RAILROAD WEEK IN REVIEW
January 15, 2016

"We are grateful for the pivotal role that state and local economic development agencies play in aggressively competing for new industry." Clark Robertson, CSX

CSX kicked off the Q4 earnings season on a down note. Total revenue declined 13 percent on six percent fewer rev units. Adjusted revs after stripping out fuel surcharge fees dropped but two percent, so you can see how this artifice adds to the top line. Operating expense came down 13 percent ($300 mm) of which half was fuel. The reported is OR 71.6, down 22 basis points; ex-fuel surcharge it's a solid 69.7, down 183 basis points from a similarly adjusted 71.5 a year ago.

Operating income was $791 million, down 12 percent, though — to show how bad the quarter was compared to the rest of the year — full-year operating income was essentially flat, down less than a point. And the full-year OR dropped 183 basis points to 69.7 from 71.5 a year ago. Reported net income $466 mm, down 5 percent; ex-property sales $367, off 23 percent. Reported EPS was 48 cents, down 3 percent; however, the share-count dropped 2.2 percent year-over year on the $804 million share repo program; a same-shares EPS would be down five percent.

CSX gets points for using the downturn to make the railroad run better. Operating Plan train-starts scored a 79 percent on-time departure rate *vs.* 52 percent a year ago; on-time arrivals hit 61 percent *vs.*43 percent last year. Dwell remains in the 25-26 hour range, though one can see dwell shortening as more on-time arrivals permit more on-time departures.

During the Q&A on the Wednesday call, Chief Operating Officer Cindy Sanborn cited improved car-cycle times, taking steps to increase lane density by shrinking the track-mile footprint to meet demand, and taking out some 1,000/ train-starts a week. As a result, merchandise trains are 23 percent longer and bulk train-lengths (coal and grain, e.g.) are up 5-10 percent. She says track space is a bigger constraint on train size than power, and that we will see further reduction in facilities and branch-line miles going forward. Short lines, get out the maps.

Every commodity group but "waste and equipment" posted revenue declines; revenue units dropped in every line but auto and intermodal; revenue/unit lost ground everywhere but metals and forest products. Coal revenue came down 38 percent, $273 million, and was three-fifths of the total revenue drop. Core pricing was up 4.5 percent ex-coal, 4.1 percent all-in.

By commodity line, ag products declined on lower volumes of export grain, packaged foods, and ethanol; fertilizer dropped as farmers delayed planting. STCC 28 chems were flat; STCC 29 petrochems, crude oil and frac sand took hits. Metals carloads slipped with domestic production down, imports up. Lumber loads decreased as inventories got ahead of builders' needs, and lower printing paper orders hurt the STCC 26 group. Finally, construction aggregates posted a modest gain thanks to the weather-related longer construction season.

The outlook is decidedly down for 2016. The only carload favorites are automotive and construction aggregates. The darker export picture will put a dent in ag carloads; the low price and abundant supply of oil and its derivatives won't help the chemical group; the trucks are eating the west-coast produce trade; neither lumber nor paper look particularly healthy; the relative high cost of domestic steel and over-supply of off-shore metals will trim vols here; and, for dessert, farmers will delay fertilizer purchases until prices stop coming down.

So what's a regional railroad to do to survive in this sorry environment? In ag and fertilizers, focus on domestic feed grain and North American origin plant nutrients, especially as low nat gas prices help nitrogen suppliers. In chemicals, look for increased plastics production and frac sand to profitable drillers. Move what metals and forest products you can, cutting cycle-times by minimizing hours between place and pull. Finally, push pre-blocking to increase train-length and cut terminal dwell times. Keep an eye out for places you can increase your footprint by helping CSX reduce theirs. And stay very nimble. Lots to discuss at the Short Line Workshop March 6-8.

Meanwhile, CSX reports 107 new or expanded customer facilities local to CSX or its connecting short lines. These projects represent some $2.2 billion in customer investments and are expected to generate approximately 1,500 new jobs in the CSX service area. The energy, industrial products, and ag products groups head the list, which is expected to generate some 143,000 new carloads for CSX, of which short lines will touch (my guess) nearly 30,000 loads.

And Dean Piacente has been named vice president of intermodal, Clark Robertson as vice president of chemicals, and Tim McNulty as vice president of agriculture. All will report to Fredrik Eliasson, executive vice president and chief sales and marketing officer.

Norfolk Southern has begun to make some long-overdue and greatly needed strides in reducing its operating footprint. Effective Feb 1, NS will combine its Virginia and Pocahontas divisions to form an expanded Pocahontas Division, with headquarters in Roanoke. By way of review, The Virginia Division includes the former N&W and Virginian routes across the southern tier of Virginia, Norfolk to Bristol, and the Shenandoah Valley line to Hagerstown, Maryland. The former Southern main between Danville and Alexandria remains in the Piedmont Division.

The original Pocahontas Division covers the coal-mining regions of southwestern Virginia and central West Virginia, all former N&W and Virginian properties, with lines extending north into Ohio at Portsmouth and almost to Columbus, though the latter has seen steady traffic declines in recent years. The new Pocahontas Division will cover 2,581 route-miles of railroad.

The competitive advantages of this route structure are several. First, the critical Heartland Corridor double-stack route between Norfolk and Portsmouth, Ohio, goes under the control of one division. Second, placing most of the company's coal routes under the operating authority of a single division will improve asset utilization and improve service. Third, division headquarters goes to Roanoke, which is entirely fitting. Fourth, Mike Irvin, a 33-year employee with many years of division operations experience, will lead. Given the pressure from Calgary, I'm hoping this is the first of such changes that will lower variable expenses, cut the number of miles to be maintained at FRA Class 4 and up, and let everybody work at the top of their skills.

Union Pacific has weighed in on the CP-NS situation. Reuters caught up with CEO Lance Fritz, who was in the Chicago area for the Midwest Association of Rail Shippers Winter Meeting, and asked him what he made of CP's unsolicited bid for NS. Said Fritz,

> We don't want Class I railroad mergers to happen. I think we're doing a fair job of helping state and federal legislators, our customers and the STB understand our perspective. I think the chance of a merger happening is slim because we're working hard to make it slim.

Reuters concludes, "That opposition could significantly harm Canadian Pacific's case if a merger reaches the STB for a review. Customers are concerned a merger would lead to others among North America's remaining railroads, resulting in an anti-competitive duopoly."

The timing was perfect. Last week CP issued a White Paper saying, "The status quo is not an option for North American rail. The solution lies in adding capacity without adding infrastructure, increasing the efficiency of the overall network, and addressing critical issues such as congestion in Chicago." The paper then proceeds to elaborate on CP's perceived benefits of such a combination.

Last Friday the STB made public the letters received commenting on the proposed transaction, establishing a website page, "Major Railroad Mergers and Consolidations Correspondence." Here one can read all the correspondence connected to the proposed merger of Canadian Pacific and Norfolk Southern. The correspondence is in PDF form and can be downloaded by anyone.

Says the Board, "The STB is aware of a recent offer by Canadian Pacific to merge with Norfolk Southern. A number of stakeholders have submitted correspondence to the STB about this offer, including members of Congress, state and local officials, shippers, and members of the public. At this time, there is no proceeding before the agency related to a merger of CP and NS." Take a look. I see a lot of unhappy campers.