RAILROAD WEEK IN REVIEW

February 5, 2016

"2015 had the fewest U.S. rail carloads since sometime before 1988 when our records begin." — AAR Rail Time Indicators, January 8, 2016

Commodity carloads for the first three weeks of 2016 have declined nine percent from where they were a year ago. Add back intermodal, auto, coal, grain and "other" and total Class I railroad revenue units are still off seven percent. I see two reasons.

YTD 2016/2015	Week 3	Week 3	% Chg	Vol Chg
TTL x-coal, grain, IM	816,750	874,022	-6.6%	-57,272
Auto	100,349	91,648	9.5%	8,701
Other	55,077	55,765	-1.2%	-688
What's left	661,324	726,609	-9.0%	-65,285

One, manufacturing activity remains depressed and the strength of the dollar makes US exports more expensive to consumers in the rest of the world. Two, the logistical trend is toward more frequent, smaller shipments — the exact anathema of 100-car trains departing every 28 hours.

Time is money. As margins shrink, money gets scarcer. Ergo don't let margins shrink. The longer a car spends getting from origin to destination, the more it costs both in out-of-pocket ops expense but also in opportunity cost from lost track space and other assets — crews, locos — consumed getting those cars over the road. Bottom line: Single-car shipments spending more time in class yards than it takes a truck to cover the entire distance waste money and reduce margins for customer and carrier alike. Get rid of them.

Moreover, writes a regular WIR contributor, the industry has failed to address the labor-intensive, slow and consequently expensive process of single-car place and pull at the customer location. " A technological solution to the problem is probably a lot more difficult than over-the-road driverless trains, but when a man sitting in an office in Las Vegas can control a plane in Afghanistan and put a missile into some Taliban's car, we ought to be able to figure out a way to switch industries more economically than is done right now. Even if you only reduced the switching crew to a single man there would be a large saving."

Another reader observers, "Local service is both a source of massive dwell of assets (both rail owned and client owned). Further, it is a key source of client conflict over level of service and transparency on 'additional service fees.' We've got the solution at hand, having seen the benefit

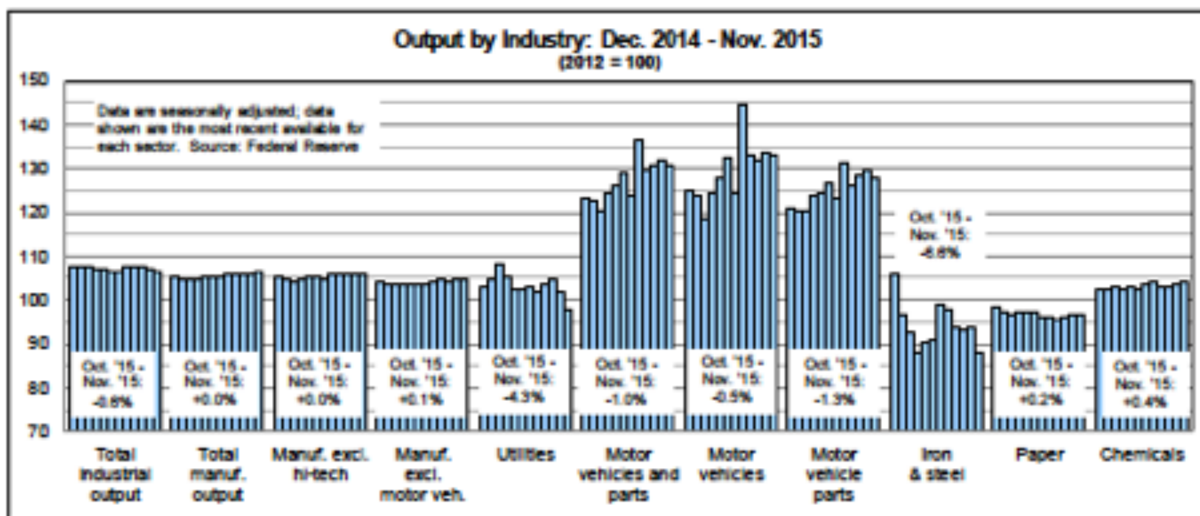
of having moved about half of the carload first/last mile into short lines and Conrail Shared Assets–type structures.”

By so doing, the customer-facing service provider can fit train time to demand time, make it regular (see Reading & Northern’s two-hour window commitment), and transparent, in ways that are clearly beyond the Class I’s capability. Moreover, short line business development teams are the true “market extenders” for the Class Is, and perhaps relieve the Class Is of some of the more onerous Big Railroad Baggage (turf-protection, pricing models, artificial constraints).

Doing so would go a long way toward providing the innovation required to stimulate the base demand and products. It’s being done elsewhere: a friend who works with rails in Europe writes, “German Rail has 300 independent rail operators, of which half are effectively shortlines, and another 150 industrial railways that are effectively customer directed.”

He concludes that much of the German carload network “remains viable and active due to these close-to-customer operators.” And, in like fashion, a significant number of shortline WIR readers report volume increases — not losses — in 2015 precisely because they listen to customers.

As you can see, industrial production in the US is not exactly robust. This chart, from the AAR



Rail Time Indicators for January 8, says only motor vehicle-related commodities have shown any significant growth of late. Iron/steel and paper are down; the chemicals category shows slight growth of late. Please note that this chems block is *only* STCC 28 chems, from ferts to plastics, and does *not* include crude oil. Ergo the bump to the right in the chems bar may well be plastics, where cheap nat gas as an ingredient has upped vols. Note too, this is ALL industrial output, of which a mere fraction moves by rail. No wonder manufactured goods carloads are flat to down.

Canadian Pacific on Wednesday released yet another White Paper, "CP–NS: A Comprehensive Approach to Regulatory Approval," further detailing why CP believes that "all stakeholders will benefit if the proposed transaction is evaluated on its merits… free from political interference." CP begins by reminding readers that the STB's 2001 merger rules, as yet untested, emphasize showing that a proposed transaction "enhances competition… while minimizing the risk of any potential harm from transitional service problems." In other words, without the data screw-ups in the Conrail split or the Houston yard follies in UP+SP. CP says we can do it.

As for the voting trust, the aim is to "enable the target carrier's stockholders to receive consideration prior to regulatory approval, thus removing their exposure to regulatory risk during the STB process." Moreover, CP intends to structure the voting trust so as to "insulate the carrier in trust from unlawful control," relying on the STB's built-in enforcement authority to address any conflicts it perceives.

After all, "the principles central to a voting trust – independence and irrevocability – were established many decades ago and are embodied in the STB's regulations." In a footnote, CP adds, "Voting trust decisions focus largely on the financial harm if divestiture is ordered. But NS financial data to calculate the necessary baseline and projected income and balance sheet financial statements for that analysis are unavailable to CP prior to a merger agreement." (Thus one must ask how CP could project savings in their December 8 presentation, slide 8).

CP highlights how combining CP and NS would meet "public interest" tests through eliminating bottle-neck pricing and modifying terminal access practices. Customers could conceivably benefit from "single line haul, access to new markets, improved asset utilization, routing efficiencies, and increased capacity."

On the other hand, I worry that giving second-carrier service to a marginal branch line customer will eventually drive off the incumbent and the customer will revert to the dreaded "captive" status. Also not clear is whether "terminal access" applies to non-Class I carrier interchanges. CP says they'd eliminate paper barriers; will they let the short line run 50 miles down the CP main to access a second Class I? That has to be one of the devils in the details.

CP's Feb 3 White Paper concludes, "The proposed CP-NS transaction should be evaluated within that framework on its merits and based on a full record – free from political interference, just as Congress intended." I'm sure we'd all like that, and to help us decide, Norfolk Southern might well prepare its own White Paper on the merits of remaining on its own, leaving the Squires team to finish what it's just started.

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