RAILROAD WEEK IN REVIEW
January 13, 2017

"In China you have a social contract that is authoritarianism in exchange for development. But in Egypt you have authoritarianism in exchange for non-development." — The New Yorker, "Egypt's Failed Revolution," January 2, 2017

No sooner had I launched last week's Letter than Dan Keen, AVP for Policy Research at the AAR, came back with a news item about goods from China reaching the UK by rail direct. This inaugural train is en route even now, and is scheduled to arrive in East London Jan 18. It left Yiwu, roughly 200 miles south west of Shanghai, Jan 5.

China overland rail freight routes to Europe (Image: China Railways)

Also this week *The New Yorker* ran a story about how Egypt is, in the words of one Chinese diplomat in Cairo, going in the opposite direction from China. "It's a reverse image. I can understand a social contract that is authoritarianism in exchange for development. But in Egypt you have authoritarianism in exchange for non-development."

Egypt sits along the Suez Canal that the present Silk Road sea lanes use to get goods to western Europe. Given the geopolitical turmoil in that part of the world, it's hardly a sure thing it will always be available on demand. Add that to China's sea routes having to navigate the blockadable chain of islands in the South Pacific, and you can see that a land-locked China with no other way out could quickly see exports tumble.

The Silk *Rail*Road makes the Suez almost redundant, with goods moving direct to western markets from manufacturers in China and doing so in half the time of an ocean voyage and half the cost of air freight. Consider this: containers arriving in the UK or the Netherlands via rail are transloaded to ships for New York, Norfolk, and Charleston. Who needs the Suez now? Or LA/ Long Beach, for that matter?

I spend a lot of time chasing the energy news because of the impact that industry has on carload traffic that originates or terminates (or both) on short lines. A January 9 Roth Research note on Callon Petroleum is an excellent example of why attention must be paid. To start, Roth gives us four reasons why drilling in the Pecos River area of West Texas is a good idea — all of which suggest needing high volumes of drilling supplies from sand to pipe to cement.

The closest Class I Railroads to the Pecos River are the BNSF's ex-ATSF Transcon and the UP's ex-T&P line between Ft Worth and El Paso. But they run east-west and the river runs north-south. At one time the Santa Fe Carlsbad branch ran all the way to a Pecos interchange with the T&P but that's been shortened to Carlsbad, and operations transferred to the Southwestern Railroad.

There are two short lines. The once-independent Pecos Valley Railroad is now a Watco property and runs south and west away from the Pecos River at the Pecos interchange with UP. The 33-mile line began operations in 2012, mainly to serve the sand and gravel quarry located near the end of the line. How fortunate.

Watco also has the 111-mile Texas & New Mexico Railway in New Mexico and Texas. The line runs north from the UP ex-TP at Monahans, skirting the eastern edge of the area cited in the Callon note. The railroad handles inbound oilfield commodities such as drilling mud and hydrochloric acid, frac sand, pipe, as well as outbound petroleum products including crude oil.

I maintain that as marginal drillers get active again with longer laterals and fewer down-holes, the rails are bound to benefit. Now comes John "Outside the Box" Mauldin with this simple fact of life. An oil (or nat gas or NGL) producer can do only two things to improve margins: raise prices or your production cost. He continues,

> Back in 2015 I wrote about new drilling techniques and other technology that promised to bring oil and gas production costs significantly lower. Now, in the last few weeks, people in the business have told me these technologies are moving rapidly toward deployment. They foresee considerably lower drilling and production costs by the end of this year… In some cases the amount of oil produced per dollar spent on drilling is going to more than double.
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> There are significant chunks of the petroleum-producing parts of the United States where $40 oil will not be a barrier to drilling and new production. Even as many oilfields dry up, there will be new fields developed from previously unprofitable sources… ***Energy exploration and production is quickly becoming a technology-driven industry, with the US as world leader***, [and with] more pipelines and natural gas export terminals, we could see North American exports rise considerably in the next few years.[Emphasis Added.]

Finally, Wells Fargo chimed in Tuesday with a 72-page report on Master Limited Partnerships (MLPs). Even though the message is largely geared to investors, there are shoes that fit the railroads supporting the energy exploration sector. The value to short lines is being able to see Who's Who in the field so you can position yourself to play a key supporting role. Here are a few tidbits in the early pages to help zero in on targets and not waste time chasing DUCs (Drilled UnCompleted) wells.

You read above what John Mauldin has to say about energy prices stabilizing and drilling costs dropping. Here, Wells Fargo says crude, NGL, and nat gas prices are up. "We maintain a positive outlook on the midstream/MLP sector for 2017. From a fundamental perspective, E&Ps are adding rigs and increasing capex in low cost basins including the Permian, SCOOP/STACK, and Marcellus/Utica."

Wells goes on to say the E&Ps are adding rigs and increasing capex in low-cost basins including the Permian, SCOOP/ STACK, Marcellus and Utica. A further recovery in crude prices should drive increased drilling activity in the "next tier" of basins including the DJ, Bakken and Eagle Ford, and reduced organic investment opportunities should lead to further industry consolidation.

The report highlights the 0.65 correlation between MLP share prices and oil prices. As I understand correlation, as oil prices go up or down $1, MLP share prices go up or down 65 cents. Moreover, MLPs outperform in shareholder return, yielding, for example, more than twice the XLU (Utility ETF) and darling of yield-chasers. I'm guessing that's because MLP investors are more willing to pay a premium for (1) visible, above-average growth; (2) strong distribution coverage; and (3) balance sheet strength.

Finally, Wells cites "distributions," in terms of shareholder returns, not the amount of product spewing forth. That said, the more solid the distribution the stronger the cash flow of the issuer. And those are the guys we want as "sticky" customers.

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