THE RAILROAD WEEK IN REVIEW

December 17, 2010

"The recession has made us a better railroad -- it's made us more creative with our maintenance programs, improving the railroad and reducing costs. When the traffic level turns around, we can handle it." -- Rob Himoto, President, Santa Maria Valley Railroad

The Santa Maria Valley Railroad is a spunky 14-mile short line on the Southern California coast on the UP's ex-SP Coast Line about 170 miles up the coast from Los Angeles. The railroad turns 100 year old in 2011; SMVR President Rob Himoto's investment group, Coast Belle Rail Corp, bought out the original family owners in 2006. In the five years since, the new owners have transformed the railroad from a sugar-beet short line running GE 70-tonners on 90-lb rail into a regional rail terminal operator that can take 286, 000 lb cars and is running the same GEs augmented by a newer GP-9. The 2-6-0 may be toast but the loco shop remains, giving today's railroad an edge in the lucrative car-repair market.

I first "met" Rob 15 or so years ago when Week in Review was something I'd begun in conjunction with my role as "MF Rails," the rail analyst for *The Motley Fool*, just beginning its long run as a premier stock-watching space.

Rob and I correspond fairly regularly, though I must admit some months had gone by when this note landed in my e-mail box the other day. Rob has graciously consented to allow me to quote him at length as it's a great example of what a determined *short* shortline operator can do.

He writes, "Our carloads have been down considerably the past two months. Frozen vegetables are way down; we think some of it is farmers planting wine grapes on the marginal land and planting strawberries instead of greens elsewhere. Also, thanks to the health kick of eating fresh vegetables, farmers are selling a higher percentage of their crops to the fresh market, which makes sense because fresh yields much higher margins than frozen.

"This month is much better. Frozen vegetables are moving by rail and we are bringing in lots of nitrogen fertilizer. We are even seeing some carloads of lumber and drywall. We have one customer who uses our line as a staging area for their Long Beach plastics plant and they moved record amounts of cars in and out of storage. They expect to significantly increase their car-loadings and, along with a new customer who bales used plastic from the strawberry fields for boxcar shipment to Mexico, we should hit the magic 100 carloads per mile per year next year.

“Area farmers are excited about this plastics move as currently they are taking the used plastic to the local landfill and being charged to dispose of it. Kudos too to the marketing people from UP Mexico: This is a first time rail customer with some logistics challenges and his logistics people needed a lot of hand-holding. We may have more opportunities with traffic to Mexico and I am looking forward to working with UP Mexico again.

“From day one I have made it a goal to diversify our traffic because at the outset it seemed like over half of our carloads were STCC 20 frozen vegetables and berries. Our traffic mix continues to improve and UP industrial development folks are supportive.... We continue to have a half a dozen potential leads in the works. I will let you know how it pans out.”

Thanks, Rob. Your note shows what one can do when one drills down to the opportunities at hand, finds the right advocates at the connecting Class I, and takes a results-oriented approach to turning opportunities into cash. And in this political environment, where one never knows what the government will do next to mess with markets, it pays to be independent. We will continue to keep up with Rob Himoto and others who think like him.

RailAmerica reported a total of 71,419 carloads for November 2010, including 712 units on the Ottawa Valley, up 5.3 percent year-over-year. The good news is that nine of 12 commodity groups were up, and three -- coal, STCC 01 ag products, Chemicals including ethanol -- were up double-digits and account for exactly half of RA’s total revenue units. The less-good news is that month-to-month carloads thus far in 2010 are stuck in the 71,000-72,000 units range. Still, year-to-date revenue units are up 6.5 percent.

Looking at the individual groups, RA says, “Coal increased primarily due to shipments in the central US. Chemical volumes were up primarily due to increased shipments in our Midwest, Northeast and Western Regions.” RA also cites the nine percent gain in their Non-Metallic Minerals and Products commodity group, due largely to “higher shipments in our Midwest, Central and Northeast Regions.” Automotive carloads were off 64.7 percent (the category is only 2.7 percent of the total number of units) because of “decreased shipments in the Midwest Region.”

The Genesee & Wyoming story is much the same. Total November 2010 carloads came in at 71,861, up 14.1 percent year-over-year. However, for an apples-to-apples comparison with RA, we must consider the fact that the strong Australian grain harvest added 2,749 units to the agriculture column; strip that out and the November increase for the North American properties is 9.7 percent, still a respectable number. GWR posted double-digit year-over-year gains in coal (including coke and ores), aggregates, paper, and “farm & food” (though absent the Australian increase the commodity is unchanged). Year-to-date revenue units are up 8.7 percent.

Month-to-month volume deltas are minuscule -- down four percent here, up three percent there, down half a percent in another place. But the mix is important. Coal and aggregates account for two out of every five carloads. Third place goes to either the paper group or ag, depending on whether you count Australia. I don’t because I’m looking for North American comps and, if this be the case, coal, aggregates and paper etc. account for 51.4 percent of total loads. All three were up double digits (coal is ten when you round up the 9.6 percent reported) and that’s good.

Watco is heading for Australia, having been awarded a long-term grain rail contract to provide services to the CBH Group of Western Australia, a farmer-owned co-operative with more than 4,800 grower-shareholders. The group stores and transports Western Australia's annual harvest averaging 11 million tonnes a year (a "tonne" is 1,000 kilograms or 2,200 lbs) through its 197 collection points and four grain export terminals. Some 60 percent of the grain crop (70 percent wheat) moves by rail to export over 5,100 route-kilometers (3,400 route-miles) of standard and narrow gauge railroad.

The the railhead-and-below infrastructure is owned and maintained by WestNet Rail (now under Brookfield Infrastructure Partners, L.P.), providing rail access to railroad operators such as the Australian Rail Group (ARG) and others. Here's where it gets interesting. ARG itself was formed in 2000 as a consortium between GWR and Wesfarmers, the largest private employer in Australia and one of the county's largest retailers, to bid for freight operator Westrail which was being sold by the owner, the Western Australian State Government.

That relationship came to an end in 2006 when GWR and Wesfarmers agreed to sell their ARG train operations in Western Australia to Queensland Rail and the track infrastructure to Babcock & Brown Limited. At the same time GWR bought out Wesfarmers' 50 percent-ownership of certain South Australian operations of ARG, renaming the now 100 percent-owned GWR subsidiary Genesee & Wyoming Australia Pty Ltd .

It turns out the ARG had been the CBH supplier for grain train operations for 70 years but CBH went looking for another supplier because it wanted greater control over rail operations and having a supplier in-house, as it were, was the better way to go. In fact, according to a statement from CBH Group chief executive Dr Andrew Crane said the Watco award "marked a new era for grain rail freight in WA, which would deliver significantly greater value, efficiency and safety to grain growers and the grain industry."

The Watco contract is for ten years starting May 2012. Under the agreement Watco will provide rail logistics planning, which includes train operations and scheduling, railcar tracing, railcar and locomotive maintenance and inventory control. Says Dr. Crane, "Our decision to go to tender for our rail transport requirement has resulted in the introduction of competition for the first time in the Western Australia grain rail freight market and the first major investment in new rolling stock for decades." Dr Crane adds, "We still need continued support and engagement with below-rail provider WestNet and the state government to achieve an optimal outcome.

As part of the service plan, CBH intends to invest $175 million in rolling stock to be maintained by the Watco Mechanical Team. Combined with a satisfactory new track access agreement and with the state and federal governments' $350 million funding package, this total planned investment of $525 million has now been committed to the grain transport network after what Dr. Crane calls "decades of neglect."

Elsewhere, Watco and Kinder Morgan Energy Partners, L.P. have inked an agreement whereby Kinder Morgan will invest up to $150 million over the next year in Watco Companies, Inc., in exchange for a preferred equity position in the company. Kinder Morgan's initial investment will be $50 million upon closing, which is scheduled to occur in January of 2011.

This is no small potatoes deal. Watco CEO Rick Webb tells me the transaction provides capital to Watco for further expansion of specific projects and offers Kinder Morgan the opportunity to share in the subsequent growth. What we have here are two companies in the terminals business -- Rick says with a laugh, "So what if our first-mile last-mile service is 200 miles long"-- teaming up to provide the same kind of one-stop shopping that Watco has long promoted: load the car, move the car, unload the car, fix the car, and fix the track it's on at your location. No doubt this capacity was also a major selling point in Australia.

This will be the last *Week in Review* for 2010. I normally just take off the week between Christmas and New Year's Day but, to quote a classic line from *Trading Places*, "Nobody works on Christmas Eve, Louie," and so I shall not drop a WIR on your doorstep that day. Look for a double issue for January 7, 2011. Merry Christmas.

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