THE RAILROAD WEEK IN REVIEW

August 29, 2014

"Manifest train size is up two percent year-over-year. We can do even better with more cars moving faster." — Cameron Scott, Union Pacific EVP Operations

More than 300 persons representing some 200 short lines and regional railroads converged on Omaha this week for the annual Union Pacific Short Line Railroad & Port Conference. As in the past, UP opened the session with the formal commercial and operating presentations. New this year, the second half of the morning was split into two sessions: Short Lines and Ports. This was entirely fitting as UP serves nearly 80 ports, roughly split between the Pacific and Gulf coasts, and a third of the attendance represented ports and the short lines that serve them.

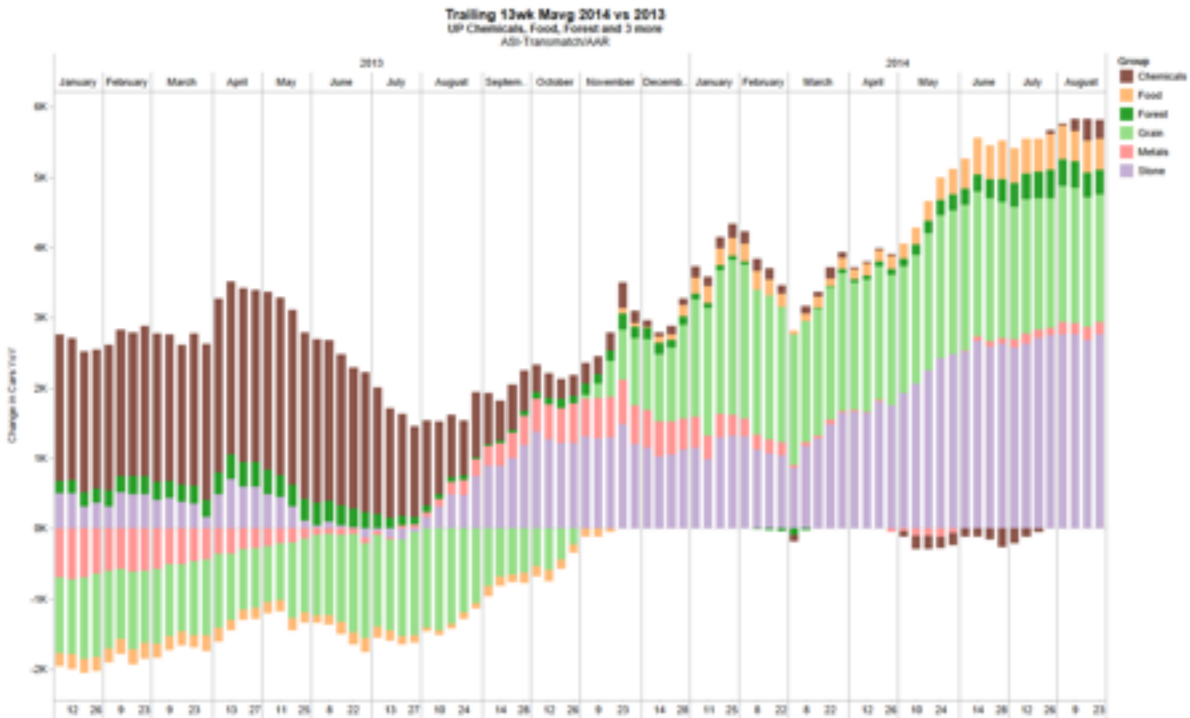
Moreover, short lines move about 15 percent of UP automotive carloads and five percent of intermodal loads, mostly concentrated among the port railroads. At the other end of the scale, short lines touch 38 percent of UP's chemicals and petroleum volumes, 14 percent in agriculture, more than half all Industrial Products group vols, and a surprising 19 percent of coal — three trains a week of export Colorado coal through California's Richmond Pacific Railroad, e.g.

EVP Marketing Eric Butler and EVP Ops Cameron Scott both stressed the importance of the short lines' entrepreneurial spirit and how their new business capabilities help offset the natural 10-12 percent churn UP sees in its customer base. Scott says they're averaging 90 cars per merchandise train; they can accommodate 130. Moving faster is always better: increasing system train speed by one mph means 250 fewer loco units to run the railroad. Most of the growth is in the Twin Cities and South Central regions and I'm encouraged by their emphasis on terminals to give their bigger trains places to go.

Tuesday afternoon featured breakout tables by discipline and commodity. For example, I learned from Network Service Design that they're putting more emphasis on advance consists than ISAs (in a separate email, UP confirmed they encourage ISAs but don't make a big deal out of them). And the car management team confirmed their covered hopper buys are concentrated in the big grain cars, encouraging shippers to bring their own specialty cars, including small-cube sand cars. The boxcar focus is the 100-ton, plate F plug door car, though slow turn rates are causing shortages in some lanes. (I had wanted to speak with the coal and network design teams, but they, alas, were MIA. Other shortline attendees told me later that they had no-shows, too.)

Wednesday was devoted to Marketing Day at Union Pacific Center where, once again, UP assigned specific rooms to individual short lines for them to interview UP counterparts of their own choosing. The seven holding companies (GWR, Watco, Iowa Pacific, et al) got whole classrooms; 27 short lines and port railroads took meeting rooms. This scheme makes a lot of sense because UP staffers don't have to schedule meetings for short lines in advance (more than

300 break-outs at NS, for example), the UP reps don't have to leave their building to make the meetings, and nobody has to invest time in finding meeting locations.



This chart, courtesy of Drew Robinson at ASI-Transmatch in NYC, shows the UP volume trends for merch commodities received and originated. Grain and aggregates dominate the picture.

The challenge now is for the short lines to put management's desire to capitalize on the small railroads' competitive advantage to the test and for UP staffers down the food chain to embrace the short lines' entrepreneurship. Too often what's said in the formal sessions doesn't necessarily get transmitted to the Class I action officers, and it happens at all the Class Is. Let's hope the momentum of the 2014 UP Shortline Meeting is still on when we reconvene in 2015.

As for momentum, or the lack thereof, a friend who recently retired after a long career in railway operations and customer advocacy writes,

> The woes of increased volume and service have remained surprisingly constant. For quite a few years, I witnessed railroad capital investment for future growth that repeatedly exceeded previous levels BY MILLIONS. Yet, the railroads still seem to have been caught flat footed. One interesting element is how that malaise is being felt.
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> I had occasion to chat with some intermodal customers earlier this summer. When THEY started to complain about their service, I listened and was really surprised by their complaints. They spoke about delayed placements, lack of crews and power and, of course,

> congestion. As a guy that spent almost forty years listening to and dealing with those identical issues from *carload* customers, I was genuinely amazed. If the top tier of railroad customers is now feeling this pain, where did all that money go? It couldn't have all gone into crude oil capacity or PTC.

To which I reply, the money's been spent adding capacity in mainline track, locomotives, crews and other operating necessities. The problem as I see it, is trying to stuff too many cars into too few trains starts to keep ops expenses down and Wall Street expectations up. As long as pure pricing plus fuel surcharges keep the revenue line growing faster than the expense line, who cares? The customers, that's who, ergo my friend's remarks.

A recent Morgan Stanley note on utilities' coal-to-gas switching got me to thinking mostly in the context of gas drilling activity, where there's likely to be more or less of it, and coal demand. Says M-S, nat gas production growth has been "more than adequate" and $4 gas prices have helped. As a result, "nearly all Northeast gas generation is in the money versus coal, helping send weather-normalized power demand higher." And the power sector is the "marginal consumer of 'trapped' gas in the region." Marcellus is named.

Elsewhere, power plants in the southeast are burning more Illinois Basin coal, making them more competitive with peers burning gas priced south of four dollars. Part of the reason is the fact that "delivery costs for coal vary significantly at different plants across the southeast, making fuel switching less uniform and sometimes less predictable than other regions." My take: NE power plants will use gas where they can, irrespective of Henry Hub prices. Good for drillers in the Marcellus. Coal has more staying power in the SE, good for Ill Basin and Northern APP (Central and Southern too costly) coal.

To sanity check Morgan's thesis, I checked with a friend who knows the Illinois Basin coal business intimately. He asks rhetorically which utilities are signing 3-5 year contracts and says one can't really tell what gas prices will be that far out, noting that greater demand will drive up prices unless drilling costs come down significantly. Is there enough gas around at that price to cope with winter that is as bad as or worse than what we had in 2013-2014? Not to mention what happens when it's legal to export gas so US producers can realize closer to world market prices.

Finally, my contact doesn't doubt that gas "will continue to erode coal's market share at the margins. But long, term, I think utilities are going to have to be careful they don't end up in the same trap they created for themselves when they built hundreds of gas-fired peaking units only to drive the cost of gas up to the point most of those units didn't run for years."