THE RAILROAD WEEK IN REVIEW

August 20, 2010

"You can observe a lot just by watching." -- Yogi Berra

If the economy is in the toilet, you'd never know it by watching traffic volumes on the Interstates, full parking lots at hotels and well-patronized restaurant chains from Ruby Tuesday's to McDonald's. We drove more than 1,000 on our little jaunt to southwest Virginia and back and observed that, with the exception of two hours of early Monday morning motoring on the Blue Ridge Parkway, we were always behind somebody and faced an endless stream of vehicles coming the other way. And not just any vehicles - late model autos, high-end RV's, expensive Harleys. I observe there's still a lot of consumer discretionary spending out there.

Air conditioners were running full blast every place we stopped. Restaurant portions were huge and the patrons looked as if they'd never gone hungry. The truck traffic on I-81 from Carlisle, Pa. to Stanton, Va. left little room for mere autos, so clearly there's still a lot of "stuff" on the roads. In short, if this is what an economy in trouble looks like, I shudder to think what we'd have out on the highways in "better" times.

Which brings me back -- naturally -- to the subject of railroads. Norfolk Southern is the principal player in the parts of Virginia we visited and it was an impressive show.
I returned to Riverton Jct. (top right) to see the just-completed track realignment (WIR July 16) and as if on cue NS presented a northbound merchandise train of 100 cars or so. It never even slowed down where the intermodal job I'd seen three weeks before had been restricted to 10 mph.

Three days later outside Luray (lower right) we paced a southbound merchandise train with as many cars at a steady 50 mph. And even when we couldn't see the tracks, we could hear the trains. You're never far from the former N&W line when you're on US 340 in the Shenandoah Valley, so when you stop for a burger or gas you can still hear the action.

With all those mouths to feed, fuel and air condition at night, the supply chains have to be kept humming. NS is clearly doing its part.

RailAmerica carloads for July 2010 came to 73,071 units, up 4.7 percent year-over-year with increases in nine out of 12 commodity groups pretty much spread out across the country. Chemicals at ten percent of total volume increased eight percent primarily due to increased shipments in the Midwest, West and Southeast regions. Agricultural Products, 15 percent of all carloads, increased five percent primarily due to higher shipments in the Central region. Coal, the largest single commodity group at 22 percent of loads, barely held its own, up less than one percent.

The biggest jump was in the Metallic Ores and Metals group, up 84 percent with increases across all regions but accounting for less than eight percent of total loads. But at less than 6,000 units and eight percent of the total volume, it's not that big a deal. The three smallest groups -- petroleum, auto and other -- represent less than nine percent of loads and were down in order 8, 25 and 36 percent.

It may be the summer doldrums, but July posted the smallest year-over-year monthly gain since February, 2010. Year-to-date loads continued the positive trend, up seven percent , having started the year up just five percent. However, RA appears to be stuck at the 70,000 car-per-month level: March was more than 75,000 and the month-to-month deltas since then range from minus four percent to plus three percent (July was a zero-point-five percent improvement over June).

Patriot Rail Corp. has agreed in principle to purchase all of the six short lines belonging to Weyerhaeuser. Among them they do about 60,000 cars a year and have some 120 employees; the acquisition is expected to close in the fourth quarter of 2010. Here's the line-by-line breakout:

• DeQueen and Eastern Railroad Company is really two names -- the DeQueen and Eastern and the Texas, Oklahoma & Eastern railroads -- with a combined 87 route-miles in southeast Oklahoma and southwest Arkansas;
• Columbia & Cowlitz Railway, 9 route-miles in southwest Washington;
• Weyerhaeuser Woods Railroad, 30 route-miles in southwest Washington -- essentially an extension of the Columbia & Cowlitz;
• Golden Triangle Railroad, 13 route-miles in central Mississippi;
• Mississippi & Skuna Valley Railroad, 21 route miles in Mississippi.

Each of the railroads interchanges traffic with at least one Class I carrier, either directly or through other properties included in this transaction. The transaction, though not wholly unexpected as forest products and other companies have retreated to their core businesses, is a win for Patriot as it "doubles the number of names in our rail portfolio" according to Gary O. Marino, Chairman, President & CEO of Patriot Rail. The company owns and operates 331 route-miles across six short lines in eight states. Additionally, Patriot recently signed an agreement to lease and operate the 13-mile Piedmont & Northern Railroad in Gaston County, North Carolina. See also www.patriotrail.com.

The Andersons Rail Group reported second quarter 2010 operating income was $0.1 million, down from $0.6 million year-ver-year, thanks to lower fleet utilization rates and the corresponding carrying costs of idle assets (storage fees to short lines go here). Second quarter revenues were $24 million in both 2010 and 2009 though the present quarter garnered $1.7 million in gross margin from the scrapping and sale of railcars, twice last year's number. The corporation's second quarter earnings doubled due mainly to the 120 percent revenue gain from the Grain & Ethanol group, to $19.6 million, an all-time record.

The Rail Group has approximately 22,800 cars and locomotives, which is down slightly from the prior year. The average utilization rate (the percentage of the fleet in service) for the quarter was 71.0 percent compared to 80.6 percent for the same period last year; as of June 30, the utilization was 71.4 percent. [All the Class Is and short lines said grain vols were up year-over-year so if fleet utilization rates are down it sure looks like more grain is moving in fewer cars. Higher revenues, lower equipment costs, higher incremental margins. It all fits.]

During the second quarter the Rail Group made a significant minority investment in Dan Sabin's Iowa Northern Railway Company, a major ethanol hauler both for corn in and alcohol out, and owner of a recently refurbished car repair facility near Waterloo. The Andersons will be a major user here, and a good thing, too. The Andersons repair group's 2010 first half operating income was $1.1 million on $50 million of revenues.

Now look at the Andersons rail fleet management strategy in the context of employment. The Iowa-Nebraska-Illinois sphere makes up the core of the ethanol business and naturally Andersons will be using lots of cars to move the corn in and the ethanol (and DDGs). This being the case you're going to "home base" your equipment in the midst of the heaviest users. So to the extent that cars are home-based and maintained across a lot of short lines, the care and maintenance will touch many lives.

But to maintain economies of scale, fleet owners will want to put that support process in as few places as possible, ergo the IANR location makes a lot of sense. But it also could mean the loss of car repair profit centers across a number of short lines in the same service area. The management of the Fallen Flag & Eastern isn't going to staff up for car repair if that business is now being done elsewhere.

Clearly, car repair revenues for centralized car repair shops are going to go up faster than the marginal expense for labor, utilities and materials. The Andersons will pay less across the board because they have fewer railroad overheads to support. Those left in the field will see improved productivity and their customers will see more constant outputs, lowering their car maintenance expense still further. More work, fewer shovel-ready low-skilled utility men.

Deflationary signs are afoot. Art Cashin cites Keene Little's overnight column for Premier Investor Newsletter, with this observation: "We're seeing more stories about prices dropping, which again for consumers is not a bad thing (we all like paying cheaper prices for things). Even food is starting to show signs of deflation. During the recent Safeway earnings call Chairman, President and CEO Steven Burd discussed the problem of deflation in their business.

"The company had accurately predicted a 1% deflation rate for the first quarter but it's become worse than expected since then. Safeway had anticipated inflation of 0.5% for the second quarter but the company instead experienced 2.4% deflation. Management is clearly disturbed by this--in their earnings call they mentioned the word "deflation" 57 times. The word "deflationary" was used another three times. You can bet Safeway is not the only one recognizing this problem and they will not be alone in pressuring their suppliers to lower their prices. This is how it ripples through the economy.

It's bound to show up in rail freight rates, too. I know some folks who pay attention to these things and they say their clients say the rate increases are getting out of hand. What bothers them -- and me -- is that rate increases are coming on top of huge incremental cost savings -- more volume on unchanged train starts and lower operating expense per GTM. We know truck users are pushing back against rates and thanks to over-capacity, truckers aren't pushing the envelope.

Well, lower rates are attractive and when the railroad value proposition goes away so will the tonnage. Then the goods available for shipment vs capacity to move them will shift as vols come down, and as vols come down so must rates. So why not just keep the rates where they are and make more money by continuing to lower ops expense per GTM? If I were the ASLRRA I'd be pushing for this as rates that get out of hand cost my members carloads.

Set aside Sep 28-29 for RailTrends 2010. Sponsored by *Progressive Railroading* magazine, this year's iteration will again hold forth at New York's Affinia Manhattan hotel on 7th Avenue, across and down two blocks from Pennsylvania Station (never mind the Pennsylvania Railroad hasn't called here in 42 years; the name stuck).

This two-day summit was carefully crafted to address the issues that matter most to rail professionals. Facilitated by some of the rail industry's most-respected authorities, the topics are wide-ranging and particularly germane for the present uncertain economic environment. We will get an intelligent discussion from freight railroad executives on the role of railroads in the post-recession economy coupled with a candid dialogue about the Obama Administration's approach to railroad regulatory policy.

On the finance side, there will be a thorough drilling down into Wall Street's take on the rail industry -- and why shares are trending as they are against the broader market. Lenders will tell us what they're looking for in potential railroad investments and what to make of the recent refinancing from folks like Kansas City Southern and RailAmerica. In sum, this is yet another rare opportunity to meet with and learn from some of the rail industry's most prominent, influential deal makers, trend setters and high rollers. Registration and other details are on-line at www.railtrends.com. See you there.

Book Review Page: Brian Solomon's two Voyageur Press locomotive books released in earlier this year -- *Baldwin Locomotives* and *Alco Locomotives* - really ought to be read in tandem. Lurking just beneath the surface of each is a marvelous case history in business management, strategy and customer relations.

In *Baldwin Locomotives*, Solomon tells how Philadelphia jeweler Mathias Baldwin began his trade in 1817, morphed into the manufacture of stationary steam engines and by 1832 had built the first locomotive for the Philadelphia, Germantown & Norristown Railroad. For the next 118 years The Baldwin Locomotive Works continued to build steam locomotives even as it shifted over to straight electrics (PRR's prototype GG1, New Haven box-cab freight motors) and dabbled in diesels as early as 1925.

Alco Locomotives begins by telling us that, as a locomotive builder, Alco didn't even exist until 1901, when "eight of the best-known commercial locomotive manufacturers in the United States merged in a joint effort to compete more effectively with Baldwin, America's foremost locomotive manufacturer." Solomon shows how the Alco team brought together some of the best and the brightest in the locomotive business and over the next 50-plus years "pushed the American steam locomotive to new levels of performance and reliability."

In each volume Solomon takes us through the development of bigger and bigger power together with the advent of new technologies like compounding and articulated locomotives. He's done a masterful job of illustrating his highly informative text with a superb collection of builder's photos (his Baldwin introduction delves deeply into its corporate philosophy on locomotive photos), early black and white action photos and, especially in the Alco book, color photography.

Neither Baldwin nor Alco saw the diesel-electric evolution of the1920's electric locomotive and gas-electric railcar technology as serious competition to Big Steam. Even though, Solomon writes, the early Alco-GE-Ingersoll Rand box-cab diesel (CNJ's 1000 is the best-known example) is considered by many locomotive experts to have been the first commercially successful diesel-electric power, it was not enough.

The Electro-Motive Corporation, a division of General Motors, had entered the diesel-electric locomotive market and had begun to "mass-produce locomotives the same way it built cars" -- a handful of variations on a single theme suitable to a wide variety of operating environments (hence the General Purpose, or GP, nomenclature). Baldwin, meanwhile, "continued to build diesels the same way it built steam locomotives -- in small, customized batches." Alco fared only a little better with its reputation for innovation but in the end EMD's market share lead, plus GE's entry into the locomotive market place, doomed Alco.

Solomon has given us a pair of volumes that can be dipped into repeatedly with something new and refreshing always in the offing. These two books are worthy of prominent placement on the bookshelves of any serious railroad historian.

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