THE RAILROAD WEEK IN REVIEW

April 8, 2011

"A conflict exists when a person's private interest interferes in any way with the interests of the Company." -- Code of Ethics, Berkshire Hathaway Corp.

L'Affaire Sokol at Berkshire Hathaway brings into sharp relief the need for corporate values and how the Class Is' corporate cultures can bear on their relationships with connecting short lines. I've written here in the past about the CSX code that opens with "It starts with the customer." Norfolk Southern is explicit about business partner relationships: "The Code may also apply to other people who are working on Norfolk Southern's behalf or at our direction." I would take that to include shortline partners that have revenue-sharing arrangements with NS.

As for BNSF, the Buffett "style," if you will, is to buy good companies with good managers and let those managers keep on doing what they do best. Without getting into the Lubrizol deal, let's just say the better one can see how a company does business and why, the better the commercial relationship is bound to be.

A year ago, when the Berkshire-BNSF transaction was brand new, I wanted to se how the Berkshire Way might affect short lines doing business with BNSF. It was all right there in Warrren Buffett's 2009 *Shareholder Letter*, available for downloading at www.berkshire-hathaway.com, in the form of "What We Don't Do" on page 4. Not only do these "don'ts" speak volumes about how BNSF wound up in the Berkshire fold but they also flag what short lines can do to fit the Berkshire mold.

The short form is for short lines to avoid shippers whose business is not on a firm financial foundation, to avoid becoming dependent on the kindness of strangers, to eschew management by committee and to keep the lines of communication with stakeholders open and uncluttered. The ALIGN program that's designed to take what some call the "friction" out of the BNSF-short line relationship (see WIR 11/5/2010) helps short lines not do what Berkshire won't do. And so, irrespective of any awkwardness caused by *l'afffaire Sokol*, we're reminded once again of the importance of having a Code of Ethics and adhering to it.

Rule 11 is not exactly a hot topic as I make my usual rounds but that may change. A recent Wolfe Trahan note on the legislative scene suggests that Sen. Kohl's Rail Antitrust bill "faces somewhat better odds of passage if it can get attached to separate legislation." And if it does, then what?

A friend who has a practice in rate-consulting with major shippers feels that the specter of anti-trust will encourage the rails to be much less willing to collaborate on through rates and Rule 11 will become the norm. My sense is that sometimes Rule 11 is used because not all roads are "in sync" with one another on contract terms, like the duration of contracts or escalation provisions or where to set fuel surcharges.

Rule 11 is much easier for the railroads on many levels -- rate creation, publishing, and billing. No negotiations, no divisions, no revenue settlements at the end of the month. Rates can be changed at a railroad's whim without the need to consult with connections. On the other hand, the railroad making Rule 11 rates can't hide outrageous factors, can't blame "the other guy" for a high rate or a delay in publishing a rate, and can't as easily control markets through pricing.

For the shipper requesting Rule 11 rates, there's a significant downside, and it's called the Rule of Unintended Consequences. Under present present practice, railroads can negotiate and agree on how to divide a market-based through move price end-to-end. The shipper gets one invoice from the settling road and pays it. Under Rule 11, the shipper gets separate invoices from every railroad in the route. Do they really want this hassle?

An increase in Rule 11 moves ought not to have much impact on Class II and III carriers as they are paid out of the connecting Class I revenue. But there's a caveat. I've seen of late a push by rate complainants to separate the short line revenue divisions from the Class I's revenue, bribing short lines to acquiesce lest they get included in rate complaint cases and incur the legal fees and headaches thereunto appertaining. But if they accept the bribe and short line revenue divisions get too exposed, the short lines could be in very grave danger of having to defend their revenue-cost ratios -- something many short line owners have no clue about -- in court.

The state of the economy continues to loom large. Liz Ann Sonders,Senior Vice President, Chief Investment Strategist for Charles Schwab & Co., writes in a recent client letter, "Large parts of the US economy continue to show signs of strength. Manufacturing continues to lead the way with regional surveys posting robust readings. The Philly Fed Survey rose to its highest level since January 1984, while the Empire Manufacturing Survey moved to a very strong 17.50 reading. Both of these readings were confirmed on a national level by the 61.2 reading of the ISM Manufacturing Index.

"Additionally, the Index of Leading Economic Indicators posted its eighth-consecutive monthly gain at 0.8%. And while not as rapid as we would like, the labor market continues to improve and we believe is picking up speed, which will likely be key to Fed policy and market performance in the second half of the year. The four-week moving average of jobless claims, which is a leading indicator for labor, has moved solidly below the critical 400,000 level, while many of the employment sub-indicators in business surveys indicate a greater willingness to hire. This increasing strength was bolstered by the March labor report, which showed the unemployment rate decreased to 8.8%, the lowest level since March 2009, while the economy added 216,000 jobs.

"Unfortunately, despite the efforts of the Fed and the federal government, housing appears to be sliding again, although weather-related problems may be skewing the numbers to the weak side. Regardless, we can't ignore existing home sales dropping 9.6% and prices falling to their lowest level since April of 2002. Additionally, building permits fell to their lowest level in over 40 years, while new home sales fell 16.9% to a record low." See chart following disclaimer.

And here's Liz Ann's wrap: "Frankly, the government is going to have to 'pay the piper' eventually. Running deficits at the current level is untenable as global lenders will be likely to

demand higher interest rates in order to finance our debt. With state and local spending already being slashed across the country, we are watching the results of these budget debates carefully. While massive reform across a variety of programs is needed, including entitlements, we doubt it will occur this time around."

She concludes that sharp cuts in household discretionary spending could take a further toll. To which I would add, any slowdown in consumer discretionary spending can short short lines in chemicals, both liquid and bulk, brown paper for Amazon boxes, coated paper for newspaper inserts, ethanol if there is less discretionary driving and even cattle feed ingredients as budget-conscious consumers eat less beef and more beans. And these items represent just the top end of a very long list.

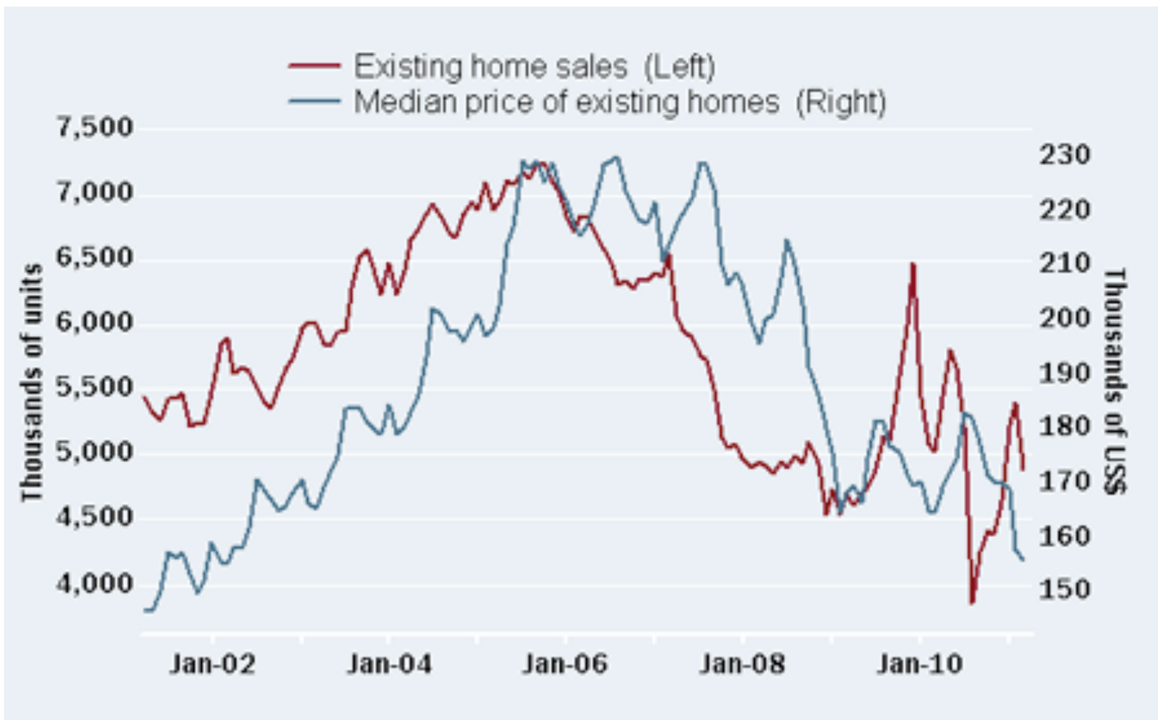
Larry Kaufman once again nails it in this provocative *Rail Business* piece, this time on captive shippers. "If shippers that are captive to the railroad that serves them have it so bad, how come none ever go out of business after citing the depredations committed by the rapacious, monopolistic railroad? The principal reason is that railroad executives are inherently intelligent, and understand fundamental economic principles. It bears repeating: Charging all the traffic will bear means charging the right price.

"If the price is too high, freight won't move and neither customer nor railroad profits. If the price is too low, the carrier is shifting its owners' wealth to the shipper's owners. A railroad supplies transportation service to manufacturers, distributors, retailers and other businesses that want goods moved from where they are to where the goods are needed. The railroads only prosper when customers entrust their transportation needs to it."

Needless to say, the column was not met with approval from the lobbyists working for the shippers calling themselves captive. However, says Larry, "the wide majority of people who see my list off-line, as it were, and who commented on it (yours truly included), liked it. One correspondent referred to it as a good example of a Transportation 101 lecture." Bravo.

[Wednesday's *Wall Street Journal* "Heard on the Street" carries yet another warning about utilities and captive markets. Liam Demming writes that "size matters in the energy business." The argument is that to withstand the financial onslaught of a Gulf oil spill or a radioactivity leak, "consolidating balance sheets and diversifying exposures through mergers offers a way of offsetting high risk premiums," which spills and leaks certainly are. Thus "smaller, regulated utilities make prime acquisition targets" and give the biggies one more reason to cry "captive" when the regulators are looking to stir up trouble.]

This Just In Dept. CSX Transportation is searching for the next big environmental idea with The Tomorrow Moves Project contest on Facebook. The company is encouraging individuals to "like" its Facebook page and submit ideas that describe how they would help protect the environment for tomorrow. A panel of judges will choose two winners who will each receive a $5,000 cash prize.



Source: FactSet. Nat'l Assoc. of Realtors. As of Mar. 24, 2011.

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