THE RAILROAD WEEK IN REVIEW

July 15, 2011

"Norfolk Southern is now a growth company." -- Don Seale, Chief Commercial Officer, Norfolk Southern at the annual shortline meeting

Norfolk Southern's annual annual shortline confab s took place in Roanoke, Virginia this past Sunday and Monday, with golfers and Caucus members sticking around through Tuesday. As reported in this space a week ago, my spies were exactly right: the Sand House session was indeed lively and well-attended and there was good audience participation during the Monday morning formal presentations.

Chris Spiceland, NS System Manager for Short line Marketing, made his podium debut with an in-depth presentation on where and how NS short lines are handling more traffic year-over-year and doing it with growth rates that are significant multiples of what we see on other roads. [Later, Rob Robinson, NS AVP for Shortline Marketing and Commercial Development, told me they're actually seeing truckload diversions to carload, not just intermodal, and that it's happening mainly on short lines.]

I particularly liked what Chris said about the "shortline multiplier." NS short lines operate on more than 18,000 route miles, which, when combined with NS' own 21,000-mile system, provide a 39,000 route-mile network, of which short lines have 46 percent. He adds that short lines handled nearly three out of every four Marcellus Shale-related carloads.

Don Seale, EVP and Chief Commercial Officer led off with some sobering facts about the trucking business and how their travails play directly to NS strong suits and the implications for NS short lines. He reminded us that 53 percent of Norfolk Southern's 2010 revenues came from manufacturing and agricultural commodities plus another 28 percent from coal, all strong suits for short lines. As for the shortline contribution, Seale said that short lines touched 26 percent of Norfolk's 3.8 million non-intermodal units in 2010: nearly a million carloads.

Seale also picked up on the theme of NS leadership in 2010 shortline year-over-year volume growth -- up 22 percent, handily beating second-place UP and its 13 percent increase. Metals and construction (Marcellus goes here), ag products and chems accounted for two-thirds of NS shortline carloads YTD through May and each was up year-over-year. The Jan-May run rate plus the outlook for the balance of 2011 suggest that this could be a record year for NS short lines, hitting about 1.1 million units, edging out the previous all-time high of 1.0 million back in 2006.

Clearly the emphasis is on growing the shortline sector's carload contribution through projects that can bring profitable traffic and are "location agnostic" (Robinson's term) -- whether on NS local or a short line, what suits the customer better? [*I picked up half a dozen examples where NS helped locate a new industry on a short line because it satisfied a customer requirement. -- rhb*]

CEO Wick Moorman was the noontime speaker, and, as expected, spoke on where the growth is coming from, where the margins are, the importance of superior service as defined by the customer and the cost of increasing federal oversight and regulation. But the focus has to be long-term and that's where he says Norfolk Southern's strength in people, power and infrastructure will pay off.

The carload sector -- including coal -- still accounts for 55 percent of NS revenue units and that's where the margins are. Message to short lines: your first-mile, last-mile contribution combined with your own business-development skills are critical. The corridor initiatives may have a strong intermodal element, but the faster railroad helps everybody. Welcome aboard.

Perhaps the highlight of my Roanoke visit was a half-hour one-on-one session with Rob Robinson. I had three items on my Hit List and Rob nailed 'em all. First was the NS Guiding Principles for Shortline Relationships document with roots going back to the Conrail transaction in the late 1990s. Is it still in effect, I wanted to know. Rob unhesitatingly told me it definitely is and that short lines working with NS ought to refer to it in all their NS dealings.

Second, I wanted to know about the division of labor and assignments among the staffers reporting to Rob. First, the Roanoke folks. Rob and Chris are the go-to guys for guidance relating to commodities, rate-making and administration. The Commercial Development Team Members are your field contacts for site development and even some operational liaison matters. The Authorized Sales Agents are contract reps whose main focus is winning small shippers who have left the railroad back to the railroad. To be sure, there is bound to be some cross-ruffing between these last two groups, but, says Rob, this is a starting place.

Finally, I wanted to know what he wanted most from his shortline partners. In a word, clean lines of communication. What he needs are facts, figures, dates, names, places, times, and so on before he or any of his staff can help. We spoke about a number of places where conflicts had arisen where they ought not to have, but for a lack of clear communication. The door is open. Walk right in.

Genesee & Wyoming reported total June carloads were up 13.4 percent to 84,999 units, of which 67,137 units were in the US and Canada, by themselves up 5.3 percent. Australia jumped 60.0 percent year-over-year, thanks largely to 20,194 units from the December, 2010 FreightLink acquisition. Absent this increment, the total same-store traffic increase was principally due to increases of 3,515 carloads of coal & coke, 2,685 carloads of farm & food products and 2,016 carloads of minerals & stone. These increases were partially offset by a 3,487 carload decrease in metals traffic. All remaining traffic increased by a net 3,392 carloads.

Drilling down to North American results, which I tend to focus on for the shortline comps, same-store totals are again skewed by an anomaly, in this case, the Huron Central (HCRY). Reported loads for June, 2011 include 1,295 carloads in June 2011 and 1,253 carloads in June 2010; quarterly loads are adjusted accordingly.

To review, GWR announced its intent to discontinue operations of HCRY June 15, 2009. After negotiations with certain customers and government entities, HCRY entered into an interim agreement to continue operations. Because of the nature of the temporary agreement, during this interim period, which lasted from August 15, 2009 through December 31, 2010, GWI did not include HCRY's carloads in its monthly carloading press release.

On January 1, 2011, HCRY started operating under a new agreement with certain customers and GWR resumed including HCRY traffic in its monthly carloading press release. To facilitate comparison to the prior year in the June, 2011 car-counts, GWR included HCRY carloads from June 2010 and the second quarter of 2010 which were not previously included in the press release for the same periods in 2010. [*You got all that? There* will *be a quiz. -- rhb*]

For June, 2011 major (greater than 10 percent of total units) GWR North America commodities that posted double-digit traffic gains included coal, aggregates, and "other," a euphemism for NS overhead coal in Ohio. The metals group was the only major commodity to post a double-digit decrease.

Second-quarter revenue units increased 3.5 percent year-over-year to 195,677; year-to-date through June vols increased 5.7 percent to 389,907. Every month Jan-June was up year-over year; month-to-month sequential changes were erratic: down 12.8 percent, up 22.8 percent, down 7.3 percent and so on. But I think GWR's unique strength comes from its regional approach plus Rail Link for the smaller, scattered properties -- many of which are not included in the car-counts. Consequently, the car counts we *do* see are for the regions as opposed to aggregations of individual shortline names.

RailAmerica's June carloads decreased 4.4 percent to 70,238 units from 73,466 units year-over-year. Coal, the number one commodity by volume, dipped 19.2 percent to 12,358 units and to 20.8 percent of total units from 24.0 percent a year ago. Charlie Patterson, RailAmerica's Chief Commercial Officer, says the reduced coal traffic came as a result of "sourcing shifts in the Illinois Basin, reduced demand across several utilities and flooding."

Elsewhere, RA posted increased shipments in six out of twelve commodity groups. The largest increases were in Metallic Ores and Metals and in Forest Products. Metallic Ores and Metals were up primarily due to higher shipments in the Central and Northeast regions. Forest Products were stronger due to increased shipments in all regions.

Petroleum carloads were down primarily due to lower shipments in the West region. Non-Metallic Minerals and Products volumes were down primarily due to decreased carloads in the Southeast and Central regions. June 2011 carloads include 660 carloads from the acquisition of three railroads in Alabama. On a "same railroad" basis, carloads declined 5.3%.

The year thus far has not been kind to RA. Year-over-year monthly comps have been small negative deltas in four out of six months. Year-to-date deltas were small negatives in all but January, 2011; YTD through June loads were off 2.0 percent against the 2010 first half. Back out the 660 loads off the three recent Alabama acquisitions and we get 420,477 units across 40 railroad names, about 21,000 annualized cars on 7,400 route-miles of railroad - 185 miles per name. Do the math and get 114 cars per mile per year, certainly within my Rule of 100, but not by much.

This being the case, RailAmerica looks very much like a cross-section of the 500+ names in my shortline database. And if RA is struggling to stay even with last year, much less score significant year-over-year gains, it does not bode well for the low-density shortline community as a whole. (RMI's RailConnect Index through Week 26 -- July2) has shortline vols ex-intermodal but including coal up just 8.0 percent.)

Double-digit gains for grain, chems, waste and aggregates (47 percent of shortline vols) helped the total volume picture, but having two of the four in typically low-rated commodity groups doesn't help Class I returns that much. Attention must be paid.

Earnings Season is upon us. The AAR reports gross ton-miles for the week ending July 9 -- a pretty good proxy for the second quarter YTD -- up only three percent. Not a good omen. The Class I calls begin with CSX next Tuesday and wrap with CP on July 27 -- I don't expect to see any barn-burning results. Look for essentially unchanged merch carload and coal vols with revenue deltas positive in low double-digit percentages.

My baseball buddy Tony Hatch sees it thus: "The railroad numbers might be uninspiring, but the calls won't be. The rails head into Q2-11 earnings without the benefit of any strong economic or other tailwind but nonetheless brimming with optimism about the future, near, intermediate and (especially) longer term.

"This quarter is not likely to show any real earnings surprises, although CSX will lead-off Tuesday with earnings growth of about 22 percent. Overall, the Big Five reporting rails will produce year-over-year earnings gains of about 13 percent, roughly in line with the S&P 500 (after beating that benchmark for years); if you take out CP's expected earnings decline of 10-15 percent, the Class I rails slip back into their familiar leadership role of around 20 percent, with KCS providing the exception, leading the pack with a growth rate approaching 30 percent."

Stay tuned.