THE RAILROAD WEEK IN REVIEW

March 13, 2015

"Dow Theorists contend that the activity of the Industrials and Transports provides a filter to detect whether the stock market is in a healthy or unhealthy state." — Dow Theory

AAR Railroad Performance Measures for the eastern Class Is show how two railroads, both operating in the same environment, can have different operating patterns. Cars-on-Line, Train Speed, and Terminal Dwell are related in such a way that changes in one will affect changes in the others. Take this four-week snapshot for the weeks ending Feb 6 through Feb 28.

CSX cars-on-line increased by four percent, system-wide average train speeds slowed 8 percent, and railroad terminal dwell gained 16 percent. Yet total year-to-date revenue units through Feb increased 2 percent, suggesting that not that many more revenue units were taking up space on the railroad, just that they were taking longer to get where they were going. And, logically, as yards fill up they slow down, and as yards get plugged, more trains are held out or don't make departure time.

NS, on the other hand, saw no measurable increase on cars-on line even as YTD vols were unchanged. System train speeds remained constant and yard dwells worsened by a mere 3 percent. Which tells me trains are getting over the road pretty much according to plan.

However, the stock market trends do not bode well for the "stuff that moves" commodities. I track 10 commodity-based ETFs, from XHB Homebuilders and XLB Materials to XLP Consumer Staples and XOP Oil & Gas Exploration for an indication of investor sentiment concerning the outlooks for these industries. Of the lot, only the XLY Consumer Discretionary (restaurants to retail) is above the 50-day moving average, and that by less than two percentage points. Everything else is waving red flags.

Moreover, the Dow Jones Transportation Average has been tracking a range between 8,500 and 9,000 since late October, and that does not bode well for shares in general. Boiled down to basics, the Dow Theory posits that an advance in transports presages an advance in the broader market as more goods move in advance of anticipated sales. Conversely, when market sentiment points to retrenching sales, the transports carry fewer goods and earnings go down.

For this reason, I do not expect particularly robust gains in rail traffic vols for the next six months and I would be using the lull to sharpen my supply-chain focus and run only those trains needed to carry the goods and run them according to schedules — all of 'em. Intermodal, manifest, ag products, automotive. Then, when biz does come back I'll be running a Precision Railroad (thank you HH) where every car regardless of contents moves according to plan.

Indiana Rail Road, a privately-held regional railroad, has a $17.5 million capital program slated for 2015, on top of the $20 million 2014 capital campaign that went largely for rail and tie renewal. The 2015 program targets bridge renewal and replacement as well as new rail installation, ballast and miles of undercutting scheduled. Of particular note, INRD will replace two timber bridges on the Chicago Subdivision between Linton and Elnora, Ind. Two concrete culverts will replace the northern bridge, while the southern bridge will be replaced by at 159-foot steel and reinforced-concrete ballast deck structure.

INRD also marked progress on the $14-million replacement of the 117-year-old White River bridge, which is scheduled to be finished by August. Renewal of the existing piers is complete, steel girders have been delivered and construction of the temporary bridge is underway. In all, INRD has 208 bridges on its system of 500 route-miles, many of them over major waterways.

The railroad says bridge work will continue to dominate its future capital plans with the replacement of a 112-foot timber bridge near Newton, Ill., scheduled in 2016. INRD also says to expect "the most aggressive bridge replacement program in the company's history" in 2017. The Indianapolis Subdivision is scheduled to see eight timber bridges replaced with steel and reinforced concrete ballast decks. The railroad's Shuffle Creek Trestle north of Bloomington, Ind., is also scheduled for renewal in 2017.

Independent rail analyst Tony Hatch, a good friend and associate of some 25-years standing, enjoys a sufficiently large audience among railroads sad shippers that he can pull together conference call panels on the many *topics du jour*. This week, Tony hosted a call on “Lower Oil Price Implications for the North American Rail & Rail Equipment Markets.” The conversation featured Taylor Robinson, President, PLG Consulting, a firm with 15 years experience in the energy and bulk by rail space, and Phil Ireland, whom many WIR readers will recall from his interline relations work with CP Rail, now teamed up with the PLG crude-by-rail forces.

To set the scene, PLG says the Bakken and Canadian Oil Sands are the main crude-by-rail players, moving nearly 90 percent of North American crude, with other plays such as Niobrara and Permian smaller but consistent contributors. PLG predicts Bakken will stabilize at about 800,000 barrels per day (I use 700 barrels per tank car as a rough guide) while pipelines and local refineries could diminish Oil Sands rail shipments over the next few years.

Still, Robinson says we’re “only in the 2nd or 3rd inning” of the new energy revolution (Tony’s term). Crude oil will follow the supply/demand/adjust pattern we have already seen in natural gas; downstream impacts, such as the resurgence of US industrial production led by chemicals, will be more evident in a few years, though the build-out is being perhaps lengthened but not really curtailed by the oil price drop.

The rate of growth of the US land oil rig count seems to be slowing; however, frac sand and petroleum rail carloadings continue to move up and to the right. Even though $50 WTI oil is “challenging,” reining in new capex and lowering operating expenses lets well-capitalized

producers focus on "sweet spot" drilling, winnowing out the smaller, weaker players. At the same time, "Frac sand shippers/receivers will continue to move towards more efficient methods of rail transportation, especially with heightened pressure on frac sand delivered cost per ton" — read unit trains and silos at destination terminals, again not the province of mom-and-pop ops.

None of which is surprising given frac sand car supply. As Ireland sees it, "The current market is one of mixed signals: there is significant activity in short-term subleasing and railcar storage and some shifting of new-build delivery schedules, but few outright cancellations of car orders. On the other hand, new-build production schedules are 'full' through mid-2016, subject to change; a few late-2015 low volume, new-build slots are available through negotiation; but the overriding appetite for 2016 production is one of wait-and-see; typical full service lease rates are currently $650 -$675, down from late Q3 2014 (was over $700)."

When all is said and done, however, the lower crude oil and nat gas pricing environment is mainly caused by oversupply, and lower prices will mandate cost reduction throughout the supply chain. That in turn will lead to industry consolidation as weaker, less well-capitalized firms retire from the field. It's entirely possible lower prices "will dampen growth profile for shale oil and crude by rail volume in the short term," taking some of the heat off the market for tank cars and small-cube covered hoppers. For now.

Returning to the Oliver Wyman conversation on scheduling paths, not trains, a Pennsylvania shortline operator writes, "PRR used to do this. They kept coal and iron ore drags on the secondary routes as much as possible. The ore trains that ran up and down the mountains in northwest PA from Erie all the way to Allentown were an example. However, modern class ones do not have all of the routing options they did in those days. Most secondary lines have been abandoned or shortlined. Happily, short lines now running these branches can handle successor Class I trains overhead."

A chap who used to run a regional railroad in the WV coal fields adds, "Not so fast on using weak coal vols to free up core resources. For example, many CSX coal lines are in the wrong place to offer many easy slots for intermodal, given they are ex-C&O or L&N. Moreover, opportunistic track removals in Rice era [SAL Petersburg-Raleigh??] are also causing some issues in the southeast for the intermodal theme.

"So IMHO it's not only a question of slots on coal lines but also of too many miles with too many tunnels and too few trains." My point exactly: keep the coal trains on the C&O and L&N; keep 'em off the NYC and B&O West End.

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