THE RAILROAD WEEK IN REVIEW
June 10, 2011

“Economics still demand that corn be planted: 165 bushels per acres of $7 corn is hugely more profitable than 45 bushels per acre of $14 soybeans.” Dennis Gartman, The Gartman Letter, June 6, © 2011 with permission.

Railroads in the corn belt could be in for a banner year, especially if one considers the amount of nitrogen and other nutrients (by the carload) one must put in the ground to grow that corn. It’s good for Class Is all around. good for short lines only where you’re not competing with super-shuttle centers and you have a niche of your own.

Short lines on the terminating end for animal feed and ethanol will do better, I think, because both are part of the heat-and-eat continuum. The STCC oh-one commodity group year-to-date represents 14 percent of 2011 year-to-date total shortline revenue units vs. 13 percent through May a year ago, an increase of some 27,200 units and we haven’t even gotten to harvest.

The AAR reports that May, 2011 carloads increased 0.5 percent year-over-year while May intermodal loads jumped 7.5 percent year-over-year. May, 2011 was the 18th straight month of intermodal gains and is the second highest May revenue-unit average on record. The gains in intermodal can be attributed to growing international trade, better service, large investments in infrastructure and equipment by railroad companies, highway fuel costs, congestion and truck driver shortages, and the even conversion of some boxcar traffic.

“For the second month in a row, rail intermodal traffic was great, while carload traffic left something to be desired,” said AAR Senior Vice President John T. Gray. “Like other national indicators, rail traffic reflects a degree of uncertainty regarding the direction of the economy. Railroads join everyone else in hoping current trends are just a bump in the road rather than a portent of things to come.”

Jason Seidl at Dahlman & Rose writes, “While volumes should continue to improve, we believe the year-over-year growth rate of weekly traffic in the first half of 2011 will remain mostly in the low single digits, limited by unfavorable 2010 comparisons thanks to the then robust growth rates, where we saw some weeks jumping 20 percent over the 2009 comps.” And Thursday I heard Schwab’s Liz Ann Sonders say FY 2011 GDP growth could wind up in the low twos.

How fitting it was to have this week’s 2011 Norfolk Southern Investor Day in Altoona. NS has a story to tell that is steeped in railroad culture and history, and that’s Altoona in a nutshell. It’s home to the Juniata Shops, where the PRR built its own steam and electric locomotives, passenger and freight cars of every type, and was one of the biggest railroad facilities in the country. And Altoona itself at the base of the famed Horseshoe Curve.

In his opening, CEO Wick Moorman acknowledged the shop complex as the “crown jewel” of the Conrail acquisition, where they’re bringing “cutting edge technology” to locomotive fleet management. He also reminded us of the Southern’s “Green Light for Innovation” slogan in the 1950s, when I can remember seeing home-grown ballast regulators and mid-train boxcars with radio sets for remote-control locomotives that were the predecessors of today’s distributed power units.

And while we’re reminiscing, let’s not forget the N&W ran main-line steam locomotives -- many home-built in Roanoke -- longer than anybody else. Moreover, the newest power, the As and Js, were some of the best-designed steam locos ever to pull revenue trains, and the N&W’s ability to service and turn locomotives kept availability at record levels. That’s why it was fitting to have this session in Altoona, a location that a made a name for itself in railroad innovation and service “firsts.”

Chief Commercial Officer Don Seale opened the proceedings with a superb slide set that sets the truck-competitive scene and then segues to how NS leads the other Class Is in variations on the revenue/RTM theme, where that revenue is coming from, and by what percentages by commodity group. Throughout his presentation Seale shows how NS strives to create and nurture long-term profitable customer relations and how continuing investments in infrastructure and industrial development achieve that end.

Chief Operating Officer Mark Manion was next. To me, the best parts were the resource planning and network management segments. These commentaries provided the best detail I’ve seen since the early TOPS presentations many moons ago. Manion acknowledged some service lapses over the past few quarters yet drilled down to causes, and what that boils down to is market intelligence.

This is where NS excels at telling How We Do What We Do. Manion explained that NS forecasting capabilities drill down to commodity O-D pairs based largely on customer forecasts -- market intelligence, if you will. As such, you can only plan on what’s in front of you and absent accurate customer forecasts you’re whistling in the dark. And so it was that unexpected changes in everything from weather-driven coal demand to changes in intermodal patterns to grain forecasts turned what was once thought an accurate forecast into a series of moving targets.

Happily, the Operating Plan Developer is responsive and one can in hours revamp schedules that once took days to change. With roughly 175,000 cars on on the railroad every day, and with every car having several options to get it where it’s supposed to be, having a tool that can do it all even as it minimizes crew-starts, maximizes car-miles per day is an essential part of present-day railroading. And it pays off in allowing one to move more cars faster and farther with fewer assets per revenue move.

Now comes Deb Butler, EVP for Planning and Chief Information Officer to tell the Strategic Thinking story: Why We do What We Do. Much of her presentation went into considerable detail about the technology NS employs to improve train performance, network efficiency and on-time connections and these are in themselves commendable. However, her list of benefits -- train handling, reduced emissions, better event reporting and fuel savings -- didn't give us a feel for how much money is at stake.

We know, for example, that not only is NS an industry leader in revenue per revenue ton-mile but NS also leads the industry in operating expense per revenue ton-mile and lags the industry in gross ton-miles per gallon of diesel fuel consumed. In her Future Track (the label applied to the NS Five Year Capital Plan) coverage, Deb talked about initiatives to improve results in safety, service, revenue growth, workforce productivity and asset utilization. These are all excellent initiatives, but what's the expected benefit in dollar terms?

When Don Graab, AVP Mechanical, took the stage, it was all about locomotives and presented in terms that financial and operating types alike could relate to. His was a strong opener: why NS is the low-cost railroad in locomotive maintenance and in acquiring replacement power. You want numbers? How about the locomotive page of the R-1 report to the STB paired with a peer-chart on annual loco maintenance cost to put NS in context? How does NS do it? The same way the Southern, N&W and PRR did: by growing their own and contracting out as little as possible.

Same goes for replacement power. Everybody knows that you buy new for road power and build the yard and local fleet out of road power that gets cascaded down. But it's hard to cascade down six-axle power into an environment where you need four-axle power because number six and eight turn-outs are the norm.

NS addresses the challenge by making microprocessor GP38-2s out of straight 38s and doing the same with SD40s where they can. They've even invented the SD60E (E for Enhanced) as a low-cost replacement for older six-axle road power. And, best of all, Graab could show the cost savings of new vs. home-grown replacement units. I just would have liked more cost-savings detail in the maintenance charts.

CFO Jim Squires provided some helpful and positive yearly comps on pricing, volume growth revenue, crew productivity, car hire expense, fuel consumption and how the technology and processes outlined in earlier presentations are producing results for NS. His "three pillars" approach to profit growth is constructive: pricing above rail inflation, volume growth above GDP growth, and productivity improvements. What a great road map for short lines.

And even though short lines are short on pricing power, they certainly can contribute to volume growth and productivity improvements. Still, it would have been helpful to see a "waterfall" chart of the trailing twelve-month operating income showing where revenues came from and where it went on the expense side.

When it was all over I came away thinking that even though the Operating Plan Developer is a great tool, we need to know more about how NS is matching specific costs to specific customers. I know of places where branch line customers are seeing less consistent service patterns due to local operating irregularities. These add to cost, making margins thin for these commodity O-D pairs.

My channel checks indicate that NS is taking significant price increases on some low-rated moves to the extent that the customers leave NS and go truck instead, putting more trucks on the highways even as NS is touting its ability to take trucks OFF the highways. There is a disconnect here and it ought to have been addressed.

Both Mark Manion and Deb Butler touched on managing first-mile, last-mile performance and how the LOPA (Local Operating Performance Adherence) tool measures it. Here again we see disconnects where local traffic volumes may not support the assets NS has to put against them, in which case the revenue stream is best protected by leasing the line segment to a local operator. I would have liked to hear at least an acknowledgement of this option during the proceedings. I can name a number of places where a lease to a short line could free up a ton of assets.

We know, for example, that NS recently leased branch lines to short line operators in Michigan and Alabama. I'm sure the investor community would like to know what were the main reasons for selecting these lines (low annual GTMs, high capex requirements, e.g.) and whether this is the beginning another round of spin-offs.

One final note: Wall Street continually carps about the fact that NS, seemingly alone among Class Is, does not provide "guidance" on everything from operating ratios to EPS. I think NS is right to leave "guidance" out of the story, leaving the analysts analyze to the presentation material and come up with their own estimates.

NS has done a great job telling us How Things Work and from that one ought to glean a general direction of revenues, volumes, margins, operating income changes and earnings-per-share. Like Yogi Berra is reputed to have said, you can observe a lot by looking around. I wonder how many analysts took the train to Altoona so they could see the NS action on the old PRR Middle Division.

I'm still soliciting items for my *Trains* feature on short-haul, single-commodity shuttle trains for early 2012 and need your suggestions. The response to date has been gratifying and it's clear these short-haul shuttles are doing great things for railroad and their customers alike. Do keep 'em coming.