THE RAILROAD WEEK IN REVIEW

April 23, 2010

"*The FRA proposes regulations implementing a requirement of the Rail Safety Improvement Act of 2008 that certain passenger and freight railroads install positive train control systems.*" *-- Federal Register, July 21, 2009*

Friday April 16 was PTC Day for the Class I and passenger railroads. That was the due date for their PTC Implementation Plans to be on the doorstep at the FRA. Class II and III railroads were not required to file PCPIPs; those required to file had to show they had asked their shortline and regional railroad connections what rolling stock they would have operating on the lines that were covered for PTC. Indications are the small railroads have been cooperative though there will most likely be many bones of contention as the players work out the details.

It's all part of the Railroad Safety Improvement Act of 2008 that is now the law of the land being put in force by the FRA to meet the December 31, 2015 compliance date. In a nutshell, the Class Is and passenger railroads are required to install PTC on line segments where there are *regularly scheduled* (emphasis added) intercity and commuter passenger trains, yard and terminal trackage excluded. Shortline operators with non-scheduled tourist trains operating on their own tracks are exempt, according to Keith Borman, the ASLRRA's General Counsel.

Then come the *Class I railroad* main lines carrying five million gross tons or more annually *and* carrying commodities that are considered toxic inhalation hazards or TIH (again, emphasis added). Short lines and regional railroads are not Class Is and so are exempt unless they host regularly scheduled passenger trains -- even if they have no TIH customers on their lines.

It gets interesting where non-Class I railroads' trains have rights over Class I lines that are required to have PTC installed. The regulation permits non-PTC equipped power of connecting shortline and regional railroads to run on these Class I lines for distances of up to 20 miles. Maybe. Feedback from my contacts at Class Is and smaller roads leads me to believe that if the Class I requires PTC on its own power used on the line segment it will require the same of its trackage-rights tenants.

Obviously, the PTC requirements do not affect the vast majority of the nation's 500-plus short lines. For those that are included, the initial installation cost is downright scary and the on-going maintenance expense will be a burden. Rich Timmons, ASLRRA President, told the GAO in his March 30 PowerPoint that the PTC regs will require 60 member roads to pony up a total of about $16 million just to get in the game and then plunk down another $2.6 million a year for upkeep.

The bottom line is that without PTC in place on their locomotives, some Class II and Class III railroads may find themselves barred from going all the places they used to go and some of their current customers will lose the rail option. This at a time when railroads are looking to add customers and when current customers are using more rail.

(And if there's any chance your short line or regional railroad will come under PTC, it would behoove you to attend the PTC break-out sessions at the ASLRRA Annual convention.)

Union Pacific stepped up to the quarterly earnings plate Thursday and like CSX knocked the first pitch out of the park. It's a case of doing lots of things right. Operating income was up 47% to $988 million on a 16% revenue increase to $4 billion. Operating expense was held to a 9% gain (just 1.5% ex-fuel). The operating ratio dropped five points to a first-quarter record of 75.1.

Average revenue per unit was up 3% with no commodity posting a decline in RPU. Year-over-year revenue deltas were positive in every group; ditto revenue units in all but coal.
During the call Dennis Duffy, Vice Chairman for Operations, said that they were able to take road and yard train starts down even with volumes up 13% by shifting work among yards, increasing train lengths and keeping furloughed T&E folks' skills up for a moment's recall. In short, taking variability out of the network increases efficiencies for the railroad and yields greater satisfaction for customers.

Merchandise carload (all but coal and intermodal) revenue increased 18% on 16% more revenue units; coal revenue was up 5% on a one-point decline in vols with intermodal gaining 25% in revenues on 21% more units. EVP Marketing & Sales Jack Koraleski said this quarter was the first since the 2008 first quarter quarter to show year-over-year volume growth. [*Sequentially, it's the best revenue-unit count since fourth quarter 2008. -- rhb*]

Jack cited particular revenue strength in chemicals, ag products and industrial. With respect to this last group, he said it's a good sign when the comps are positive in aggregates, cement and lumber and right now he's got two out of three, waiting for cement to catch up. And though automotive is a smallish portion of shortline loads, it's important to note the UP auto parts business is up 42% year-over-year. IMHO some of that ought to rub off on short lines.

The ag products drivers were export wheat, soy beans and meal; ethanol was up 28% partly on the increased California blend needs and DDGs went up proportionately. Chemicals revenue growth came chiefly on double-digit gains in soda ash, industrial chemicals and fertilizer. On the call Morgan Stanley analyst Bill Greene asked about inventory management on the part of UP customers [*fitting, given the number of shipper surveys he does-- rhb*]. Koraleski said it's mostly just-in-time replenishment stocks with few manufacturers willing to bet on inventory builds.

Below the line, earnings-per share-came in at $1.01, up 41% over last year's $0.70 and against a $0.95 consensus estimate. However, some analysts see earnings in the $1.09-$1.11 range as "clean" numbers that strip out some one-time items. The consensus estimate for the second quarter is $1.04; a similar beat and taking out one-time stuff could be in the cards, implying a strongish second quarter where once again the carload network (56% of first-quarter sales) takes a leading role.

Morgan Stanley's *Freight Pulse*, the semi-annual survey of shippers going back to May, 2001, is now in hand. Right out of the box it confirms what we've heard from UP and CSX in their quarterly calls and what we heard from short lines in the fourth quarter of 2008. As regards the first, *FP 18* tells us the 500 shippers surveyed (responsible for more than $7 billion of annual transportation spending) expect volumes to increase nearly 3% going forward.

As for confirmation of the past, *FP 14* (March 2008) saw estimates up 0.8%; by FP 15 the following October expectations had fallen to -0.1%, hitting a low of -2.0% in April 2009. More than one shortline owner told me in early 2009 that he'd been OK through the 2008 third quarter but the bottom dropped out in October. So if *FP 18* says expectations for early 2010 are for a 2.6% increase, I'd say it has legs.

The current survey also supports UP's Koraleski on inventory. Shippers were about equally spread among higher, lower and the same inventories relative to last year. Asked about ordering new supplies relative to last lear, 72% of respondents said more than or the same as last year with the balance saying lower than a year ago. In other words, says FP 18, inventories are lean and replenishment is only now beginning.

Price still counts in modal selection. Using a weighted average by shipper revenue, 49% of truck shippers said they were shifting orders to rail from truck; going the other way only 32 of rail shippers said they were contemplating shifting any business to truck from rail. Put in the context of annual transportation budgets, it's clear the bigger players favor rail whereas the smaller ones are more truck-friendly.

For shippers with annual transportation expense north of $20 million, 62% see a "significant" or "some" shift to rail from truck and the percentages decrease as budgets go down. Going the other way, the smaller the rail shipper the more likely he is to stick with rail, with only 4% in the under $100,000 category contemplating any change and 48% in the $20 million-plus group considering a move to truck from rail.

The commodity breakout is instructive. Of those shifting truck to rail, carload commodities include agriculture, chemicals, food and beverage (see the joint UP-CSX Railex train), forest products (both STCCs), and building materials. The same guys are going the other way, too, with more leaving the railroads than going to the rails in every commodity group.

So -- if the smaller shippers tend to stay put with the rails, and the bigger shippers are more likely to move truck to rail -- it may be a good omen for short lines. The big guys like to be on the big roads -- Ford on NS, Peabody coal on UP and BNSF, e.g. -- and the short lines get the smaller players. Now come the UP and CSX calls and their experience with the "value proposition" and it all begins to fit.