THE RAILROAD WEEK IN REVIEW

October 5, 2012

"The combined effect of the fiscal cliff changes could shrink the economy by a nearly three percent annualized rate in the 2013 first half and push the unemployment rate up to 9.1 percent by fall." -- Associated Press, September 30

It takes more revenue units to generate more revenue and more revenue to generate more operating income. What happens below the line is beside the point to shortline operators and others who depend on increased volumes to make their nut. Yet Wall Street is busily pumping up the railroads' earnings prospects -- without much reference to increases in revenue units. Could be there isn't much to write about.

Allison Landry Credit Suisse writes of KCS, "We believe that 2012 is an inflection point for the company, whereby a substantial pipeline of new business opportunities will likely drive [new] revenue growth in 2013-2015." That's mainly Mexico, a niche market for them. Ditto for UP, per John Larkin at Stifel Nicolaus: "We believe the company is positioned to benefit from continued growth in cross-border movements into and out of Mexico... and from increasing crude by rail shipments to its St. James, Louisiana terminal."

The only rain -- well, maybe a light mist -- on this parade comes from Larkin, who cautions, "The downward revisions to our 2013 and 2014 EPS estimates reflect an expectation for even more modest economic growth (i.e., ~1.0%-1.5% annual GDP growth) relative to what we were previously assuming." And Benjamin Hartford at RW Baird is "lowering estimates for selected domestic transports," seeing "limited near-term catalysts for the rails."

Tony Hatch writes, "RailTrends 2012 will be eclectic and future-focused." Based on the note he sends, that's a pretty accurate description of what's in store. The Nov 1-2 event will once again take place at the W Hotel at 541 Lex in NYC and -- by zeroing in on what's coming vs what's gone before -- ought to offer some valuable insights.

RailTrends 2012 will feature a a considerable Washington cohort. The STB's Dan Elliott, FRA's Karen Hedlund and NTSB's Deborah Hersman will present, as will NIT League President and CEO Bruce Carlton, Railway Supply Institute President Tom Simpson and railcar expert Toby Kolstad. Tony Hatch and Donald Broughton will give a Street perspective on the industry and cover competing modes, complete with their views of capex vs ROI, etc.

The rails' role in oil and gas exploration transport is to be covered by Canadian Pacific VP Tracy Robinson, Watco President Rick Webb, Dakota Plains Holdings VP of Operations, Robert Henry, CN chief commercial officer Jean-Jacques Ruest his and KSC counterpart Pat Ottensmeyer. The big domestic intermodal growth story will be in the capable hands of CSX's VP Intermodal Bill Clement and FEC President and CEO Jim Hertwig.

ASLRRA President Rich Timmons sets the shortline scene, with supporting presentations from GWR President Jack Hellmann, Watco's Rick Webb and newly-appointed John Fenton of Patriot Rail Corp., itself a 2012 purchase by PE firm SteelRiver Infrastructure Partners. And as passenger rail re-enters the national consciousness, RailTrends 2012 brings together the Heavy Hitters: Joe Boardman of Amtrak and Husein Cumber, head of the FEC/Fortress' efforts to develop a privately financed passenger operation on the old Flagler lines running down the eastern coast. Rounding out the story is Chris Aadnesen, president and CEO of Alaska Railroad -- already a hybrid freight/passenger carrier running in some of the world's roughest conditions.

Going further afield from continental North America, RailTrends attendees will have a rare opportunity to hear from Australia's Queensland National Railway. The line was privatized not long ago and is already ahead of revenue and ROI projections. Once again, the RailTrends crowd has assembled a first-rate program with first-rate presenters in a first-rate venue. I look forward to seeing you there.

The bloom may be fading from the ethanol rose. Credit Suisse has published a 26-page survey of the business, concluding that ethanol supply far outstrips demand and is likely to do so for the next few years. The fact is that the government's Renewable Fuels Standard mandates the production of more ethanol than "the plausible level of ethanol demand absent a significant, and immediate, introduction of 15 percent ethanol blend." Moreover, "US ethanol producers were already producing at or above the mandated level of production under the Renewable Fuels Standard while demand for ethanol has been limited by the 10 percent blend wall and slow implementation of 15 percent blends."

The report estimates that 2012 gasoline consumption comes very close to the EPA target of 13.2 billion gallons, so the present ethanol level of 13.5 million gallons is more than you need for E-10. And it's not going to get any better as gasoline consumption is projected to decline over the next two decades as more efficient engines are adopted.

According to the *Wall Street Journal*, "Many consumers are driving older vehicles that they must replace, most likely with new vehicles that enjoy improved fuel economy -- an attraction for buyers wary of $4-a-gallon gasoline." They are wary as well of E-15 as well and there aren't enough places to buy the stuff anyway. And one out of every ten ethanol plants built in the tulip-craze run-up is now shuttered.

Don't just take Credit Susses's word for it, either. Valero's 10-Q for the 2012 second quarter advises us, "Second quarter operating income was partially offset by the decrease of $59 million in our ethanol segment. This decrease was due to lower margins caused by *excess supplies of ethanol* [emphasis added-- rhb] and margins continue to remain depressed in the third quarter of

2012 due to higher corn prices. As a result, we have suspended operations at two of our ethanol plants and reduced utilization at other plants temporarily.”

But it gets even better. Dennis Gartman, in his October 1 Letter, points out that there are too few refineries left in the US to meet existing demand for gasoline and those that are left tend to have outages and other events that keep production down. That puts downward pressure on crude (and ethanol) prices because there’s more of both than the refineries can use. That in turn puts upward pressure on gasoline pricers because demand exceeds supply. And as our cars and trucks get more fuel-efficient, demand will diminish as well.

So much for the ethanol boom and if your short line depends on a growing stream of inbound ethanol to survive, you might want to start looking around for ways to expand the franchise. As if you can find one -- the minuscule deltas in single-carload inbound commodity moves are not going to get any better for at least another year and a half.

The frack sand business has taken an interesting twist in southern New York state. On the one hand, NS serves a now-expanded frack sand terminal at Horseheads, NY, not 20 miles north of the Pennsylvania state line and half an hour’s drive on the interstates to reach Sayre, Pa., and the US 220 route to the epicenter of one of that state’s hottest drilling areas. The Horeseheads site has seen an $20 million upgrade that lets cars unload five times as fast as before. During 2010 and 2011, the number of cars increased to 1,800 and 2,600 respectively, while 1,400 cars have been unloaded through the first half 2012.

And on the other hand, not one grain of that sand is for use in NY. An item in the Elmira *Star-Gazette* says New York’s Department of Environmental Conservation expects to miss a critical late-November deadline for its proposed fracking regs, forcing the agency to restart its rule-making process and reopen the regulations to public comment.

The paper adds, “Missing the deadline would further cloud the already murky situation surrounding the state’s decision on high-volume fracking, which is currently not allowed in New York as the DEC continues an environmental review that has stretched on for more than four years.” Meanwhile, railroads along NY’s Southern tier are making a mint unloading sand in NY and trucking it to Pennsylvania drill sites. Brilliant.

WIR’s running a day late this week as Wed-Fri I was at the Northeast Association of Railroad Shippers Fall Meeting in Brewster, Mass., right on the inside crook of the elbow that forms Cape Cod. Comments and observations in next WIR.