THE RAILROAD WEEK IN REVIEW

July 1, 2011

"Uniform rates based on someone else's estimate of average cost necessarily reduce both shipper net utility and railroad viability," -- Tom Erickson, A Railroad Manifesto*, page 21*

The problem with the STB's regulatory reform initiative is that it's based on average costs. Yet with the increased use of activity-based costing, the rails can tell to the penny exactly what every commodity O-D pair costs them: if I do it my avoidable cost is X; if I don't do it my avoidable cost is zero. The big challenge is figuring out how to match the fixed costs -- from shop force labor to heating the home office -- with the revenue from each unit in the train.

Erickson addresses this, saying, "A variable costing technique for a discrete architecture is fatally flawed if the database is populated with average statistics, not local specifics. By definition, a 'variable' cannot remain the same percentage of the whole. Non-movement-specific data cripples most variable costing models, such as the STB's Uniform Rail Costing System."

As to the hearings themselves, US Rail Desktop's Mike Behe writes, "My take is the Board will have a hard time acting on any of this, but there were some smoking guns. If proof is delivered that competitive coal rates in the west are higher than captive, that could be a biggy! IF they've done this with coal rates, will chemical rates be next? Could be the Board might have to change their rules for bringing rate challenges.

"The other issue that I found compelling is that under the Board's rules nobody has gained competitive access. Even blindly pro-railroaders know their are situations where reasonable cost switching is the answer." True enough. See the Conrail Shared Asset Operations in Detroit, Philadelphia and New Jersey or Pacific Harbor Lines in LA/Long Beach.

Behe again: "For example, my plant sits on the western edge of an eastern railroad and I have opportunity to ship west. As is, the railroads in the route come to an agreement. But what if they aren't permitted to talk to one another about prices any more? Everything would be rule 11. How do you accommodate the short line element in a world where the Class 1s don't speak to one another?"

As an aside, it looks like we're heading to Rule 11 with short lines anyway as handling fees are increasingly showing up as Class I rate add-ons from the junction. Moreover, activity-based costing quickly tells the market manager the margins of any move, and if that move involves a short line the numerator in the revenue/cost calculation is reduced by the shortline fees. Add to that the expense of equipment dwell time at the interchange, crew time in making the interchange and the admin cost of the short line group and the short line's economic advantage can vanish.

The Rule 11 matter may come to a head sooner rather than later. Privately-held Oxbow Carbon & Minerals LLC, a marketer of coal and natural gas, has UP and BNSF. According to a note on zacks.com, Oxbow accuses the two railroads "for monopolization and price fixing to illegally

increase freight rates of shipping coal and other products." The complaint continues: "Since 2003 Union Pacific and Burlington Northern colluded to avoid direct competition with each other. Union Pacific refused to ship coal from its Oxbow's Elk Creek Mine in Colorado west, to avoid competing with BNSF." Not content to let it stop there, "Oxbow further claimed CSX and NS were also a part of this price rigging and monopoly practice," though the lawsuit stopped short of naming them as parties to the matter.

From this it would appear that the game's afoot to discourage railroads from creating through rates by negotiating routing protocols and divisions. Last September the Senate Commerce Committee decreed that (Zacks again) "the discretionary pricing power enjoyed by the Class I freight rail transport companies are (sic) putting excessive pressure on the freight customers" and traces the roots of this "pressure" to the Staggers Act 30 years ago.

The Zacks article makes the argument that "the railroads are hiking their freight rates by nearly five percent per annum and maintaining double digit profit margin." Well, yes. And labor costs are going up at that rate or more. Coal revenue-per-unit increases -- and that's really what Oxbow is all about -- were in the 10-20 percent range, though some of that is due to mix changes as met and export coal became a larger part of the mix. Not discussed is funding the capex required to run these trains in the first place, cutting car-cycle times and letting the utilities move more coal with fewer cars.

But I digress. If the rails are to be told they can't create through rates without being charged with collusion, it's back to Rule 11. And so a shipment of steel that begins on the Brandywine Valley and is destined for the California Northern will create four pricing negotiations: one for each short line and one each for NS and UP or BNSF, depending on which western carrier takes it, four invoices, and four checks to be written. Now who benefits? Most likely the Teamsters.

Reader John Hoegenmeier, a shortline economist who advises Class Is on such matters, picks up on my GWR/RA note from last week. He writes:

> Your reporting of the lackluster carload growth rates of the two largest short line holding companies reminded me again that we may be near a major turning point for the short line railroad industry. Two issues facing the industry today are changes in the shortline competitive landscape and the consolidation of short lines into holding companies.
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> We really need to segregate the two components of the short line industry; the large corporate holding company roads and the locally owned roads. Both Genesee & Wyoming and RailAmerica have assets of over $1 billion with revenues in the area of $500 million, hardly "mom-and-pop" operations. Thus the impression that the 533 shortline names are all "small businesses" can be deceiving. And, if you look at overall revenue per ton-mile, there is much less of a disparity between the short lines and Class 1s.
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> As for changes in the competitive landscape, domestic intermodal can indeed cannibalize the short line carload business which is prevalent on short lines. But the growth in this market due to efficiencies and market reach will continue at the expense of the short line

carload business. Logistics have changed, making short line participation in some segments more difficult.

Transloading on a Class 1 is another major threat. Transload facilities operate more efficiently when they are larger facilities which take advantage of economies of scale. And since there is a truck component to a transload anyway, an operator may prefer a Class 1 to avoid the short line interchange and longer transit times, where the out-of-pocket cost differential between the transload and the short line fee puts the former in a stronger position.

Unit train operations remain a challenge for short lines that is particularly felt in areas where country grain elevators on short lines compete with super-shuttle elevators on Class Is. Your recent search for examples of where it works is an excellent endeavor to determine under what circumstances a short line could participate in these moves.

Finally, short line holding company consolidation over the last 10 years has been dramatic. GWR and RA combined control more than 100 road names operating en excess of 10,000 route-miles. Both of these companies have consolidated functions and centralized support systems, so much so that the local "personal touch" has been eliminated, making these organizations look like two Class 1s with fragmented lines.

What was heralded just a few years ago as the "short line advantage" has been lost unless you are served by a locally-owned short line. Customers have taken notice, and are probably less likely to pursue locating on a short line with the same effort as in the past. If the short line is solely served by a single Class 1, there is no competitive advantage to locating on it, so why do it? This could begin a trend of short line carload growth actually being below that of Class 1 carload growth."

Thanks, John. Let's see how Class I and shortline readers alike react to the realities you present so eloquently.

Providence & Worcester's 10-Q for the 2011 first quarter is pretty much par for the course. Operating revenues were $6.3 million, up 11 percent. Operating expenses increased 19 percent to $8.7 million and the operating loss was 59 percent worse, $1.8 million. The operating ratio worsened to 126.6 from 118.6 a year ago. Revenue units dropped two percent, though the system RPU improved 11 percent to $861, propelled in part by nine percent more conventional carload revenue. Common loss per share tripled to 43 cents from 14 cents. On the balance sheet, they again burned Retained Earnings, down seven percent or nearly $3 million. Enough said.

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