RAILROAD WEEK IN REVIEW

March 11, 2016

"We hope we are wrong but we have to start planning for coal to essentially go away long term." — Fredrik Eliasson, Chief Marketing Officer, CSX

CSX held its 27th Annual Short Line Workshop at World Golf Village near St. Augustine, Florida this week. Three things stand out. First, CSX joined the digital age with a smart-phone app providing the program schedule and related documents, an attendance list (tap on a name for affiliation, job title, and contact info); biographies of the presenters; details on the ShipCSX app, and other useful stuff. No paperwork to carry around, recycle, or trash.

Second, CSX handled the Q&A portion at the end of each presentation with a text message number so attendees could ask questions succinctly, anonymously, and have them voiced to the presenters by an announcer in the back of the room. In this way, the announcer could sort through and prioritize the questions, rewording if necessary for clarity.

Third, this was the debut performance for Arthur Adams as Director of Regional and Short Line Development. Following in the footsteps of predecessor Len Kellermann, who presided over the annual Workshops for more years than any other single holder of that assignment, could have been daunting. But I think Arthur pulled it off like a real trooper, clearly comfortable in his role and adept at keeping the audience engaged.

They didn't waste any time getting to the meat of the matter. CFO Frank Lonegro, new to the CFO role but no stranger to those of us working with and around PTC, where Frank literally ran the show from planning to finding/making the assets, and directing implementation. I think the key to success in addressing this crowd is avoiding the "30,000-foot viewpoint." The better route, as amply demonstrated by the CSX presenters, is to show how and where the company spends its money in ways that can benefit CSX short lines.

There big takeaway here is the fact that CSX recognizes the accelerating rate of decline in the coal franchise, and is replacing lost coal volumes with more service-sensitive commodity business that may cost more to deliver, but, properly managed, can attract higher margins. Frank then went to fitting the network to the new commodity mix, and why CSX isn't going to be selling branch lines as part of that process. Instead, the LIRC upgrades, the Selkirk bypass, and the Acca Yard (Richmond) upgrades, for example, will help merch carloads move faster.

Fredrik Eliasson, Chief Commercial Officer, is Lonegro's immediate predecessor in the CFO slot, and, as Oscar Munoz did in his segue from CFO to COO, brings a critical financial eye to the present task. He brings a relentless focus on "executing what we can control," meaning maximizing yield, minimizing inefficiency, pricing to the market, and adding supply-chain value.

Yes, that's a mouthful, and a number of attendees took that as more price increases, perhaps running off core O-D pairs. Fact is, if CSX is looking to average rate increases in the four percent range, then some rate hikes are going to be much more than that. It's a double-edged sword, too. Contribution per car-day is a biggie, so if a car takes longer to make a move, then rates will have to go up to make the target contribution per car day. Charging more for worse service is a non-starter, for sure.

It also means market managers have to know their markets. The ethanol desk has got to know the effect of the blend-wall and more fuel efficient cars on the outlook for ethanol volumes. The lumber desk has to know how many board-feet of 2x4 eights can fit on a center-beam and what the truckers are getting per thousand board-feet in that lane. Trouble is, at all railroads, there are so many newly-minted MBAs running these desks that the institutional knowledge is missing. It's up to the Fredriks of this world to get that fixed. Or else they'll never get past the coal hurdle.

Putting COO Cindy Sanborn in as clean-up batter was brilliant — merged what Lonegro had to say about where and why they're investing for reliability together with Eliasson's remarks on consistency for a price. For once we're getting a granular look at local service performance and measurement metrics, and that's good. What's not good is the fact that even as trains lengths go up and delays go down, we're still playing *Where's Waldo* with Trainmasters and yard supervisors.

In the same vein as the market manager who doesn't know his markets, I'm getting reports of not being able to find local supervisors who can address local service failures. My message to short lines is always, drill down for an answer. "I don't know" is not an answer. Either there's somebody covering the national account or there isn't. Either local supervision is accessible or it isn't. One or zero. Find the zeroes and make a noise.

So even as I give CSX high marks for a well-run and innovative workshop, I'm still finding that CSX, like the other Class Is, leaves a huge gap between what they *say* is being done in the field and what's *actually* happening out there. The trucks are eating our lunch in the short-to-medium haul business, yet on every Class I we still see the typical single-car shipment hitting two or more intermediate class yards between OD pairs, losing more time standing still than it takes a truck to cover the entire distance. Block for the distant node and save days.

My hope is that the shortline and regional representatives attending this excellent session will go out into the field and *force* their local Class I counterparts to be responsive and responsible. There is nothing less at stake than the future of the whole carload franchise.

The BNSF 10-K is in. Whereas I had to use rounded numbers from the Berkshire Annual Letter (WIR March 4), I can now report total 2015 revenues slipped 5.5 percent year-over-year on unchanged revenue units and a 6.2 percent revenue-per-unit decrease. Carloads in the Industrial Products group came down 5.9 percent mainly on oil-related commodities — crude oil, frac sand, and steel for piping. Agricultural Products carloads were up 7.2 percent on increased

domestic grain shipments and milo exports, yet the whole manifest carload group vols still came in 1.6 percent lower. Consumer Products (intermodal and auto) and coal volumes were each up less than one percent.

Operating expense dropped 13.3 percent for operating income of $7.8 billion, up 11.1 percent, for a 63.7 OR, down 550 basis points. According to the K, “Fuel expense decreased due to lower average fuel prices, improved efficiency and lower gross ton miles volume, purchased services decreased primarily due to a favorable insurance recovery. Depreciation and amortization expense decreased primarily due to internally developed software becoming fully amortized during the first quarter of 2015.” Below the line, net income increased 11.8 percent to $4.9 billion. No share buy-back gimmickry here.

Fuel surcharge collections were less than half what they were in 2014. As a result, adjusted revenue without FSC increases 1.4 percent to $20.1 billion and operating income leaps 58.1 percent to $6.5 billion. See why I want to see fuel surcharges “essentially go away” because of the way they distort the results picture?

GWR, like CSX, needs to start planning for coal “essentially going away.” February carloads slipped 2.0 percent from the Feb 2015 number, though if you take out coal, carloads increased 4.7 percent. Feb coal was 13.1 percent of the total carloads; a year ago coal was 18.6 percent of total carloads — a drop of 5.5 percentage points, and down 31.2 percent year-over-year.

Like ag products, coal is largely weather-dependent (though with a political twist) and there’s not much a carrier can do to affect volume changes. In like manner, “other” carloads, largely Class I overhead traffic, ebbs and flows pretty much of its own accord. It’s now just 4.1 percent of total carloads, down from 4.6 percent a year ago. With any luck, that will “essentially go away” too.

On the bright side, six of the seven commodity groups that make up 80 percent of total GWR volume saw year-over-year volume increases, coal being the sole exception. You can see at a glance how GWR is replacing coal: Ag products, chems, both forest products STCCs, and metals all increased their share of the total pie.

Total Feb carloads were up a point over Jan; cumulative year-to date carloads are down 9.9 percent, whereas they were down 16.6 percent at the end of Jan. To be sure, two months do not a year make. But if each month the year-over-year comps grow “less worse,” as Scott Group would have it, we could be seeing an upward trend once again. What a relief.

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