THE RAILROAD WEEK IN REVIEW
August 7, 2015

"Remain globally diversified and patient, but limit risk-taking in the near term." — Liz Ann Sonders, Chief Investment Strategist, Charles Schwab & Co.

Genesee & Wyoming North American freight revenue declined five percent in the 2015 second quarter (eight percent foreign exchange adjusted, which I ignore because FX is a cost of doing business and has little to do with railroad performance). Total carload revenue was off six percent to $283 million due mainly to nat gas substitution for utility coal and a flood of imported steel dragging down the metals commodity group. Freight-related and other revenues were essentially unchanged at $73 million. Total Q revs: $311 million.

Fuel expense dropped by a third to $19.8 million, but so did fuel surcharge revenue by $11.4 million. Add in the losses in coal and metals and combined they more than offset the $15.2 million in new revenues from the RC P&E and Pinsly Railroad acquisitions, creating a $14.7 million revenue shortfall vs. last year.

GWR has, thankfully, taken the intermodal line out of the NA reporting sector. What was "North America and Europe," because it included the Rotterdam Port operation, is now just North America now that Rotterdam is part of the UK/Europe reporting segment (Australia is the third). Now we have a clean carload line, and it's down eight percent for the quarter. I've already cited drags on coal and metals; overhead was off by a third — some 8,300 cars. Ag products, chemicals (STCC 28 only), aggregates, and STCC 26 paper etc. all gained in the Q and represent roughly half of all NA loads.

I find the paper results particularly interesting. Up six percent while the world as we know it is lucky to get half that. USRailDesktop has a nifty tool that tells you where it's coming from, and I overlayed those geographic areas on the GWR map. Roughly half of all paper shipments in the US originate in the southeast from the Carolinas through Georgia and west to the Mississippi River. Continue west across Louisiana and Arkansas into East Texas and you cover 80 percent of all paper produced. A third of GWR's 100+ short lines are here, so little wonder paper's strong.

North American operating expense declined two percent thanks in part to both fuel and casualties/insurance being down a third. Comp & benefits gained six percent, staying within my guideline of one third of revenue. The OR rose 157 basis points to 75.4. Below the line, Corporate GWR earned $53 million on $542 million in revenue, down 13 percent.

The second-half outlook for North American GWR operations is not encouraging. We're looking at total loads in the 410,000 to 425,000 range, down 10-15 percent from last year's same-store carloads. With GWR owning perhaps a quarter of all railroads reporting into GE's RailConnect

Index, and with those names spread around geographically much like the broader shortline community, I have to conclude we must remain in hunker-down mode for the rest of 2015.

Twice in the last two days I've been asked about car dwell times on short lines and whether these days are included in Class I per-car calculations. With respect to the first, the time in days between interchange/on and interchange/off varies widely between properties, and customers are largely to blame.

Paper is always a challenge. Some mills were built around the Plate-C, 50-foot, 70-ton boxcar so the door spacing is all wrong for the Plate-F, 60-foot, 100-ton unit that is increasingly becoming the gold-standard for boxcars. Roughly 60 percent of all moves in this car are forest products paper-related, with two-thirds of that in plywood and pulpboard (raw material for Amazon boxes, to you and me). The 50-foot, plate-C car is about a third forest products.

Trouble is, paper RTMs have declined steadily over the last ten years, and cars aren't getting any younger. There have been no 50-foot cars built in the last 20 years, and the rate of new 60's coming on line has been roughly 2,500 a year. No wonder the boxcar fleet has declined by 40 percent to 116,000 units over the last ten years. And origins are geographically concentrated, as noted in the GWR section, above.

The nature of the boxcar business is such that the load-empty-load cycle time runs about four weeks, meaning this $120,000 asset with a 40-year service will see only 12 turns a year and, because boxcars tend to carry low-rated commodities, one is limited in the amount of replacement cost one can put in the rate. Ergo the railroads see no urgency to buy new boxcars.

There is a solution, and it comes from the chemical and agriculture industries. Light-loading DDGs need their own cars, as does crude oil and certain industrial chemicals. Thus shippers get their own cars. So let the paper guys who need the 50-foot cars supply their own. Where they won't or can't, forcing the serving railroads to spot 60s individually at doors spaced for 50s, let the rates reflect the added assets consumed where doors and cars don't match.

Shortlines do it all the time: they calculate the assets consumed from man-hours to fuel to track-wear and build their revenue requirements around those numbers. If the freight won't move for those prices, then the assets are freed up for other work that *will* pay its own way. Which leads us to per-car calculations.

The Class Is in their quarterly earnings calls refer to car-miles per day, car contribution per day, cars-on-line and so on. I've asked every Class I whether they factor in the car's time on the short line when doing their numbers, and the answer is universally "No." Asked why not, the answer is invariably it's a function of what a short line's customers want and we can't make them turn cars faster.

I beg to differ. As noted above, cycle times affect the all-important contribution per car-day metric. You say you need X dollars a day for boxcars for everything from mechanical repairs to replacement cost. Ergo the customer who can spin a car in 10 days will get a lower rate than the customer who takes 20 days. The slow customer thus has the incentive either to speed up or find another carrier. And the short line earns a higher division, generates more RTMs, and lowers its car-hire bill.

What we're faced with is nothing short of the need to reinvent the railroad. The coal tonnages of yesteryear are gone and ain't never coming back. The strong US dollar is doing a global number on commodity pricing from copper to crude oil. Amazon and the like are reshaping consumer buying habits for everything from refrigerators to printer cartridges. And truckers are finding intermodal an attractive alternative to long-distance hauls *only* as long as as service is consistent and reliable.

The carload product has its niche and there's a pretty good moat around it. However, it has to be priced high enough that we can re-purpose the former coal routes (or let them die altogether or short line them) as well as other now-lightly used former core routes to be profitable carload service lanes. Here's how one shortline operator puts his advice to the Class I community:

> On business development, lead, follow, or get out of the way. Small customers make up far more of our business than do national accounts. We are very connected politically, economically and personally to the areas we serve in ways a large company cannot be. Recognize the contribution we provide; don't treat us like a "cost add on." [*Revenue to a short line is money the market manager can't count towards his bogey. - rhb*]
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> Don't tell us the rate is what the computer says or they can't truck it for that rate. Use our boots-on-the-ground battlefield intelligence to gain that critical competitive advantage. And never never tell a customer he is at a disadvantage because he served by a shortline [*A Class I sales guy told me this doesn't happen any more; my channel checks indicate otherwise - rhb*]
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> Do a better job of telling your employees who interface who we are and what customers we serve. Not all do. And finally, empower sales reps to set rates. Having the guy in the field knowing the local issues is better than a distant person looking at a screen telling them what should or should not be.

That's got to be a major part of reinventing the railroad for Tony Hatch's *Railroad Renaissance* to continue.

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