THE RAILROAD WEEK IN REVIEW

November 30, 2012

"Given the high fixed costs associated with rail operations, average costs will be far above variable costs for small railroads operating over light density lines." -- Carl Martland, MIT, Verified Statement before the STB, April, 2011

The Metals commodity group, according to the RMI RailConnect Index, represents eight percent of Class II and III railroad carloads. Year-to-date through November 10 the group is down five percent and to just over 460,000 units. How much of that is finished metals and how much is iron ore is hard to tell, though if we use GWR as a proxy for the North American short line and regional universe, it would appear metals (coiled sheet, plate steel, I-Bars, re-bars and the like) represent about 88 percent of the business.

As for the state of the steel business, Brad Sorenson, Schwab Director of Sector Analysis, rates the materials sector (of which steel is part) Underperform because

> economic growth in the US is still sluggish, there is a deepening recession in Europe, and Chinese growth has disappointed while the country's monetary and fiscal responses have been relatively tepid. We continue to believe these issues are unlikely to change near term so an underperform rating is appropriate for the time being.
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> Positive factors for the materials sector include the developing countries' need for more natural resources to support their infrastructure building and signs that China may be mounting a monetary easing campaign, which should help to support the materials sector. Negative factors include a slowing of Chinese steel demand as the country transitions from a net steel importer to a net steel exporter. Several governments are implementing austerity measures, potentially crimping demand for materials, and wage costs are rising in the materials sector.

Schwab gives the Metals and Mining Group an F rating, meaning don't go there. However, within the group are such names as Reliance Steel, Worthington, Allegheny Technologies, Nucor, US Steel and ArcelorMittal that earn B (weak buy) or C (hold) ratings. If this is the case, the market for steel must not have gone totally south, yet shares for Cliffs Natural Resources, the largest producer of iron ore pellets in North America, have nose-dived to $30 from $75 year-to-date. That seems a bit of a mystery as North American carloadings of iron ore -- at least for the first half of 2012 -- are not that far off their 2008 peaks.

Cliff's ore production goes primarily to integrated steel companies in the United States and Canada from their six North American iron ore mines located in Michigan, Minnesota and Eastern Canada that represent nearly half of total North American pellet production capacity.

Canadian National is the dominant rail player with well over half a million loads out of the mines in northern Michigan and northeastern Minnesota, having absorbed such classic ore names as the Missabe Road and the Duluth South Shore & Atlantic. The Lake Superior & Ishpemeg remains, though for how long is open to question. BNSF is a distant second, with a quarter of that volume, thanks to the remains of the GN heritage around the Hibbing mine and its Allouez ore docks at Superior. The only other extant short line is the Escanaba & Lake Superior, but is a smallish player as it doesn't reach any of the Cliffs facilities.

Another factor working against Cliffs Natural and the iron ore trains is the electric arc furnace that makes new steel out of scrap steel and uses no iron ore at all. ArcelorMittal runs a huge EAF facility at the former Lukens Steel facility in Coatesville, Pennsylvania, and Nucor has established itself as North America's leading recycler of scrap steel. But iron ore and taconite aren't out yet. Thanks to cheap and abundant natural gas, Nucor is building a "direct reduced iron" facility in Convent, Louisiana, where Nucor will team up with gas-driller Encana to provide a dependable, sustainable source of fuel for the ore-based process.

Nucor says the new facility, "together with our ability to ensure a long-term low cost of natural gas, is an important phase in the execution of Nucor's raw material strategy of providing 6-7 million tons per year of low cost, high quality iron units to our steel mills." I see iron ore in by rail and "sponge iron" from the DRI process out by rail, just at the Coatesville plant feeds slab iron to ArcellorMittal rolling mills elsewhere.

Norfolk Southern Chief Financial Officer John Rathbone held forth at the Goldman Sachs Global Industrial Conference held in Boston two weeks ago and his remarks about service performance were particularly apt. Terminal dwell is one component of the NS "Composite Service Performance" and runs a close parallel with UP's days-between-loads metric (WIR 11/2/2012). Recall that UP said it didn't include shortline dwell, but perhaps it should. Ditto with Norfolk Southern.

The measurement tools are at hand, beginning with the NS standards for shortline event reporting. A note on the Shortline Integration page at www.nscorp.com says more work is needed to eliminate "black hole" reporting errors that leave gaps in any car's trip plan compliance. The challenge to short lines -- especially the smaller ones -- is to pay as much attention to reporting the movement as they do to the movement itself.

NS has established event reporting goals for every car movement from interchange-received to interchange-delivered and include actual and constructive placements, customer releases, and so on. Within this framework short lines are expected to report 80-90% of all reportable events within a specific time after the event, typically four to six hours. Personally, I can't see why there should be any delay at all. Here's why.

I run my business through the Apple iCloud. When I make a note on my iPhone, it shows up immediately on the MacBook base station computer and on the iPad. and when I make a note on

the office machine it shows up immediately on the mobile devices. I know this may sound like an Apple pitch, but I risk that because it shows the technology is there and can be applied in the field. The big benefit is letting the T&E crews take charge of the event reporting so they can show customers how the car is moving in real time. And forget about trying to report events six hours after they happen.

The fiscal cliff that's dominating the headlines has yet to rear its ugly head in any shortline conversations I've had or even get a note in the trade press. Yet Obamacare is likely to be "the biggest headwind from government for business in 2013," according to Bret Jensen, former Chief Investment Strategist a Miami-based long/short hedge fund. Writing for seekingalpha.com,

> The CBO estimates this legislation will mean 800,000 job losses. I think that estimate will come in on the low side as companies slow or curtail job growth to deal with the extra costs of this legislation. Small firms that are close to the 50 employees that trigger the penalties will be particularly impacted as will companies that operate low margin business with a large number of currently uninsured employees. Costs will also come in higher than expected for the government as companies opt to pay the $2K per employee fines and dump their employees with minimal existing coverage on this new entitlement program.

What's really scary about the health mandate is the way short lines have gone from being the low-cost rail alternatives in the early nineties to being much higher cost options today. Increasing fixed comp & benefit expense or limiting hires to stay under the 50 employee limit will not help anybody. And if you doubt this, take another look at Carl Martland's Verified Statement before the STB a year ago. (It's in the aslrra.org library.)

> Given the high fixed costs associated with rail operations, average costs will be far above variable costs for small railroads operating over light density lines. On high density Class I rail lines, the fixed costs of track maintenance, supervision, and communications and control can be spread over vast amounts of traffic. As a result, average costs of operation over these lines are not greatly in excess of variable costs, and changes in traffic volumes will not have a dramatic impact on variable or average costs per ton or per ton-mile.

And that's one reason BNSF took back the NENE: to spread the cost of upgrading and maintaining that line segment across a 30,000 mile system, something no shortline operator can do. Let me repeat: ten mph and a cloud of dust doesn't hack it amy more.

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