THE RAILROAD WEEK IN REVIEW

January 4, 2013

"We did a good job of resetting the network in 2012 and we are driving strong service and velocity performance across most of our network." -- *Matt Rose, BNSF CEO*

BNSF Merch Group Carries the Day. The quarterly magazine of BNSF, *RAILWAY*, is always full of useful information about how BNSF goes about its work and why. Moreover, since BNSF is no longer a public company, Wall Street doesn't follow it and provides no comps of BNSF against its peers. The company magazine helps fill the void.

The Fall 2012 issue of *RAILWAY* is a case in point. On the inside front cover is a table of BNSF Performance Measures through mid-Nov. I have recast them thus:

BNSF Performance Measures		YTD 11/13	
Rev Units	**2012**	**2011**	
Coal	1,882,632	1,981,744	-5%
Agriculture	894,290	911,979	-2%
Industrial	1,468,713	1,300,820	13%
Consumer	4,185,786	3,993,853	5%
Totals	8,431,421	8,188,396	3%
YTD 11/6			
Reportable PI	407	474	-14%
Velocity 11/13	Goal	QTD	Variance
Loco Miles/day	306.00	304.90	-0.36%
Ag car miles/day	191.00	197.70	3.51%
Merch car mi/day	138.00	149.30	8.19%
IM Transit days	3.89	3.80	-2.31%

Coal and ag are off a bit -- no surprises there. Consumer (includes intermodal containers and trailers plus finished vehicles) is up, another non-surprise. But merchandise? Up more than 1.1 million units, more than enough to offset coal's loss and most of ag's. One caveat, however: much of this comes from the dramatic increase in Bakken Shale crude-by-rail coming out of No Dak over the former GN routes.

Whereas Jason Seidl's "Track Work Weekly" carload summary shows BNSF chems (part of the Industrial Products commodity group) up 22 percent year-over-year, BNSF's Week 51 revenue units chart has chems down three percent and petroleum up 74 percent. As a double-check I found the sum of the BNSF chems and petrol lines equals the chems line Jason reports.

Now look at velocity, above. Merch car-miles per day are eight percent better than the YTD goal. Coal's about flat and intermodal transit days between origin cut-off and destination de-ramp kiss slightly. And note the improved vols come with fewer reportable injuries, down 14 percent.

To be sure, unit crude-oil trains are really just point-to-point intermodal trains with tanks instead of boxes and will skew transit times mightily to the favorable side. But I mention this because there are anecdotal tales out there of cars laying at interchange because the Class Is don't report advance consists properly or the train-master lets crews blast by the interchange to make an early quit. The gaps between the performance metrics we hear on earnings calls and actual performance we see in the field are unfortunate, to say the least..

Smaller Inventories (WIR 12/21/2012) Redux. Larry Kaufman writes,

> You make the point that intermodal does not appear to be taking traffic from boxcars, and I think you could not be more right. If you were to really drill down, I think you'd find that intermodal takes traffic off the highways, and is sold on the basis of price. Look at all the industrial parks around the country that do not even have rails into the premises. Those facilities are made for intermodal, and going back in ancient history to my days at the AAR pre-Staggers, we always worked on the belief that intermodal was a truck fighter, that boxcar traffic was not a competitor to intermodal. If it were, I suspect boxcars would have disappeared by now (just a bit of hyperbole on my part.)
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> There are those who argue that intermodal isn't really doing as well as people like me try to say, but sells strictly on price. Assuming the naysayers are right and that intermodal is growing only because it sells on price, is this per se wrong? I think the Class I executives are smart enough to know their own businesses and how to manage them. That is, they know how to take costs out faster than price falls, and that creates a good place in which to be.

In other words, if the intermodal shoe fits best, wear it. But if the boxcar shoe fits as well or better, wear that. The smart Class I execs Larry points to are looking at things like contribution per car day and if the single-car model works best, then it's offered. But if it doesn't, intermodal at least keeps the shipment on the core railroad.

"Shares of iron-ore producer Cliffs Natural Resources got an added boost Monday morning on strong manufacturing data out of China," according to a note on seekingalpha.com. The writer continues, "The numbers give triangulation to the China rebound thesis" thanks to earlier reports of a significant jump in iron ore prices.

Not only will CLF benefit directly, but also will GWR and CNI (carloads in its met ores commodity group are essentially unchanged year-over year through Week 51) thanks to their iron ore exposure in Northern Canada. I can also see a derivative benefit to CP and its exposure to the met coal coming out of Teck Resources and going over Vancouver to China. (Actually, CP coal is doing ok -- up seven percent through Week 51.)

The US Steel Sector -- including mills and service centers --has received an upgrade from Credit Suisse with renewed focus on near-term industry fundamentals. “Recent proprietary channel checks support our view that improving U.S. demand (e.g. autos, industrial production), disciplined supply (i.e. muted imports), and low inventories should support higher prices.

We also see a number of upside risks which could surprise investors in 2013, including: 1) a potential non-residential construction recovery (non-residential typically lags housing by 9-12 months); and 2) cost containment, as 2013 should see lower overall raw material costs (met coal, iron ore) vs. 2012. Looking at returns from Jan. to April over the past 10 years, we believe all steel stocks can be "winners" in this scenario, but service centers have outperformed historically.

Canadian National on Jan 1 officially concluded its efforts to merge the EJ&E into its Wisconsin Central subsidiary. As we have long expected, CN confirms in the merger announcement that the transaction simplifies CN's corporate structure and its operations in the United States. A chief benefit is being able to do the work of both roads “with a unified workforce, which will permit better management of crew staffing and more efficient and reliable rail service to customers throughout the region.”

The final merger comes as the result of an STB filing back in May, 2012 as a “notice of exemption for transactions within a corporate family” and became effective a month later after CN had negotiated voluntary implementing agreements with the various craft unions. However, the merger will not alter the STB's continuing oversight and reserved jurisdiction over CN's 2009 acquisition of the J and the related agreements thereunto appertaining.

Congress has extended the 45G tax credit for shortline track maintenance. A note from Wolfe Trahan says the extension is part of the fiscal cliff deal and is retroactive to the beginning of 2012 as the previous allowance expired at the end of 2011. Wolfe says the credits “will boost GWR’s consolidated net income (now including RA) by $25M or $0.44/shr... Going forward, GWR will record the full tax credits as a reduction in its effective tax rate, from an estimated 35% book tax rate to an effective rate of about 28%.”

That leaves more than 400 privately-held short lines that may avail themselves of the credit, either as an offset to their own maintenance programs, or assigning them to customers who benefit from the program as an offset to their own tax bills. At a nominal $5,000 per mile per year just to keep shortline track up to FRA Class 2 spec, it’s a worthwhile program, even if it does max out at $3,500 per mile. Like Blanche in “Streetcar,” short lines clearly benefit from this “kindness of strangers.”

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