THE RAILROAD WEEK IN REVIEW

November 9, 2012

"More than a dozen ethanol producers have filed for bankruptcy in the last 18 months." -- Bloomberg, Nov 7.

BNSF revenue for the quarter was $5.3 billion, up eight percent year-over-year, on 2.4 million revenue units, up six percent. Operating expense was up a mere three percent to $3.7 billion; operating income jumped 21 percent -- the best delta among the Class Is -- to $1.7 billion. The operating ratio came down 3.4 points to 68.8, a virtual tie with UP's 66.6 and the 66.7 KCS scored. Net income was $937 million, up 22 percent over 3Q2011.

Volume comps were favorable across the board. Consumer products (intermodal and auto) gained four percent, industrial products (where most short lines live) increased 14 percent, coal was up four percent and agricultural products (another short line strength) up three percent. Industrial products volume increased primarily as a result of a tripling of crude oil carloads plus increased sand shipments. Coal gained partly on easy year-over-year comps after last year's severe flooding along key coal routes during the third quarter of 2011. And ag was helped along by a higher number of soy bean shipments.

BNSF provides detailed weekly revenue unit volume figures by commodity here. The weekly tables don't break out commodities as to consumer, ag and industrial, so a little digging is required. Suffice to say intermodal and auto are in "Consumer," (though I put auto in merch carloads because that's where the other Class Is have it), coal is in coal. Ag is grain, grain mill and "farm." Everything else is Industrial Products.

The BNSF merch carload franchise (including autos) vols were up 11 percent to coal's four percent and intermodal's three percent, leading the way in revenue unit growth. Within the group, sand & gravel (frack sand is here) was up 12 percent and petroleum (normally with chems) nearly doubled, and it's just getting going, too. In all, a solid quarter, especially for the merch carload sector.

The tea leaves point to a continuation of same. Chief BNSF Commercial Officer John Lanigan is taking his retirement on Jan 15, 2013 and the leadership changes put all the right people in the right places, IMHO. Steve Bobb becomes the new Lanigan, Steve Branscum gets the coal group and Katie Farmer the consumer products desk. Happily, Dave Garin, who's done such a great job with the carload sector, stays put. Thanks, John, for a great ten years. And best wishes to Katie and the two Steves (sounds like a rock group) in their new assignments.

The Berkshire Hathaway 10-Q is useful for more than just the BNSF numbers. Berkshire has owned 80 percent of Marmon Holdings (Union Tank Car's owner) since 2008 and is “contractually required to acquire substantially all of the remaining non-controlling interests of Marmon no later than March 31, 2014,” meaning all that Bakken crude provides a double revenue stream for BRK.

A bit of UTLX history may be in order. The company was founded in 1866 to support Standard Oil’s western Pennsylvania interests, was acquired by the Rockefeller interests in 1891, and was divested into the Union Tank Car Company in 1911 when the Supreme Court broke up Standard Oil. Over the years Union Tank had become a lot more than just rail cars so in 1969 the Trans Union Corporation was formed as the parent holding company.

That outfit was in turn acquired by the Marmon Group in 1981, which was then rolled into the Berkshire Hathaway Family of Companies 27 years later. The Bakken crude oil by rail business now brings UTLX full circle, back to the petroleum business where it started, thus proving once again that What Goes Around, Comes Around. (And, oh yes, don’t forget BRK’s XTRA container leasing company.)

RailAmerica has posted its last set of quarterlies as GWR will include RA’s 4Q2012 results with its own results under the “equity method” below the line. Third quarter freight revenue was up eight percent to $113 million on 214,357 carloads (that’s really carloads as RA handles no intermodal boxes in revenue service), up four percent; system RPU was up four percent as well (same-railroad up one percent), thanks mainly to pricing, mix and FSC.

Coal is back to ten percent of carloads from less than eight percent a year ago while the Metallic & Metals and Paper commodity groups both declined three points as percent of the whole. The Industrial Products group was up four percent year-over-year largely due to growth in petroleum, motor vehicles and the mix of commodities -- crude oil included -- that move within RA’s “other” commodity category. Met ores & Metals are off 12 percent, Chems are up 3 percent, helped by the Marquette Rail acquisition and more ferts to the Midwest.

Paper is down eight percent; ag products are up four percent on whole grains, grain mill products and export beans and meal to Asia. Corn and wheat volumes are down, as are DDGs and beer. Construction materials -- STCC 24 and aggregates, mainly, -- are showing “slow but consistent growth” particularly in the PNW. Non-metallic minerals growth was mostly the result of volume gained through the acquisition of Marquette Rail. Non-freight revenue increased 21 percent and is now 27 percent of total sales, up from 25 percent a year ago, pushing total revenue up 11 percent to $155 million. The big gains are in car storage, car repair and contract switching.

Operating expense as reported jumped 24 percent due to an $18 mm increase in purchased services related to the GWR transaction, dropping year-over-year income down an eye-popping 31 percent. I backed out the charge and found ops income from running the core business was up an admirable 39 percent --strong stuff as I wrote in my lead above. Not a bad way to write *finis* on Act II: RA is running pretty well now and GWR has garnered themselves a handsome prize.

Genesee & Wyoming's 3Q 2012 saw freight revenue increase five percent to $108 million on 192,168 revenue units. Once again "other and haulage" vols were cut in half as the NS overhead coal that worked so well in 2011 has dried up. Minerals & stone took a 21 percent hit (16 percent same-railroad) on lower road salt shipments. Met ores and lumber were up double-digits on frack sand and housing starts. To date GWR has not participated directly in crude-by-rail but during the Q&A on the call CEO Jack Hellman said the RA deal will help with terminal access; significant origins are still lacking.

Non-freight revenues (terminals and smaller short lines) came to $43 million, unchanged and remaining at roughly 29 percent of total sales. Total NA revenue was $150 million, up three percent. Operating expense was $117 million, up eight percent, and ops income was $34 million, down 12 percent; the North American railroads operating ratio finished at 77.7, a deterioration of 3.7 points. Below the line, after non-GAAP adjustments for the RA transaction, GWR earned 74 cents a share, up 3 percent.

Nebraska Northeastern Redux. A long-time WIR subscriber who knows his way around the corn belt writes,

> Back in mid '90's, that line had a couple of 50-car corn, bean and wheat loaders to go with a handful of single-car ferts receivers. Barge competition out of Sioux City, processors in Sioux City/Omaha and the NE Central short line out of nearby Norfolk kept traffic down. BN couldn't wait to get off it.
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> How the world changes. Now there are at least three 100+ car shuttle loaders and a couple unit-train ethanol loaders to go with the DDG by-products and higher inbound ferts volumes. Class 1 unit train economics were always comparable to short line efforts – and that gap has likely widened the past several years in favor of the bigger RRs. If BNSF can justify buying back 125 miles of corn/soybean branch line RR, look for more such buybacks of properties like it – but with lower track miles - that have morphed into unit train operations. There are more than a few out there.

Couldn't agree more. Short lines took off after Staggers as they were the true low-cost operators. Two-man crews, happy to run trains over 10-mph track and with first-generation diesel power, working for flat FAK per-car revenues as opposed to full ISS divisions, and so on. Now the Class Is have two-man crews and remote-control units, have the capital forces to keep branch line track up to 40-mph specs, and would like not to have to split revenues with the short lines if they can help it. My correspondent has a point: this buy-back may be just the beginning.

Redux Number Two has to do with ethanol. In WIR Oct 5 I asked rhetorically whether the bloom was off the ethanol rose and gave a sense of why it looks that way. Now comes Bloomberg this past Wed with this update:

> Shrinking distilling margins have resulted in a 14 percent drop in output this year to 12.6 billion gallons annually, Energy Department data show, 600 million gallons short of the amount refiners are mandated to use under a 2007 law that calls for escalating consumption of the biofuel. That would be the first yearly decrease since 1996. As many as 10 companies, from Valero [*which I own -- rhb*] to Biofuel Energy, have closed distilleries after the worst drought since the 1950s sent the price of corn to a record just as gasoline demand slumped. And more than a dozen producers have filed for bankruptcy in the last 18 months, including the country's largest -- VeraSun Energy in Brookings, SD.
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> Based on December contracts for ethanol and corn, producers are losing about 39 cents on each gallon of the biofuel made, according to data compiled by Bloomberg. They were earning 29 cents a gallon a year ago. The 2007 Renewable Fuels Standard requires refiners to mix 13.2 billion gallons of biofuels, such as ethanol, with gasoline in 2012 and 15.0 billion by 2015. The Energy Department now estimates that ethanol production will fall to 13.0 billion gallons next year, nearly six percent below the 13.8 billion consumption target.

That's an 800 million gallon spread, enough to fill more than 13,000 trains of 100-cars at 600 gallons each. US RailDesktop says UP, to pick just one Class I, is getting something on the order of $4,500 per car and did some 100,000 cars of ethanol in 2011. Six percent of that revenue stream is $27 million, a fair piece of change. And clearly it's the marginal producers and distributors that are the first to go, meaning serious revenue hits to those short lines that have built their franchises around ethanol.

The Paper Barrier Battle is afoot once again. The STB in Decision EP 714 proposes to re-write the rules that govern branch-line sales or leases to other operators. The decision specifically targets paper barriers and wants "information on any interchange commitment's impact on shippers and on the purchaser or lessee railroad."

For every new application that entails an "interchange commitment" (paper barrier to you and me) they're asking for -- among other things -- a list of shippers that use or have ever used the line in the last two years, carload vols for each, the names of potential connecting railroads, and what percentage of the acquirer's revenue might come from the railroad putting up the paper barrier.

The Board is concerned with "interchange commitments that last in perpetuity" and I think that's a good thing. We all know of leases that were made in the early post-Staggers years that were appropriate then but by now have little or no bearing on the shortline franchise that has evolved since then.

That is not to say I go along with the EP 714 language, however. Even though the carload info is to be submitted "under seal," I object to having the feds tell me what I can and cannot put in a contract with people who wish to do business with me. And to the extent that others object as well, this could have a chilling effect on line rationalizations. Staggers was intended, after all, to *preserve* rail service. I'm not convinced 714 perpetuates that intent.

And in one more example of an egregious waste of time ginned up by the regulators, the STB has decreed that Berkshire subsidiaries Marmon and MidAmerican Energy must divest themselves of two tiny short lines, total 18 miles, that are called common carriers but which appear to be more like industrial switchers. Says the ruling, Berkshire must sell these properties to "persons that are neither rail carriers... nor own other rail carriers."

Between these two STB actions and the turf war over whistle-blowers OSHA is waging with the FRA (and winning, according to the recent UP shortline meeting presentation), I can see the regulatory heat being turned up on the railroads, and the short lines are going to bear the brunt of it in terms of percentages of revenues spent in compliance. Not a good time to be a small, independent single-car short line.