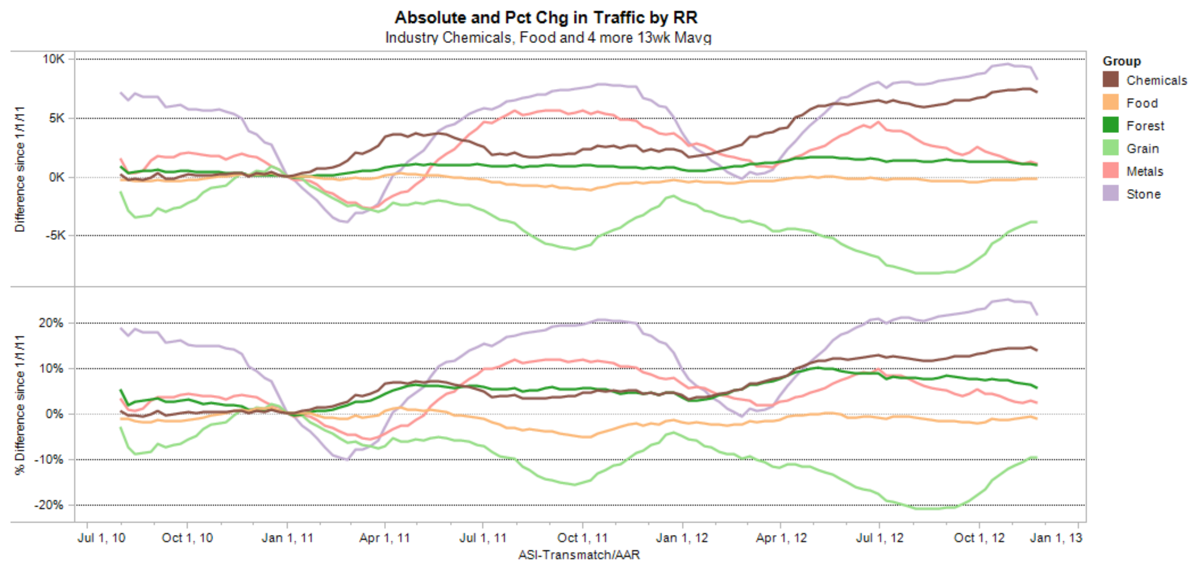
THE RAILROAD WEEK IN REVIEW

December 7, 2012

"Customer service is doing what you say you're going to do." Hunter Harrison, CP

Class I revenue units through mid-November, measured from Jan 1, 2011, aren't showing a very pretty picture. Chemicals and stone are the only commodity groups showing any life since Jan, 2012; crude-by rail (though STCC 13 still in the chems commodity management group) and frack sand are the likely suspects.



Fewer than 15,000 carloads of crude moved by rail in the 2011 third quarter; by the end of this years's Q2 the number had jumped to nearly 100,000 units with BNSF and UP the clear leaders with roughly 34,000 loads each with CP in a firm second place at 12,000 units. At the end of Q2 this year the rest were clustered in the sub-5,000 units range, with NS the leader in growth rate over the past three quarters. Crude-by-rail is the reason for the steeper slope in the chems line.

Frack sand has not done nearly so well (all these car trends are from US Raildesktop, BTW). The commodity started to take off in 3Q2009 and rose at a goodly rate through 4Q2012 when the growth rate flattened out. BNSF 3Q2011 through 2Q2012, up 11 percent whereas the rest of the names remained unchanged, with CN and CP actually coming in slightly. This explains the slower rate of change in the grey line above since October, 2011.

The AAR says YTD revenue units through Week 47 (ending Nov 24) inched up eight-tenths of one percent. Carloads including coal and auto were off 1.9 percent; intermodal was up 4.5 percent. Revenue units ex coal, auto and intermodal actually increased 1.3 percent. Still nothing to write home about, but at least it's a positive number.

RMI's RailConnect Index of short line and regional railroad revenue units for the same period has total units up 1.5 percent YTD, including all the commodity groups. RMI says the number of short lines with any auto or intermodal is a minuscule percentage of the total short lines and regionals reporting, and we know coal vols are pretty much restricted to those few handling the last mile into generating plants. I exclude these from the RMI numbers to get a better feel for what the "core commodities" for most short lines are doing.

Net YTD "core" carloads dipped 1.3 percent year-over-year to 4.6 million units from 1.7 million units a year ago. Grain, 12 percent of shortline carloads, was off four percent; metals and metal products, eight percent of shortline vols, were off five percent and paper, six percent of core carloads, slipped three percent. Chems, the largest single shortline commodity group at 17 percent, increased three percent, without any push from crude-by-rail as shortline participation in this market is negligible. The short form is that the majority of short lines that depend on FAK handling line allowances live and die on vols and where they're off, operating income suffers.

One can gain additional perspective on shortline traffic trends by taking apart and comparing Genesee & Wyoming North American carload trends with those of RailAmerica. Happily, we can still do this because, until the STB gives its full blessing to the merger, both companies must report their results separately.

October is the most recent month for running the comps. Whereas the RMI shortline community as of Week 44 (endingNov 3) had 5.7 million revenue units up 1.5 percent, GWR reported 64,388 units, down 7.8 percent, and RA posted 75,833 units, up 3.8 percent year-to-date over the 2011 period. RMI Week 44 year-to-date carloads (423 roads reporting) ex coal, auto and intermodal, came in at 4.4 million units, down one percent vs. 2011 YTD.

Here's where the RA-GWR comps get interesting and where you can see how RA fills in some blanks for GWR and vice versa. RA has no intermodal but has twice the auto vols of GWR. A year ago GWR had moved nearly 7,000 cars of overhead coal YTD, since cut in half; RA had none. RA reported 4,000 cars of "other" YTD but that's spread across a dog's breakfast of commodities so isn't really a fair comp with GWR.

Take out coal, intermodal, auto and other from both roads and we get a better comp of what these hundred names were doing. And since these names represent a quarter of reporting names, we get a fair idea of how the broader shortline community is faring. RA, absent coal, auto, and other (no intermodal), did 58,931 units in October, up a highly respectable 9.7 percent. By comparison, GWR, absent coal, auto, intermodal and other, did 43,517 units, up 4.7 percent -- not bad by any means.

Now go back to the RMI numbers and strip out the same four groups. The broad measure is down 1.2 percent to 4.2 million units. Conclusion: the combined RA+GWR is doing better on average than 75 percent of the other shortline and regional names, with RA bringing to the

combination a third more "core" revenue units and once we get past GWR's rotten "other" comps from the overhead coal fiasco, this is going to be one powerful combination.

Canadian Pacific took over New York's posh Plaza Hotel Tuesday and Wednesday with a reception, dinner, some remarks from Hunter Harrison to set the scene and a day of presentations to provide the whole New CP story. I caught the Tuesday evening HH opener by webcast and was quite pleased with what I heard, teeing up, as it did, the Wednesday Main Event, which CP Investor Relations VP Janet Weiss had graciously invited me to attend. Slides are on the Investor page at www.cpr.ca; you will find following along helpful.

Hunter's opening remarks Tuesday evening served beautifully to set the stage for the Wednesday Main Event. The theme slide -- yard productivity, war on bureaucracy, network review, streamline the asset base, new train designs and do it all without anybody getting injured -- framed what was to follow. It's a cost take-out story, he said, and service improvements flow from that. He mentioned a "passion for the work," a favorite phrase of ASLRRA's Rich Timmons and something we've all talked about from time to time.

He defines customer service as doing what you say you're going to do and doing it from the field without a huge office staff meddling. Having found a top-heavy organization in a downtown Calgary office tower away from the railroad, he's closing that, moving the HQ to a track-side location five miles away where you can see the product as you work. And saving $18 mm in rental expense in the bargain.

Some 1,800 souls have left CP in the past five months and another 2,000 will go shortly (which VP Human Resources Peter Edwards corroborates on slides 52,53). The older work force lends itself to a natural attrition and the younger staff is staying nimble as work assignments change. CP expects ultimately to be running the railroad with 4,500 fewer employees

Out on the railroad, CP has already taken a day out of intermodal transit times east-west. Hunter says nobody moves bulk trains over the mountains better than CP and he wants to expand that mindset to merch and intermodal trains. They're taking out passing sidings that are too short and stringing the track segments removed into longer passing sidings at more strategic locations, saving capex dollars and ops dollars (cut crew-starts 30%) in one pass.

They closed four hump yards that were designed for 1,400 cars a day and were doing only half that. These yards were designed 50 years ago to support a single-car operating model where there were no unit trains or intermodal services. Now, with 70 percent of CP revenue units in unit trains or intermodal, the three-yard (receiving, bowl, outbound -- See Guido De Ciccio slides 32-38) hump facility has outlived itself. Better to combine the three yards into one flat-switch yard and convert the excess assets into free cash flow. We ought to see rapid ops ratio improvements over the next 18 months with a slowing rate of change after that.

During a brief Q&A following, somebody asked about plans for the DM&E west end (see brackets below). Hunter says that business will come to CP regardless of who runs the trains, so CP might has well have somebody out there who can deliver that business to CP at lower cost. He was less forthcoming on the D&H, where he says they're taking a "cautious" approach (see MacFarlane, below). But after all that, one really got the sense he's One of Us when he said, "Every night I take the map home and wonder What If."

The tone of the of the Main Event was one of railroaders talking to railroaders about How We Work and Why. To be sure, there was a fair amount of grist for the analyst mill, but to me, listening with the ears of one who's spent some time on locomotives and on the ground as well as selling rail services to shippers, it was as if they were talking to me in my language.

Three operations presentations started the day and set the scene to put all that followed in that context. SVC System Ops Scott MacDonald showed how hump yard closures force blocking for the distant node, suggesting there may be an incentive for shortlines to pre-block their outbounds, facilitating block-swaps at flat switch yards. Better blocking through train design (slide 26) also yields faster loco returns and a smaller loco fleet to do the work. (For sale: 58 SD90MACs). It's all about keeping trains out of each other's way, says Scott, and inviting those who will ultimately do the work to take a leadership role in making process changes works wonders.

Next comes SVP Canadian ops Guido DeCiccio to build on the yard theme Harrison touched on Tues eve. The name of the game is keeping yards fluid and keeping down car-dwell time. He has buy-in from all but a few old heads for the more fluid process, making me think of certain regional railroad yards where the younger guys are taking the lead in bringing on change. CP case in point: Winnepeg, where on closer examination it was clear only one car in five actually needed to be there to meet specific customer needs. Going to flat-switch reduces yard car-counts 80 percent.

Doug McFarlane, SVP for U.S. Ops, touched on the unique interline considerations affecting their decision to flat-switch Bensonville (Chicago), how they're upgrading the No Dak lines to 40 mph from 20 to keep the crude oil and frack sand trains moving and the upgrades to Kenwood Yard in Albany, NY, to accommodate more crude oil and ethanol trains. Once again, it's all about car cycle times and how shippers will out seek the routes that offer the most round trips in the fewest days. (As for the D&H fit, Hunter added later that routing protocols may give Chicago hand-offs to CSX and NS a competitive advantage. Call me if you need specifics.)

With the operating scene thus set, it was time for Chief Marketing Officer Jane O'Hagan to show how they will use this revitalized property to generate revenue growth at a 4-7% CAGR over the next four years. To begin, it will take sustainable, profitable commodity OD pairs and depend upon customer collaboration in finding them. Of particular interest to merch carload shippers and short lines is the mix change on her slide 75. Whereas intermodal and bulk (grain, ferts, coal)

make up 70 percent of revenue unit vols today, that will shift over the next four years to 60-40 bulk over merchandise. [*Boy, talk about an open door to short lines! -- rhb*]

Granted, the emphasis shift is due to an energy-related mix, a mixed bag for short lines where there are good growth opportunities in frack and and pipe at both ends but limited opportunity in crude-by-rail. Putting the energy mix in Scott's train design context, oil trains will run through the yards; frack sand blocked by the origin road for the distant node can block-swapped for beyond.

I think Jane's slide 77 Summary says it all for the entire session: using improved service design to add competitive advantage to customers' supply chain processes to create more customers and build a 4-7 percent CAGR revenue stream in the bargain. And I think they told the story most eloquently. I talked with a number of the 100-plus analysts in the room and found an air of acceptance and wanting to believe it'll work. The fact that CP shares jumped nearly four percent on the day tells me the message is getting through.

[Before the call CP dropped a press release saying it wants somebody else to run the west end of the DM&E. "The line includes approximately 660 miles of track which encompasses CP's current operations between Tracy, MN and Rapid City, SD, north of Rapid City to Colony, WY, south of Rapid City to Dakota Jct., NE and connecting branch lines. A number of grain, ethanol, clay and merchandise customers are rail-served in the area." For the right operator, this could be another NENE.]

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