THE RAILROAD WEEK IN REVIEW

June 14, 2013

"The sustainability of the rails' pricing story is the single-most important lever in the rails' model." -- Peter Nesvold, Jefferies & Co., June 10 note to clients

Nesvold notes an important fact about railroads, and it's an important follow-on after my CP observations last week. While CP is talking about taking out costs irrespective of volumes, Nesvold is talking about what pricing can do, assuming there are revenue-unit volumes to price. He writes,

> Investors debate the sustainability of the rails' pricing story, which has been compounding at mid-single-digit rates for upwards of a decade. We have long argued that this is the single-most important lever in the rails' model. Our CSX model says 200 basis points of real rate (or roughly four percent nominal price), combined with $150 million of productivity, can drive ten percent-plus EPS growth on as little as a point or two of volume growth.
>
> CSX has benefitted materially from the repricing of below-market, legacy contracts, allowing CSX to reinvest into its network, thereby materially improving service levels. We can see evidence of better equipment turns and asset utilization when we look at revenue units, velocity, terminal dwell, and railcars in storage.
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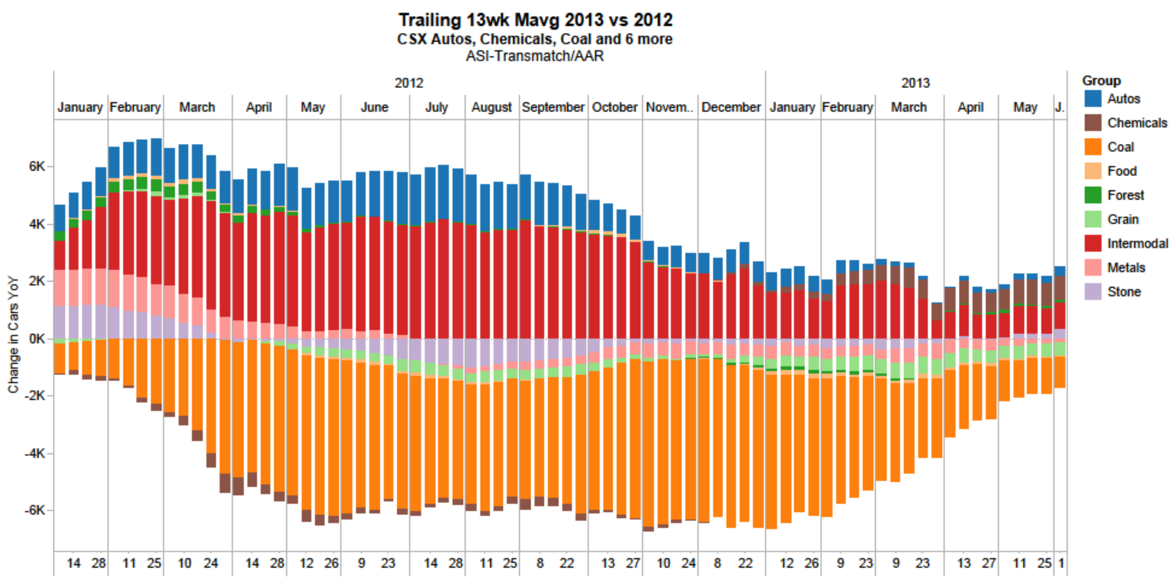
> These investments into enhanced network fluidity come back to benefit shippers because shippers, not the rails, now own most types of railcars [*and more of the fleet -- rhb*]. As a result, CSX is able to sustain inflation-plus pricing via an ever-improving service proposition.

They have to, and they are not alone among Class Is. This table summarizes the Week 23 (ending June 8) carload table under the Investors tab on the CSX website (all the rails have it now):

Commodity	2013	2012	YOY Ch	2013 Pct	2012 Pct	Vol delta
Intermodal	1,105,477	1,078,077	2.5%	38.8%	37.7%	1.1%
Petrol	53,307	35,152	51.6%	1.9%	1.2%	0.6%
Coal	493,731	538,229	-8.3%	17.4%	18.8%	-1.5%
Auto	192,289	190,278	1.1%	6.8%	6.7%	0.1%
Total	1,844,804	1,841,736	0.2%	64.8%	64.4%	0.4%
All-in	2,845,552	2,857,927	-0.4%	100.0%	100.0%	0.0%
Merch CL	1,000,748	1,016,191	-1.5%	35.2%	35.6%	-0.4%
Source:	CSX Week 23					

The “All-in” line is total revenue units; the “Total” line is all those revenue units that are not likely to show up on your typical short line. Not much movement ex-petrol. Now look at the yearly “Pct” columns for the percent each commodity group represents of the total units moved. For 2013, intermodal has moved up a point to 38.8 percent, petrol has increased 60 basis points to 1.9 percent, and the merch carload group -- where the short lines live -- is now 35.6 percent of total units, off 40 basis points year-over year. You can get the line-by-line commodity specifics on the CSX website.

Now jump to the ASI-Transmatch chart of sequential changes. The shrinking bars reflect the small year-over-year deltas of individual 13-week slices of time. Only intermodal, chemicals



Change in Cars YoY for each Date Day broken down by Date Year and Date Month. Color shows details about Group. The data is filtered on Railroad, which keeps CSX. The view is filtered on Date Year and Group. The Date Year filter keeps 2010, 2011, 2012 and 2013. The Group filter excludes Null, Carload and Total Traffic.

(petrol goes here) grain (individually off 13.0 percent) and coal even show. Everything else -- both forest STCCs, metals, ferts and aggregates, etc. -- are lost in the noise. That’s why Nesvold’s comments merit attention: if you’re not making your numbers on vols, you’ve got to get them on pricing, and to get them on pricing you have to make the service worth more. Thus the emphasis on service performance.

Genesee & Wyoming North American carloads for May increased 9.8 percent to 145,335 from 132,318 in May a year ago, adjusted to include RailAmerica as if the two had been combined then; same-store loads increased 8.8 percent. Big gainers were petroleum products (crude oil and LPG) and the coal & coke group. These commodity groups, plus auto and waste, were the only double-digit gainers and reflect the Class I trends as exemplified by the minuscule CSX deltas, above. Year-to-date, GWR units are up 5.1 percent.

My remarks last week on Hunter Harrison and short lines drew an instructive series of emails from readers who, like HH, have been there, done that. At the end of the day, I think it boils down to incremental cost and relative margins. Say CP pays a short line a handling fee that is 25 percent of revenue, leaving CP to pocket the remaining 75 percent. If CP does the work itself and had a 70 OR, it pockets only 30 percent of revenue. Better to let the short line do the work.

On the other hand, branchline cost is incremental cost to the core and contributes to system averages. If the incremental branchline cost of doing it yourself is less than letting the short line do it, then CP wins. Contrary to what I said earlier, the shortline OR has nothing to do with the case. What the short line does with the allowance is no concern to CP. If the short line uses 90 percent of the revenue to keep the wheels turning, then so be it. CP's exposure remains 25 percent of revenue.

I think the HH remarks work insofar as what Warren Buffett calls "friction" expense lowers returns. He loses the car for a week vs. 3 days if he does it; he'll have to work the interchange, possibly fouling the main, as opposed to just running up the branch and doing the work; he adds back-office expense to maintain the shortline relationship.

As one looks around the shortline community, one get the sense that most of the lines spun off in the 1980s were dogs then and still are. Yet at the time short lines could be low-cost producers without mandated five-man crews and all the other legacy baggage. The right strategy in 1980 is not necessarily the right one for 2013 and beyond; however, the Class I shortline strategy, along with everything else, remains a function of your balance sheet, marketing strategy, etc. Worry about the core carload network first, then work the edges.

Harrison's hallmark is equipment turns, whether IC unit grain trains to the Gulf or single carload cycle time at CN or closing hump yards to improve velocity at CP. The best way to achieve these ends is to control as much of the move as possible, including the frequency and timing of local delivery. Doing so allows one to adjust quickly if volumes change in either direction. And while the short line is in essence just another customer, it's more difficult for CP adjust service levels to match shortline volumes.

As one reader puts it, having a short line between the Class I and the customer can introduce new inefficiencies -- dwell at interchange, event reporting delays, e.g, -- that add cost (Buffett's "friction") to the transaction. Here again, HH most likely is thinking about places where CP can provide the local service better than the short line and with less friction.