THE RAILROAD WEEK IN REVIEW

May 24, 2013

"We saw it coming in 2007 but the magnitude of this has been surprising." -- Farmrail System CEO George Betke in Progressive Railroading

Thirteen shortline names are in the crude-by-rail space, according to an excellent article in the May, 2013 *Progressive Railroading*. Nine are line-haul carries connecting with UP, BNSF or both, though Texas-Pacifico reaches the outside world through the good offices of the Fort Worth & Western. Watco, OmniTrax and Iowa Pacific have two names each, and *Progressive* suggests all six will be kept very busy forwarding crude oil to the majors as well as bringing in supplies from pipe to frack sand.

Name	Route-miles	Home State	Shale	Owner
Pecos Valley Southern	29	Texas	Permian Basin	Watco
Southwestern	182	NM	Permian Basin	Western Group
Texas-Pacifico	382	TX	Permian Basin	Grupo Mexico
Texas-New Mexico	107	TX	Permian Basin	Iowa Pacific
West Texas & Lubbock	104	TX	Permian Basin	Iowa Pacific
Hondo	16	TX	Eagle Ford	Independent
Gardendale	18	TX	Eagle Ford	Ironhorse
Texas, Gonzalles & Northern	12	TX	Eagle Ford	TNW inc
Great Western of Colo	80	CO	Niobrara/Julesburg	OmniTrax
Hudson Terminal	12	CO	Niobrara/Julesburg	Independent
Farmrail	387	OK	Anadarko	Farmrail System
Panhandle Northern	31	TX	Anadarko	OmniTrax
Stillwater Central	275	OK	Anadarko	Watco
Sources: Progressive Railroading, company websites, Blanchard Co database				

Four (those under 20 route-miles) are really terminal operators that are not in the line haul business, and it's unclear from their websites whether the mileages shown are track-miles or route-miles. Still, having strategically located facilities adjacent to but not directly on Class I mains creates unmatchable competitive advantage.

All of these names have one thing in common: they are, in *Progressive's* words, non-Bakken plays. BNSF and CP dominate the Class I Bakken direct service offerings; the number of short lines playing similar roles can be counted on the fingers of one hand. Happily, as the table above makes clear, there is Life After Bakken and room for service-driven Class II and III carriers.

California's Santa Maria Valley Railroad (www.smvrr.com) has posted its best year ever since the new management came to town in 2006. Their May newsletter tells us volumes are four times what they were in 2007, thanks in part to six-day a week service and more consistent UP connection schedules. President Rob Himoto (a good friend since my Motley Fool days as MF Rails, the railroad guy) writes that the revenue "is reinvested back into the railroad so we can continue to improve our customer service with reliable track and power."

My back-of-the-envelope number crunching tells me they're now doing a little more than 1,100 cars a year on their 14-mile line, a tad short of where they need to be for my Rule of 100 metric (a short line needs 100 cars per route mile per year to be able to keep FRA Class 2 track up to snuff -- bridges, weed control and highway crossings excluded).

Himoto adds that 2012 was their third straight year of no reportable injuries and they're adding ditch lights to their two ancient GE 70-tonners, even though they don't have to. Speeds on SMVRR are limited to 19 mph and 49CFR Part 229.125 requires ditch lights on lead locomotives operated across public grade crossings at speeds above that. Still, safer is better and the ditch lights are a good investment, in my opinion.

For a well-written and informative story about the SMVR, see Tom Murray's piece in the June *Trains*, pages 42-49. For a 1990s video of the railroad and the SP's sugar beet operation that was at the time worth more than 10,000 cars a year to SMVRR, go to

http://trn.trains.com/Interactive/TrainsTube/2013/04/Sugar%20Beets%20Train%20Video.aspx

and note the outside-braced wooden gons with extended tops that SP had in this service.

The Wolfe Transportation Conference at the Fordham Law School on New York's West 62d Street was the 16th such outing -- six by Wolfe's firm and ten when he was at Bear Stearns before that. I was a New York commuter for the two days and heard panels on coal, crude-by-rail, Class I railroads, railroad regulation, short lines, transport industry consolidation practices and trends, and intermodal services. Plus an hour's Q&A with CP's Hunter Harrison.

The common thread among all the presenters -- 24 in all -- was that organic revenue growth from creating more satisfied customers will always win the day. The intermodal guys said getting more trucks off the highways means the rails must continue the trend toward greater train frequencies running on dependable schedules, and more terminals closer together.

CN President Claude Mongeau says "supply chain collaboration is our competitive advantage" and I believe him. GWR's Jack Hellmann maintains "playing the acquisition game within our capabilities" has propelled his company to a $5 billion market cap today from just $50 million 12 years ago. And Indiana Rail Road president Tom Hoback says they're seeing the highest level of industrial development ever along his lines.

Recently retired OmniTrax Managing Director Mike Ogborn talks about their 17 railroads in terms of product mix (originates frack sand on one road, terminates it on another; potential petroleum exports at Churchill via Hudson Bay RR) and pricing power, or lack thereof. Watco's Rick Webb emphasizes their diversity across four areas: rail freight service, multiple commodities (though 70 percent "heat and eat"), multiple geographies (US, Canada, Australia), and support operations from terminal management to equipment repair.

Norfolk Southern EVP Deb Butler says they are using technology to run a faster, smarter railroad handling more vols across the system without proportional increases in rolling stock, crew-starts or car hire. Pat Ottensmyer, EVP Marketing for KCS, cites four growth areas: Energy, both crude oil out and frack sand in; the port at Lazaro Cardenas; automotive manufacturing in Mexico (parts in, finished vehicles out); and cross-border intermodal conversions for the 2.9 million annual truckloads to/from their franchise areas. FEC President Jim Hertwig credits scheduled six trains a day each way Miami-Jacksonville and franchise expansion to Nashville with making their 77 percent intermodal railroad the success it is.

CP's Hunter Harrison held forth at lunch Wednesday with a vivid description of the changes underway. This was the first time I'd heard Harrison talk about RTMs and pricing in the same breath. RTMs, he says, are the best measure of how well you're doing; how much money you can ask for is a function of service as viewed by the customer and your own operating ratio. He cites improved turn times for customer-leased equipment as worthy of higher rates and being able to get better margins with lower ORs.

I still see CP as a work in progress. Whereas Mongeau can talk about CN's supply-chain initiatives as building on CN's service reputation, Harrison can't. He says "structural problems" -- sidings too short, labor costs too high, etc. -- can't be allowed to degrade the service offering and must be addressed. CN fixed these a long time ago under guess who's leadership. Now he's starting all over again at CP and that's why I say it's work in progress.

CP all-in vols through Week 19 are up 1.5 percent to CN's up 3.0 percent; at just under a million units, CP's year-to-date revenue unit count is slightly more than half of what CN did. CP's first quarter OR came in at 75.8 vs. 68.4 at CN. First quarter vols were up 2.2 percent at CN vs. 0.5 percent at CP. So even as I applaud HH in his turn-around efforts, I still need to see some significant volume growth. Revenue is, after all, the denominator in the operating ratio equation.