THE RAILROAD WEEK IN REVIEW
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"Society will not leave unchanged a system that privatizes huge gains and socializes huge losses."— Mohamed El-Erain, PIMCO, as quoted by Fred Frailey in Kiplinger's *for March, 2009*

What we have now is a system that lets me bet the farm and if I win, I win big. But if I lose you bail me out. And that's precisely where we are at present. The effect is pernicious and it extends to short lines that depend on government grants and other subsidies to stay in business.

The Rule of 100 works, and you can run the numbers using the model available on my website. Take the case of the 60-mile short line that was averaging maybe 30 revenue units a mile when the bankruptcy court asked me to help liquidate the line. The state owned the underlying asset and picked up the entire maintenance tab, call it $300,000 at a nominal $5,000 per mile per year to keep it up to FRA Class 2 specs. In effect, that added a revenue stream equivalent to 1,000 carloads at $300 each.

So let's see. They have 1,800 real carloads, the roadway subsidy adds 1,000 carload equivalents, so we're up to 2,800 carloads and equivalents or 47 carloads a mile. Still not enough. Annual operating expenses and keeping the doors open add another half a million and car hire runs about $100,000 a year – call it $600,000 -- against total revenues of $540,000 from a commodity base that is half lumber and fertilizer and half carbon-black for a tire-maker. The odds for any significant growth – even before the economy tanked – were not high. The question now becomes whether lagging state tax receipts can still support this excess.

A Connecticut reader who is a railroad investor, historian and enthusiast writes, "There has to be some 'price vs. benefit' analysis for some of these marginal lines that is not totally profit dependant. I think this was the original concept of state rail subsidies but the process got corrupted and became perverted. Traffic, pollution, employment, and the fact that once gone (rail banked or not) it ain't returning all need be part of the cost/benefit analysis.

"Obviously, a twenty-mile line with 80-lb rail and ten cars a month wouldn't fit this analysis unless a State Authority saw some value in maintaining it. That is the problem: for every successful operation where once-abandoned rails are now humming there are twenty properties where the only potential is in the minds of dreamers. If it fails, the State buys it and hires an operator. Either way the taxpayer is screwed. It is either a subsidy or a direct cost." The entrepreneur or state bet big, lose, somebody else bails one or both out and El-Erain's description of the present system proves true.

Taking the other side, a reader who has been very successful building the traffic base of an eastern shortline group writes, "Badly-managed rail businesses should not remain afloat buoyed by tax dollars, however, there is an argument that the asset (rail line) itself should not fall victim to poor management. Most of our lines would not be here now in the condition they are in without public investment in the past. It could be argued that without public ownership few of our roads could have stood alone. However, without the public investment in these lines the local jobs associated would not remain in the rural areas served by these marginal lines. It has been proven that in many cases if you can save the asset, the business will come back.

“I also feel strongly that moving a carload customer that has an investment in rail infrastructure to an ‘intermodal park’ type business model that the class ones favor in many areas can take a solid rail customer and makes him an easily divertible customer. I recall the Lake Erie Franklin & Clarion losing their remaining rail business to a glass plant to a CSX Trans-flow terminal 75 miles away and that ultimately caused the line to close and be abandoned. After the line was gone rates got jacked up and now Clarion not only does not have a railroad, but it does not have a glass plant either.

“As a minor point, Conrail was set to abandon what is now NBER, SVRR, UCIR, and NSHR before SEDA-COG and others stepped in. It was only later in the history of CR that they recognized that a shortline may be a much better option that total abandonment of a rail line. The point is that Conrail saw *no value* at the time in our original lines (Circa 1980). Same could be said for lines now operated (successfully) by the DL RR in Scranton and others. I remember that CR installed a chain-link fence across the tracks and right of way at Stroudsburg!”

Pennsylvania has refreshed its Rail Freight Assistance Program with $8.5 million in new grants for a number of short lines as well and CSX and NS. Projects include six thousand feet of track to re-establish service to a coal mine, rehabbing a tunnel on RJ Corman’s Pennsylvania Division, repairing 20 bridge pedestals and other track-work on the Wheeling & Lake Erie, completing an industry siding off NS’ Buffalo line, upgrading track on the property of a major rail user, building two new transloading facilities for another industry, and fixing a CSX bridge on an industry lead.

Every railroad on the list has the wherewithal to remain profitable without these improvements, however the RFAC money lowers the cost to serve these customers, makes the industries more competitive in their own fields, and keep the jobs in Pennsylvania.

Speaking of Pennsylvania railroads (small R), the two Class Is reporting this week both do a significant amount of business in the state, both on their own lines and via connecting short lines. Norfolk Southern first. Though quarterly revenues increased only two percent and revenue units decreased by eight percent, operating income jumped 19 percent because operating expense fell five percent. The OR dropped four and a half points to a highly respectable 67.5, making NS the only other Class I beside CN with a sub-70 number.

Fuel expense was down 24 percent on ten percent fewer gallons burned and a14 percent decrease in per-gallon price. GTMs were down seven percent, RTMs were down six percent. Net income increased 13 percent to $452 mm and earnings-per-share jumped nineteen percent thanks to a five percent drop in diluted shares. Free cash flow after capex and dividends was $701 million vs. $615 million in 2007; ROIC was a respectable eleven percent and calculated ROE (margin* leverage*yield) came in at 18 percent.

In his part of the presentation Marketing EVP Don Seale said 55 percent of international intermodal loads are now all-water to the east coast, up from 20 percent five years ago. (This fits with something I learned from Frank Harder of the Tioga Group here in Phila. He says their research suggests as Pacific Rim origins shift south and west toward Viet Nam and India, the Suez route becomes the preferred route, ergo more east coast landings.)

Seale also says short haul intermodal is getting shorter with more truckload conversion of local eastern traffic to intermodal. Thus domestic intermodal volume is up eleven percent against declines in the international, premium (mainly LTL and parcel) and Triple Crown sectors. The good news for short lines is that ethanol remains strong and NS is adding 514 new super-jumbo covered hoppers to its feed-grain fleet.

EVP Operations Steve Tobias was next up with some cogent clues as to what short lines ought to be doing to improve asset turns. He said performance bonuses are partly based on train performance, connections and plan adherence, with NS tightening measurements on network trains and connections. [Shortliners, read ISA performance.] In addition NS is re-evaluating terminal switching requirements using its proprietary Operating Plan Developer and this could affect short lines where switched by yard crew.

EVP Planning Deb Butler closed the day's remarks with a complete capex breakout, split about 72-28 on core maintenance and capacity enhancements, with pie-charts on where its going -- roadway, cars, locos, tech, etc. This was clearly one of NS' best earnings calls – lots of detail showing how things work and why with a minimum of self-serving hype. Hope they do more of this.

Canadian Pacific's fourth quarter revenues increased ten percent year-over-year but once you back out the foreign exchange (FX) impact of the rapidly appreciating US dollar against the Loonie, revenues rose but one percent. Moreover operating expenses rose five percent, driving operating income down twelve percent, though it was unchanged once adjusted for FX. The operating ratio added 220 basis points to 76.5.

Below the line it gets very noisy. Net income was down 41% after FX losses on long-term debt and other items, down 4% absent these items. EPS was also down 41% with items and 4% without. Diluted shares were unchanged, though after the market close CP said they had issued 12.6 mm new shares "to a syndicate of underwriters" at a price of C$36.75, a 9% discount from Tuesday's close, worth roughly C$500 mm prior to fees and representing a dilution of about seven percent to FY 2009 earnings per share estimate.

Revenue units in the fourth quarter dropped six percent as sulfur/fertilizers, forest products including paper and auto all dropped 20% or more. Grain and industrial/consumer both rose eleven percent. Intermodal units also dropped eleven percent and coal was up six percent. During the call Marketing SVP Marcella Szel noted that 40% of the revenue gain was from fuel surcharge and the DM&E represented for half the FX-adjusted revenue increase. Looking ahead, 2009 is off to a slow start as January sales are taking a hit from extended holiday shut-downs and slower re-starts, though the rate of return to normalcy (whatever that is) seems to be improving.

On the operating side, SVP Operations Brock Yates noted improved train speeds, yard dwell, cars on line and car miles per day. They have increased train weights by five percent over two years to 6,300 trailing tons (still small by some standards, but look at the western grades) and have put more than 270 locos and 15,000 freight cars in storage while furloughing some 1000 employees.

Ed Wolfe's *investment conclusion* states the CP case quite well. "Despite CP's upside report, there are so many moving parts in our model – fuel, currency and now consolidated DM&E results – that it's tough to have much conviction in our estimates. We have strong near-term concerns about CP's high-end exposure to exports particularly coal and potash. Further, CP's actions in issuing equity well before any debt issuance was due (next issuance due in 2010) gives us some concerns about management's confidence in its cash flows."

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