportation Board is another potential political coup for the United Transportation Union. Elliott, currently UTU associate general counsel, follows the appointment of UTU Illinois State Legislative Director Joe Szabo as head of the Federal Railroad Administration. For its part, UTU is hoping that, assuming Elliott is confirmed by the Senate, the twin choices will be followed by others from UTU in the future.

““The selection by President Obama of Dan Elliott and Joe Szabo to head major transportation regulatory agencies is tribute to the political influence of the UTU, which flows from the UTU PAC,” said UTU International President Mike Futhey in a statement. ‘We have good reason to expect President Obama to reach into the UTU ranks for other appointments in the near future.’ Elliott, a Democrat, would join fellow Democrat Frank Mulvey and Republican Charles Nottingham on the three-member board.”

It will be instructive to watch the confirmation hearings in the Senate. Suppose some Senator brings up this quote and asks Mr. Elliot whether he can be an impartial arbiter, not unlike the questioning of Sonia Sotomayor *vis a vis* her “wise Latina” remarks. Though my sources say Elliott has served well and honorably in his prior roles, it seems to me such an exchange could still produce an awkward moment.

Larry Kaufman touches on another aspect of conflict in he Capitol in his July 13 *Rail Business* column. The thread is what Congressman James Oberstar (D-MN) is trying to do about the Big Picture in transportation. “Oberstar has run into the proverbial vacuum. The Obama Administration, working through its DOT front man, Ray LaHood, has called for an 18-month moratorium. While Oberstar is trying to force DOT to focus more on issues of freight and passenger mobility, the new secretary trots around the country posing for pictures with governors and other pols at ground-breakings of stimulus-funded projects like a bike path in Denver. With the jackhammers put away, he tried to persuade the *Denver Post* editorial board that bike paths alleviate urban congestion. Boy, has he got a lot to learn.

“Oberstar is an expert on transportation issues, but he is about to learn that being a senior member and committee chairman is no match for White House power. He’s one of the very few people in Washington who sees transportation as more than a big public works project or pork barrel spending pot. In an outline of the bill released last month, he called for a new vision for DOT, with

performance-based policy goals.” Here again, the conflict arises between satisfying national transportation needs and political paybacks.

My personal sensibility runs toward giving Elliott a chance at STB and Szabo the same at the FRA. However, it will behoove those invested in the short line business to pay very close attention to such things as the new Hours of Service law that could cause short lines to increase payrolls or cut service and the MNA decision that could wind up costing RailAmerica a railroad and the very two-carrier service the utility seeks. Then we’ll know for sure who’s bought whom.

**CSX results for the second quarter** of 2009 were, all in all, not bad considering. Revenue units dropped 21 percent year-over-year but were even with the first quarter of this year -- during the call Chief Commercial Officer Clarence Gooden said the markets “appear to have stabilized” at current levels and that negative double-digit year-over-year volume changes may be expected in the third quarter as a result. The only bright spot, if you can call it that, is agricultural products where “heat and eat” continues to work.

Revenues dropped 25 percent and system revenue per unit was off five percent, all single-digits except in phosphates/fertilizers and metals. CSX notes in the wrap to its “Second Quarter Financial Report” that the dismal results in housing and construction affected every carload commodity group but agriculture and phos/ferts. Running counter to my “heat and eat” thesis was coal where the 21 percent drop in units propelled a 21 percent revenue skid. Says the Quarterly Review, “Volume declines were driven by a weaker export market and lower demand from electric utilities. The export market decline is a result of both lower steel production in Europe reducing the need for metallurgical coal, and cheaper alternative global sources for European utilities. The demand for domestic electrical generation from coal was down because of low natural gas prices and lower industrial production.”

The good news in all of this is that CSX continues to manage costs so they are dropping at a greater rate than either revenues or gross-ton-miles. One result is the OR shedding two whole points year over year and is the lowest in the last six consecutive quarters. Another result is operating income came down 20 percent year-over-year and, at \$582 million, is only seven percent below what it was for the first quarter of 2008.

The only bright spot was domestic intermodal where units inched up two percent while international units tanked, down 30 percent. CSX attributes the domestic successes to “truckload conversion and expanded service offerings,” yet RPU suffered 18 percent on “fuel recovery” and pricing to market, still not bad compared to what the truckload guys are reporting. The international hit comes from, naturally, the global economic recession.

What’s ahead? I think Jason Seidl at Dahlman-Rose said it best in his note: “The road ahead remains Rocky. While we believe the CSX earnings release and call provide a sliver of hope, we caution that the street may over-react to any perceived positivity at a time where much uncertainty is still looming around the railroad’s near term prospects. While the company expects improvements in pricing, volume levels and overall markets, little business has been locked in for 2010 as the company is just starting contract negotiations with customers. Based on our recent proprietary survey data, we do not expect the company to fare as well in 2010 as they did in 2009.”

Though CSX, alone among Class Is, settles with its short lines on a share of the whole rate basis, its Class II and III feeder lines will continue to see volumes at this level in most commodities if only because of their links to the auto and housing markets. Tie that with rising fuel costs and operating changes linked to the new Hours of Service Rules and STB uncertainty over bottleneck cases, paper

barriers and small rate cases, and margins could very well be constrained for a year or more. As Cashin would say, "Be very nimble."

**In a separate note**, Seidl asks, "Will Pricing Fall Before Freight Returns? The pricing pressure is on. According to our proprietary 2Q Dahlman Rose Rail Shipper Survey, railroad shippers anticipate an average base rate increase of 3.3 percent over the next six to twelve months. This is below the 3.6 percent increase expected in our 1Q09 Shipper Survey and below the 3.5 percent increase noted in our 4Q08 Shipper Survey. The drop in projected price increases confirms our concern regarding the railroads' diminishing pricing power as expressed in our 1Q09 Shipper Survey report.

"We believe that the relatively small changes in expected pricing for the railroads over the last few quarters are indicative of current macro economic pressures. If the economy fails to rebound like many expect, pricing could slide further." [Moreover, roads like NS with higher than average operating expense per gross ton-mile could see margin squeeze at a mere three percent RPU gain. – rhb]

"The rate case action is subsiding. According to our 2Q09 survey, 94 percent of shippers indicated that they do not plan to file any rate action against a railroad over the next 12 months. This is an increase from 88 percent in our 1Q09 survey, suggesting that shippers feel pricing will come in on its own or that current pricing practices are not egregious. Out of the six percent who stated they would take action, most of the reasons given were due to the current STB rulings being in favor of shippers along with it being easier to process rate actions at the STB.

"There may be a light at the end of the tunnel, however. Shippers expect their respective businesses to grow approximately four percent for the next year, versus 1Q09 survey response of a one percent decline in business. While it remains unclear as to what is driving this optimism, a pick-up in the economy would be exactly what is needed for the rail space and the broader market." And the short lines that will benefit will be those that follow the GWR rule of doing long-term due diligence on a line's customer base before they hand over a check and ask for the keys.

**Is the CSX earnings surprise** (72 cents vs. consensus 62 cents) a precursor of better days? Blogger "Skymist" writes in his seekingalpha.com space, "CSX tightened its belt and reported much better earnings than expected. When the market is demoralized and sees little improvement coming up in the economy, it keeps its eye on railroads. This is nothing new - it is expected that increased economic activity will trigger certain leading indicators, and transportation of cargo is one of these indicators. In fact, there is a formulation called the Dow Theory which describes the cycles as being led by transportation - usually railroads.

"The Dow Theory is old, really old, but surprisingly effective. It says, among other things, that Bear Markets reverse and go higher when railroads start to recover. In this day and age of course, dry-shippers, container shippers, and product shippers are occupying the same niche as railroads, and it is not unreasonable to assume they will either follow or be followed by railroads when recovery begins."

The common thread among all carriers is they move stuff. But, as *US News & World Reports* chairman and editor in chief Mort Zuckeman writes in his July 14 *WSJ* op ed piece, "The goods-producing sector is losing the most jobs -- 223,000 in the last report alone. The prospects for jobs creation are equally distressing" as employers opt to increase hours for present staff and bring back furloughed workers before adding new positions.

Households are thus hunkering down and saving nearly seven percent of after tax income, not

spending money on stuff but stuffing that money into CDs and savings accounts. Zuckerman continues, "this process is nowhere near complete and, until it is, the economy may well oscillate between sluggish growth and modest decline for the next several years until the rebalancing of excessive debt has been completed." In other words, all those commodities CSX says are linked to household expansion will not likely see the return of the 2006-7 volumes for a while.

**RailAmerica has set up** a new contract-switching division called, not surprisingly, RailAmerica Contract Switching Services. This is not a small field, with many entrants from GWR's Rail Link division and Watco Switching Services to smaller players like the Black River & Western in New Jersey running a number of isolated outposts.

Elsewhere, RailAmerica has made some changes in its management team. With new long-term financing now in place -- the nearly \$800 million bond issue -- for the 42 lines in the original network at the time of the Fortress acquisition, it's time to look at what needs to be done on the FEC. Toward that end, Paul Lundberg will continue to head up labor relations and take on the role of become chief operations officer. David Rohal, in addition to continuing as president of FEC, will take on strategic and government relations, and will have Jeff Geary as FEC vice president. Steve Truitt will become vice president of RailAmerica's Southeast Region.

In addition, they're moving the purchasing function from operations to finance under Clyde Preslar, CFO. Dave Novak, SVP and Chief Admin Officer, will add the Transportation Logistics Center that handles agency work and accessorial billing, the Revenue Protection Center in St Albans that handles all the ISS functions from collection through interline settlement, and the Transportation Service Center that does all of the above for FEC. All three functions had previously resided in Operations.

On the non-operating side of the house, RailAmerica continues its "Project Horizon" for re-engineering information processes, replacing the wide variety of practices it inherited with an array of best practices with the goal of eliminating the errors that go with an ad-hoc system. As David Rohal told me in a telephone interview, "We're concerned with accuracy, timeliness, and consistency from the administration of the price for a service through all the operating processes required to provide service, and on through the time we receive the cash."

What we're seeing here is exactly what the successful Class I mergers accomplished as they brought various disciplines under one roof, something the BNSF has done very well and the Penn Central failed at miserably. RailAmerica's getting a handle on the admin side is bound to improve financial results by shortening the accounts receivable collection time, improving billing accuracy, accelerating car cycle times and managing the loco fleet to have the right power on the right train. Kudos to the RA team are in order.

**The seven-mile Ashtabula, Caron & Jefferson Railroad (ACJR)** in northeastern Ohio celebrated its 25<sup>th</sup> anniversary last week and North Shore's Todd Hunter was there. He writes, "Owner Bob Callahan invited a number of us, including any who wanted to bring along a speeder (e.g. my friend Joel Williams and his ex-WM Fairmont M19 AA speeder), to join in the event to assist. AC&J is a former NYC passenger line that was saved by the state of Ohio from abandonment 25 years ago and, while Bob's primary business is freight, there is a weekend excursion operation on the line that normally uses one of Bob's ALCO S-2s for power. For this special event, we had steam!

"Bob had Baldwin-built American Viscose Company saddle tank 0-4-0 #6 trucked in for the weekend and this tiny steamer pulled a train of four coaches all day. Officially, I was running fire and track patrol for the event, but with the heavy rain storm in the morning everything was so wet that there was no fire danger to patrol for. They serviced her every trip, loading coal with a skid-

steer. The Six put on a good show and is now in route to Michigan for the upcoming steam festival at Owosso.

“From the freight side, it is interesting to note that the AC&J only has two direct rail customers on the seven miles they operate: a feed mill and a Smurfit Stone container plant (in bankruptcy now) on this Conrail cast-off branch. However, Bob Callahan has done an incredible job developing transloads at both ends of the line and Bob meets the 100-car-per-mile rule. Bottom line is that he has a credible business and seems to be doing well even in this economy. In my opinion few very tiny operations of this length look like the AC&J in terms of rail business. Bob ‘gets it’ if you know what I mean. He frequently does not have enough tracks for all the business!” Thanks, Todd.

**Speaking of reaching out**, RailAmerica’s Charles Hunter writes, “Our New England Central Railroad (NECR) hosted a legislative freight rail tour of the railroad June 30. The tour group included a number of high-ranking and distinguished members of the Vermont State transportation community as well as representatives from both the house and senate transportation committees. The outing began with a site visit to a rail-served LP gas facility where the theme was the importance of rail transportation to provide a reliable source of heating fuel for Vermont citizens and businesses.

“After the site visit, the group hopped on Amtrak’s Vermonter for the 62-mile ride to White River Jct. where the assembled multitude toured three major NECR customers- Barrett Trucking (road salt), Irving Oil (heating oil), and RSD Warehouse (wood pellet distribution). At Barrett Trucking, owner George Barrett arranged for a “live” demonstration of unloading rock salt from covered hopper cars into a truck and into his massive salt storage shed. All of these customer’s operations depend on the NECR to receive their products.

“After lunch in White River Jct., the group returned to Montpelier on a bus provided by VTRANS. The event was well received and offered the chance for the people that make decisions regarding rail policy in the state to better understand how those decisions can positively effect Vermont’s businesses and economy.” Looks like the time and effort paid off. Thanks, Charles.

**The RT&S Newswire** reports that The Irving Company’s 203-mile New Brunswick Southern in Northern Maine and Eastern Canada (the east end of the former CP transcon between Brownville Jct. and Saint John) is getting a C\$36 million facelift. The project includes upgrading the line and terminals in St John and McAdam to 286,000-pound capability.

The federal and provincial governments are each investing C\$9 million in the project. The premier defended the province’s investment saying the government had to get involved because (a) the private sector couldn’t do it alone and (b) the work will ensure New Brunswick manufacturers have a connection to U.S. markets, heretofore less accessible due to the 263,000-pound weight limit. Aside from maintaining 40 jobs and creating 40 jobs during two years of work, Irving said, the project will help ensure the long-term viability of the rail line, which carries more than 40,000 carloads of freight every year. The new rails are expected to last 50 to 75 years, he said.

Area companies are thrilled that New Brunswick Southern Railway is improving its capacity. Marwood will provide 40,000 railway ties as a supplier (it’s also eyeing becoming a customer) once the improvements are completed. Supplying 40,000 ties over the next two years is exciting news given the slow U.S. market, the company said. Pressure-treating the wood will take place at the company’s Tracyville location and should help maintain eight positions over the next two years.

**As a postscript to my 844 note** last week, New Jersey Short Line Association’s Kel Mackavanagh writes, “Your mention of UP 844 brought back a lot of memories. When I first arrived at Fort

Carson, CO at the beginning of November 1961, I was lucky enough to avoid being on a duty roster that weekend and was able to ride a one-way fan trip behind 844 from Cheyenne, WY to Ogden, UT. Rode the CB&Q Denver-Billings, MT train from Denver to Cheyenne, then slept on the benches in the UP station in Cheyenne until morning. At daylight I wandered over to the UP roundhouse and looked around. The Challenger was also there.

“The weather for the trip was sunny. I, and a few others, had to get off the train at Evanston, WY to catch the eastbound *Portland Rose* back to Denver so I could get back to Fort Carson the next day (Sunday). I think my total expenses for the trip were about \$50.00. Of course, this was most of my PVT E-1 salary at the time (\$78.00 gross per month). Believe I still had some Army travel money left over so this did provide a little extra cash. The photos I took were prints. Sorry, no Kodachromes! Those were the days! Thanks again.”

**Thus week WIR is sort of a double issue** as Laura and I are getting away to celebrate our having lasted this long – 25 years – in wedded bliss. We’re outta here next week and back on the 30<sup>th</sup>. We’re taking a dozen rolls of Fuji E-6 (the Kodachrome brick isn’t here yet) to record the mostly non-railroad sights. E-mail will be spotty and my cell phone will be off. (I do have a few more things to say about short line coal and I’ll try to get that out before I leave.) Cheers.

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