# THE RAILROAD WEEK IN REVIEW

## September 23, 2011

*"New England Central's professional railroaders handled the incredible job of restoring the railroad to service after the devastation of Hurricane Irene both quickly and safely." -- John Giles, President, RailAmerica*

**Steve Cucchiaro, Chief Investment Officer, Windhaven** Investment Management, writes in his Second Quarter Review that out-of-control debt problems in Greece and elsewhere may yet wash ashore in the US. Without sufficient growth to lower sovereign debt to manageable levels,

> [these countries] could in turn be forced to seek financial assistance from the Federal Reserve Board and possibly China, impacting the wider global economy. At the same time, Japan, the U.K. and the U.S. are also being forced to tighten fiscal policies and reduce their unsustainable growth in debt.
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> While most of the developed world will be engaged in debt de-leveraging for an extended period, U.S., European and Japanese economies will likely struggle to grow meaningfully without continued monetary stimulus from the major central banks. Consequently, we expect *short-term interest rates to remain low in these countries and negative in real terms compared with inflation*. [Emphasis added -- rhb]

And in a nod to the rails, Cucchiaro adds, "Equity indices we find attractive at this time include companies that have demonstrated an ability to generate profit and dividend growth even while the economy is growing slowly. These include U.S. large companies (particularly those with dividends that have appreciated consistently over the past several years)." The railroads surely fill the bill here. However...

**Non-market forces may conspire** to shut off the revenue stream. A statement from Brotherhood of Locomotive Engineers and Trainmen National President Dennis R. Pierce says the organization is going to poll members to authorize a strike in the event one becomes necessary to attain the organization's bargaining goals.

"The National Mediation Board released the BLET and several other Rail Labor unions from mediation with rail carriers on September 6, triggering a 30-day cooling off period, which expires at 12:01 a.m. Eastern Daylight Time on October 7, 2011. At that point self-help is available to the parties, unless President Obama appoints a Presidential Emergency Board (PEB) pursuant to Section 10 of the Railway Labor Act. A PEB would halt any strike or lock out by the parties, and would investigate and issue a report and recommendations concerning the dispute."

I'm not holding my breath. We have an administration that is deeply in hock to the unions and is working hard to pay off that debt -- see General Motors and Boeing for two. And although the larger labor organizations may have agreed to terms, it seems we always have one or two renegade outfits who need to make their own waves, shutting down everybody else. I would not be surprised to see a strike of at least a two-weeks duration before the grown-ups in Congress take charge and end this silliness.

**This week's sudden drop** in share prices puts me in mind of something Schwab's Chief Investment Strategist Liz Ann Sonders, Director of Market and Sector Analysis, wrote two weeks ago. She says the bottom line is that growth is likely to be constrained in this era of working down debt as well as waning consumer and businesses confidence. One bright spot continues to be corporate earnings, and if a recession is avoided, the market could perform fairly well even as earnings accelerate.

Which is all well and good, unless you make your living moving stuff around the country, both raw materials and finished goods. And if you get paid the same amount regardless of carload contents, you live and die on volume. Increasing "same-store" pricing isn't going to do you any good, nor are the "jobs" created building more highways. If anything, you lose because short line grants come out of highway money, anyway.

**"Heat and eat" commodities** are continuing bright spots for short lines and regional railroads. Iowa Pacific Holdings (IPH) is a case in point. Their Texas-New Mexico Railroad (TNMR) subsidiary is a key rail line in the Permian Basin oilfield. TNMR has experienced massive growth in rail carloads -- now hitting 7,000 a year -- as a result of new oil and gas exploration. New customers coming on stream in 2011 and 2012 will result in a tripling of carloads to 21,000. In addition, a proposed crude oil unit train facility is under development, and could add another 30,000 annual carloads to the railroad as early as the third quarter of 2012. Better track is definitely in order and funding is on the way.

Proceeds from the recent Arizona Eastern sale to GWR is will provide what IPH President Ed Ellis calls "substantial funds" for capital spending on existing infrastructure, facilities and equipment elsewhere, such as on the TNMR. The line runs between a connection with the Union Pacific at Monahans, TX and Lovington, NM, about 100 miles away.

Over the past two years IPH has invested about $10 million in track upgrades, mostly for ties and surfacing. Thanks to the Permian Basin developments, IPH plans to invest another $20 million in the form of newer, heavier rail to support increased volumes of heavy cars of sand, crude oil, and other oilfield commodities.

Moreover, the cash infusion also includes upgrades to TNMR's locomotive fleet, a new locomotive maintenance facility to be constructed in Eunice, NM, and additional interchange capacity art Monahans to improve the flow of traffic. The oil field E&P guys say the rail traffic outlook is solid for at least a ten-year period and TMNR is in negotiations with more than a dozen additional customers looking to locate along the railroad.

**DeutcheBank's investor letter *DBA Today*** reports (September 20) that share prices of the transports have of late done better than the broader market. " In the past month, our transport universe has improved 11.5% (vs. S&P 500 up 7.2%), highlighting the significant improvement in shares from oversold levels during the summer. Transport shares have outperformed in recent weeks as fears of a recession in the U.S. have eased somewhat heading into peak season. We continue to anticipate a brief peak season as low inventory levels necessitate a seasonal pick-up in freight volumes ahead of the holiday shopping season."

IMHO much of this will be reflected in the intermodal group as finished goods shipments. Short lines make their money on the raw materials side so any holiday-related increases are already baked into YTD vols. Heat and eat -- grains, ethanol, coal, shale-related commodities will continue unabated. I wouldn't expect any more than low single-digit increases yoy.

DBA Today is less optimistic about housing. "Although in the near-term we anticipate a short-term lull in some of this week's housing reports, recent developments within this severely depressed sector of the economy merit attention. At the moment we see a sharp dichotomy between new-construction inventory and the resale market."

***Barron's* last week** (Sep 5) brings us back to the future via Robert Heinlein's 1950's classic *Door into Summer*. Tom Donlan's "Editorial Commentary" notes that economist Alan Kreuger, late of Princeton and recent Obama hire, is "widely credited with with devising the 2009 "Cash for Clunkers program," intended to keep auto workers employed making cars to replace serviceable vehicles destroyed with a government subsidy. Under the program, the feds wrote checks totaling $2.85 billion for 677,000 cars traded in.

As it happens, says *Barron's*, "nearly all the cars bought by the feds were built before the Clunkers program began. At best, Cash for Clunkers was a subsidy to car dealers to move inventory, and there was a matching decline in later vehicle production. No federal estimate of the number of jobs later destroyed or not created is available."

The Heinlein link is to be found on pages 140-141 of the current edition, where the author describes an element of 21st century auto industry practices, launched by government loans to the auto industry:

> [They were] crushing new ground limousines so that they could be shipped back to Pittsburgh as scrap. Cadillacs, Chryslers, Eisenhowers, Lincolns - all sort of great big, new powerful turbobuggies without a kilometer on their clocks. Drive 'em between the jaws, then crunch! smash! crash! - scrap iron for blast furnaces.
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> The shift boss explains, "You can't run a blast furnace just on ore; you have to scrap iron as well. Matter of fact with high-grade ore so scarce, there's more and more demand for scrap. The steel industry needs these cars. It's a simple matter of economics.
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> "These are surplus cars the government has accepted as security against price-support loans. They're two years old now and then can never be sold....so the government junks them and sells them back to the steel industry." [The shift boss is asked if this isn't a waste of money and materials.] "It just seems wasteful. You want to throw people out of work? You want to run down their standard of living?"

Care to see how it works? Try this: http://www.youtube.com/watch?v=qTYL-h5_hb4 . [*Warning: For those who care about lovely cars, this is like watching an execution*.] Concludes

Donlan, “Even the federal agency assigned to brag about the program estimated that only about 60,000 jobs were "created or saved" by the program. That's $47,500 per hypothetical job, which is not as expensive as some federal job-saving programs. On the other hand, the program only lasted four weeks. Multiply $47,500 by 13 and the cost runs at a rate of $617,00 a year.” Your tax dollars at work.

Now what’s all that got to do with short lines, you ask? Not much, directly. But think about where you’re seeing similar activity in our favorite industry and the ramifications thereof. For openers, try this one from an Ohio observer:

> There have certainly been crossing projects of marginal utility. In Rossford, Ohio, an industrial spur to a new bakery got full lights and gates at a road crossing when the spur was built, even though the bakery only gets switched a few times per week. I don't know who paid for the lights and gates at a location where basic crossbuck signs surely would have sufficed in a rational calculus. It's overkill, apparently rooted in fear of liability for collisions involving the clueless. In Ohio, the state pays for the equipment and installation (often passing through federal grant funding to do so), but the railroad becomes responsible for maintenance. All crossing upgrades I have reported on include gates as well as lights; they don't do lights-only installations here any more.

**Union Pacific Railroad is investing nearly $300 million** over the next several years double-tracking its central corridor between Fremont, Neb., and Missouri Valley, Iowa. The project will make a more fluid railroad through more efficient operations, higher speeds, better equipment utilization and less delay time. Construction has already begun with three miles of second main line and a three-mile passing track west of Missouri Valley, Iowa. The track is scheduled to be completed by mid-2012.

These projects are part of a nearly $300 million investment in building 29 miles of second main line track between Fremont, Neb., and Missouri Valley, Iowa. Trains traveling from the West Coast to Chicago operate over Union Pacific's central corridor. When eastbound trains get to Fremont, Neb., they operate either through Blair, Neb., to Missouri Valley, Iowa, to continue east to Chicago or they go to Omaha, Neb., then north to Missouri Valley to continue east.
The Blair route is 25 miles shorter than the Omaha route. Though shorter, the Blair line is currently single track and train capacity is limited between Missouri Valley and Fremont. When the double-track project is complete, each train that operates over the shorter Blair route will save two to four hours travel time.

**It’s business as usual for the New England Central** Railroad (NECR). Nearly four weeks ago Hurricane Irene swept across RailAmerica-operated NECR, which stretches from the Canadian border near St. Albans, VT, to New London, CT. Railroad crews discovered the extent of damage on August 30 and quickly restored service to NECR’s north end between Burlington and Swanton, VT, and its south end between White River Junction, VT, and New London, CT.

But things were different on the NECR’s mid-section, roughly White River Junction to Essex Junction, VT, where Irene downed trees, washed out track and knocked down bridges. (See sample photos in WIR Sep 2). Damage was especially severe across six miles of rail line near

Roxbury, VT. Rail service through the Roxbury area was restored on September 19. The NECR arranged for some shipments to move via detour trains and alternative routes while the Roxbury section of the railroad was out of service.

It took a team of close to 90 people and 15,000 tons of ballast to restore rail service on the NECR. "We appreciate our colleagues' hard work, our customers' patience and the cooperation of our connecting carriers" said John Giles, RailAmerica President and CEO. "I am especially proud of the fact that our professional railroaders handled this incredible job both quickly and safely."

The NECR worked closely with the Vermont Agency of Transportation to coordinate the work, gain access to otherwise closed state roads and perform emergency repairs. Several railroads in the region, including Canadian National, Pan Am Southern, Amtrak, and Providence & Worcester, provided much needed equipment to transport large volumes of rock and fill. Local Vermont vendors worked tirelessly to provide support in the form of crushing stone for ballast, trucking, and railroad contract services. "We greatly appreciate everyone's efforts and team spirit," said Charles Hunter, RailAmerica AVP of Government Affairs.

**Management by Walking Around Department**. I've noticed of late certain Class Is bragging bout their improved average system train speed stats even as their local service to short lines as become more uneven. The AAR website tells us, "Train Speed measures the line-haul movement between terminals. The average speed is calculated by dividing train-miles by total hours operated, excluding yard and local trains, passenger trains, maintenance of way trains, and terminal time."

I asked the AAR's Holly Arthur how to square the two: average speeds down vs. local speeds up. She writes, "Average train speeds are just that, averages. They are not indicative of what the performance may be for any individual train or group of trains, either through trains or locals. Individual trains may vary considerable from the average. The fact remains that if average train speed is declining, network performance has to be improving in most areas, including the locals that are not measured.

"Even if a particular short line is not getting as reliable an interchange as they would like to have, their customers, the focus of these measures, are likely getting better overall service if the metrics are pointing in the right direction." Thanks, Holly.

**Kansas City Southern short lines convene** in Kansas City Tuesday and Wednesday in the Union Station conference center. I'm looking forward to a fascinating series of talks on topics ranging from operations to marketing to Mexico. Do make it if you can.