THE RAILROAD WEEK IN REVIEW

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"While UP's third quarter is off to a rough start, we see potential catalysts ahead for stronger grain and intermodal volumes." — Scott Group, Wolfe Research

Union Pacific held its 23d Annual Shortline Conference in Omaha this week. If any railroad ought to be shortline friendly, UP is at the top of the heap. Three out of every five revenue units are merchandise carloads, including crude oil and automotive. Twenty percent of UP's nearly 10 million annual revenue units touch a non-Class I feeder line at some point in the route.

UP operates 600 scheduled manifest trains a day over three regions comprising 20 divisions, 14 hump yards, and 31 non-hump class yards. Tom Haley, VP for Network Planning and Ops, says simply, "We like the carload business." Evidently. The railroad is sized to run nearly 200,000 units a week, though 185K has been more the norm of late. That suggests there's room for another 15,000 units a week — 150 trains worth.

At the end of 2Q2015, carload freight — including auto and crude, excluding intermodal and coal — was about 80 percent of total UP revenue units, or 120 of the 150 trains that could be added UP were running at capacity. And if short lines touch a fifth of UP carloads, we could be talking another 2,000-3,000 shortline cars a week.

In last week's commentary I suggested that it's the manager's duty to provide the tools to do the job. Similarly, one would expect the Class Is to provide the shortlines the tools to bring on more business. Here, I think UP has the potential to excel.

The meeting scheduled only half a day of speechifying, with a day and a half of giving shortline reps one-on-one time with their UP counterparts: from cross-functional areas such as service design and mechanical support to commodity business teams covering everything from ag products to plastics. And, best off all, a day of that was held at UP headquarters, where the feeder lines were assigned their own rooms and could set up times with UP staffers.

That said, I think UP could do a better job of working the shortline contribution into the formal presentations. Yes, it's helpful to know vols are up in the south and down in the north or that they're prioritizing low-cost, high-impact capex projects. What can I do as a shortline operator along the Texas Gulf, for example, to ease the pressure on UP choke points or add volume on lines that are way under capacity? I thought the slides were too heavy on analyst-speak and too light on ways to further strengthen the shortline "partnership."

A number of the shortline reps spoke with me individually about vastly improved interchange performance, but some were concerned that UP seems reluctant to market-price back-haul

opportunities or short-term spot market moves that would increase revenue car-miles per day and improve the per-train revenue-cost ratio. Linda Darr, ASLRRA President, touched the association's initiative to highlight shortline successes to bring business back to the rails, and it occurs to me UP could have a very strong story here. All it requires is Access to Tools and a value proposition that is attractive to the customer is Tool Number One. I'm hopeful the day and a half of one-on-ones has helped.

The US Department of Agriculture sees the grain outlook improving in the US but not so much in Canada. For the 2015-16 crop season the USDA boosts estimates for corn and beans but is less sanguine about wheat. The expectation is that railroad grain carloads will increase in the upcoming months thanks to current bumper crops on top of already high storage levels, suggesting there's a lot of inventory looking for cars.

Union Pacific ag loadings (grains, grain mill products from corn sweeteners to ethanol, and STCC 20 processed foods) run about ten percent of total system revenue unit volume and 18 percent of revs, with the average ag RPU in the $3,800 range. UP's Todd Whitham says short lines touch roughly two out of every five ag cars, suggesting 2015 first half shortline ag vols in the 200,000 range. At $400 (my estimate; not an official number) a car to a short line, we're talking $80 million to the UP feeder line partners.

Jason Hess, UP's Ag products VP, backs up the USDA report. He reports grain is on a rising trend line; new shortline origins and destinations are making a significant contribution. On the grain mill side, Hess says UP and its feeder line network reach five dozen ethanol producers and have access to 70 percent of the soy crush in the midwest. Moreover, the boxcar business for fresh produce is expanding as demand for processed food goods decreases.

By way of comparison, the ag commodity group accounts for about ten percent of BNSF revenue units and 20 percent of total revs. RPU is in the $4,100 range. For six months, UP did 482,000 cars of ag products, down two percent, to BNSF's 507,000 carloads, up six percent. In a note Friday, Scott Group writes that a shipper contact says BNSF export grain service levels to the PNW are back to the usual 12-13 days (round trip) after deteriorating to as much as 24 days a year ago, and that a respectable gain in ag carloads is in the offing for BNSF.

Providence & Worcester has reported second quarter results. Total freight sales came to $9.3 million, unchanged, on 15,255 revenue units, down three-tenths of a point. Carload revenue increased one percent to $8.5 million though carloads increased almost ten percent. RPU dropped eight points thanks to the loss of ethanol moves, partially offset by gains in auto and chems. Intermodal containers, a mere four percent of revenues, brought in $318,000 in sales, down 19 percent, as vols declined a similar amount. P&W says the loss is due to more international freight being transloaded to domestic boxes in the west.

Operating expense after capitalized expenses were unchanged; ops income was $930 million, unchanged (P&W includes rentals in ops revenues, so their numbers will differ); the operating

ratio remains at 90 even. P&W reported wide swings in car hire, purchased services, maintenance expenses and trackage rights with little explanation in the Q. The six-month comp & benefits line is down to 49 percent of revenue, down from 50 percent a year ago, but still 20 points more than what one would expect on a railroad this size. Net income including rentals was $773 million, up 24 percent, chiefly on a lower income tax bill.

The close ties between US oil prices and rail traffic volumes continues. Morgan Stanley's Adam Longson writes,

> The trade-weighted US dollar (USD) still matters for oil… Any notable positive headline could continue to squeeze short positions and drive a modest rally in oil prices. Bearish headlines are possible, but are increasingly priced in, and likely to elicit even a small price response at this point. Hence, the risk-reward is still skewed to the upside, in our view, especially for Brent.

Regarding Brent pricing specifically, the WSJ reports that Irving Oil in Saint John "has stopped importing Bakken Shale oil from the U.S. in favor of cheaper imported crudes." Due to the global slump in oil prices, Irving and others on the Atlantic shipping lanes "can now import crude shipped by sea for less than the cost of shipping it by rail from shale oil producers in North Dakota and elsewhere in the U.S." CN and Pan Am Rail will lose out.

Moreover, the AAR said earlier this month that U.S. Class I railroads originated 111,068 carloads of crude oil in the second quarter of the year, down 2,201 carloads from the first quarter and some 21,000 fewer carloads than the peak in 2014's third quarter.

Implications for railroad carloads of everything from above-ground storage capacity to steel pipe, to frac sand, and to the effect on non-coal energy carload volumes are mind-boggling. But it's early days so we really don't know how bad it'll be for feeder railroad volumes.

As Art Cashin, UBS Director of Floor Operations, says, "Stay wary, alert and very, very nimble."

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