THE RAILROAD WEEK IN REVIEW

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"Competitive switching would be available only to shippers at facilities that are rail served only by a single Class I rail carrier." NIT League in EP 711, page 7

Paper barrier walls come a-tumblin' down? The STB this week held hearings on the NIT League petition "to modify the Board's standards for mandatory competitive switching." At issue is the question of a railroad accessing a competing railroad's customers "if there is a working interchange within a reasonable distance (30 miles, under NITL's proposal)." The matter is enshrined in EP 711, dated July 7, 2011, so you can see this has been dragging on for a while.

The League's argument is that there has been a "significant loss of rail-to-rail competition" over the last 25 years and that "more balanced switching rules could provide a more competitive and efficient rail system for shippers without harming rail carriers." I'm not going to take sides here, but the Class I carrier stipulation (italics, above) is of some concern when it comes to short lines.

Many short lines are "Handling Lines" and are viewed as Class I "partners" in providing rail service. Very often the Class I that transferred the line to the short line did so with the proviso that the latter interchange only with the former or pay a penalty. My fear is it could be argued that a handling line with a paper barrier is *ipso facto* an extension of the Class I that set up the paper barrier. *Ergo*, a shipper on that line wanting to access a second Class I with a physical connection 30 miles away ought to be permitted to do it.

You can't make this stuff up. Not long ago a shortline customer wanted to draw his plastic pellets from a supplier that was not local to the Class I with the paper barrier. The preferred supplier was local to another Class I that had a physical interchange with the serving short line not 20 miles away. Asked for a paper barrier waiver to accommodate the customer, the Class I refused. The customer then voiced the idea of going to the STB. Whether he did or not, I can't say, but I can say the first carrier later relented and let the customer change vendors.

Now let's say the NIT League is successful with EP 711. The same customer wants to change vendors because the incumbent Class I wants a rate hike. The second Class I, however, is more accommodating and wins the business, interchanging with the short line as a Class I "partner" under EP 711. The serving shortline is made whole, but it leaves a bad taste in the mouth of the barrier-holding Class I. I can hear the question now: "Whose side are you on, anyway?"

The view from here is that EP711 must consider handling lines or somebody's going to get hurt. Wolfe Research in NYC says the rails say 711's provisions could take a double-digit percentage bite out of rail margins; NITL says only five percent of rail vols are affected and would "yield savings equal to just 1.5 percent of rail profits," whatever that means. Wolfe concludes that with additional hearings and lawsuits a final ruling is still two years away. Attention must be paid.

Meanwhile, legislators in Canada want to give shippers access to non-serving Class Is with interchanges as far as 100 miles away, up from the present 25 miles. An item in the *Globe and Mail* says the extended interchange range will provide "roughly 150 primary elevators" access to a second Class I; only 14 elevators can do so now. So much for competitive advantage.

Needless to say, CN in particular is not amused. Even though the government says the extension will alleviate the current grain backlog, CEO Claude Mongeau said in a written statement, "The legislation does not address the root cause of the current grain situation and will do little to move more grain, now or in the future. Moreover, the legislation could hit Canada's railways by opening their business to unfair poaching by U.S. railways [*i.e. BNSF - rhb*] without any reciprocity. Beyond causing financial harm to CN, it could drain traffic away from Canadian ports and cause the loss of jobs, reduce investment and undermine tax revenues across Canada."

A parallel thread in the WSJ says the Canadian government has ordered CN and CP to move 5,500 cars a week for the next 13 weeks and pay a C$100,000 per-day fine for failure to do so. Worse, the government could order the roads to move even higher volumes "if the need arises," yet leave the C$550 million annual grain revenue cap in place. In other words, do more work for the same money.

Not good. We sixty "moonlighters" watched the CN grain franchise in action as we rode VIA's *Canadian* across Saskatchewan and Alberta in Jan. This is heavy-duty railroading and it isn't cheap. Quoting WIR for Jan 17: "There are passing sidings every ten miles or so and in nearly every case we were either in one or passing/ meeting somebody in one over that entire 1000-mile stretch of railroad. Though we saw a goodly number of stack trains and unit trains of coal and crude oil, merchandise carloads of fertilizer, drilling pipe, chemicals, grains and boxcars of who knows what predominated."

Cherilyn Radbourne, rail analyst at TD Securities in Toronto, knows the inner working of Canada's railroads better than sell-sider I know, and calls this "worrisome legislation." She says the financial impact on rail share prices is well-nigh impossible to quantify, though the terms of the bill may very well undermine rail network efficiency and encourage other industries to push for "legislated service standards" that will further harm network performance. (Kinda fits with why I said about paper barrier short lines above.) Cherilyn concludes,

> We see this legislation as a surprising and worrisome response to two anomalies: 1) a western Canadian crop that was about 40% above normal in size; and 2) an unusually severe winter, which featured some of the coldest average temperatures since 1950, resulting in lower rail capacity (due to slower train speeds, shorter train lengths etc.). We see this bill as imposing a lot of responsibility on the rails, without recognizing that they are just one part of a complex

> supply chain, which also depends on the performance of grain elevators/export terminals, and the timing of vessel arrivals, among other factors.

CN averaged C$2,815 per car in grains and ferts last year, total take C$1.6 billion, 17 percent of $9.6 billion total revenues. The Petroleum and Chemicals commodity group did a third again as much, and probably at a better RVC number, given unit trains and leased equipment. So when Mongeau suggests the proposed grain legislation could "reduce investment," one might conclude the legislators ought to be careful in what they ask for.

All is not well in trucker-land. Stifel's Jon Larkin went to this week's Truckload Carriers Association Annual Meeting and reports weather was a big deal in Q1, the truck drive shortage is getting worse, and new truck buys are to replace older units being retired. He concludes,

> Enough shippers are afraid of running out of capacity that rate increases have been quite a bit easier to sell this year. The adverse weather conditions and the extremely challenging driver recruiting and retention environment have clearly tightened up supply and demand. However, the jury is still out on the economy and the strength of the freight markets once normal weather returns and spring and summer merchandise are forward deployed. With valuations at or approaching all time record highs, we are inclined to see where the chips fall once we return to normal.

Adding to that thread, RW Baird's Benjamin Hartford writes,

> First quarter 2014 Q14 marks an important shift in pricing leverage. Robust spot pricing since late 4Q13 is attributable to the confluence of a number of factors: a compressed 2013 retail peak season, new drivers Hours-of-Service rules, severe winter weather that crippled network fluidity and utilization across modes, and several years of underinvestment in fleets. We believe the instances of capacity shortages in recent months are shifting pricing leverage from shippers to the larger carriers and brokers.
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> Contacts have described the underlying demand environment as improving in recent weeks (expected given seasonal demand improvement in March). Recent retail sales data points have likely been pressured in part due to weather, which could create 'pent-up' retail volume in upcoming months.

My channel checks continue to say over-the-road van trailers and intermodal boxes continue to siphon off boxcar traffic, and the weekly RMI RailConnect reports support them.