

# THE RAILROAD WEEK IN REVIEW

September 4, 2015

*“The way in which you measure something often determines the results obtained from your experimental model. - John Mauldin, Weapons of Economic Destruction, August 28, 2015*

**Reinventing the railroad is a common theme** among shortline success stories these days. Opportunities abound on lines that once hosted utility coal trains almost exclusively; with that business going, going, almost gone, what’s to become of the asset?

In Pleasant Gap, Pennsylvania, the Nittany & Bald Eagle Railroad (NBER) has teamed up with the SEDA-COG Joint Rail Authority (JRA) to add unit trains of fresh lime to its menu of services. The occasion is the \$750 million conversion of a classic coal-fired electric generating facility a hundred miles away into one of the cleanest-burning coal plants in the U.S.

The power plant, in Homer City, Pennsylvania, provides electricity to some two million households and is on the Buffalo & Pittsburg Railroad. The owner, GE Energy Financial services, will use scrubber technology to do the dirty work and that takes lime extracted from limestone. However, just any limestone won’t do; it must be lime made from high calcium carbonate rock.

GE looked at sourcing its lime from either the Pleasant Gap quarry owned by Graymont, a privately-held international provider based in British Columbia, or a Virginia source. The selection process took over two years, but in the end, Graymont was awarded the long-term contract.

For the economics to work, the lime must move in 45-car blocks, and that requires enough track space to handle both a loaded and unloaded car set simultaneously. Even though Graymont has rail sidings for its current business, it did not have nearly enough railroad track space to handle the Homer City business. They needed to demonstrate to GE that not only could they source the huge volume of lime (a new kiln is under construction to do just that), but also have enough railroad track capacity.

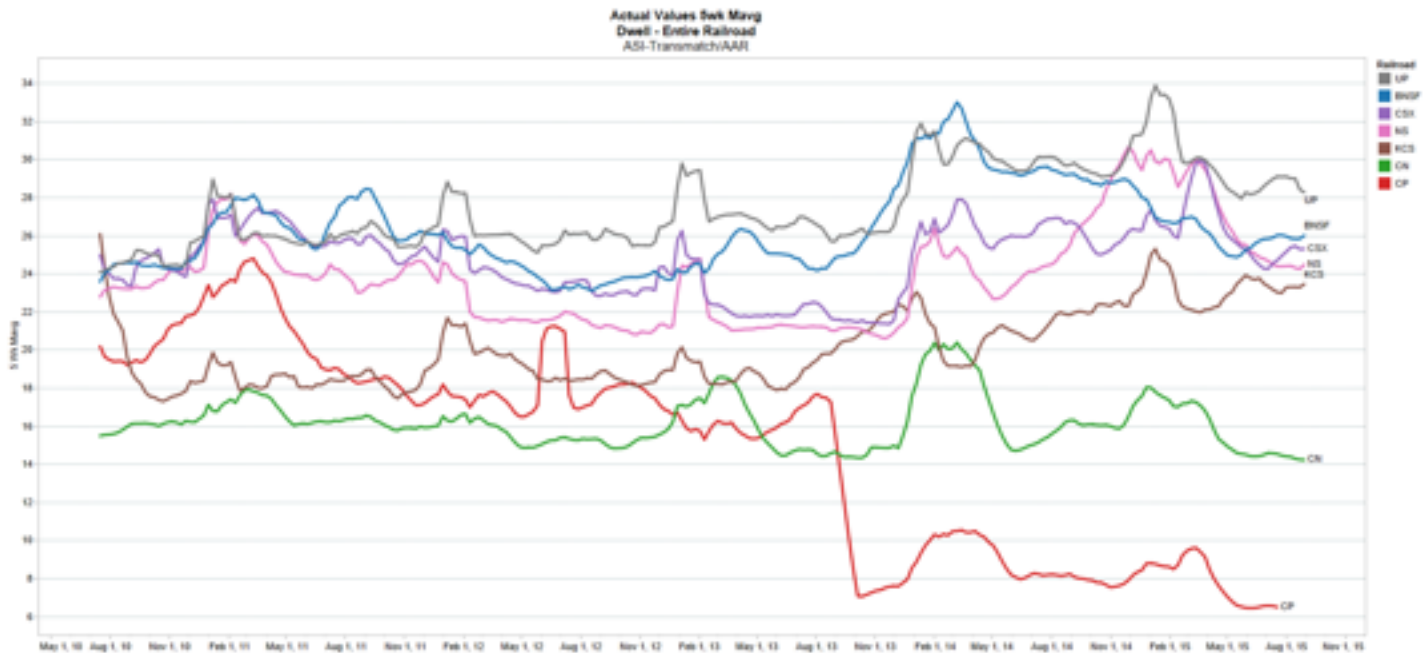
Enter the SEDA-COG and NBER. The JRA offered to partner with Graymont to construct new railroad track at the end of the line that currently serves the plant, adding a support yard that ties into new railroad tracks that Graymont will build on their property. JRA shepherded through an application for PennDOT's Rail Freight Assistance Program to share in the \$425,000 investment needed to build about 1,600 more feet of railroad track. An additional 2,800 feet of new railroad track and other related improvements will be built by Graymont on their own property.

The track project will be complete in early October with first test loads slated to move later that same month. The rail cars of lime will move from the NBER and be handed off to the Norfolk Southern and then to the Buffalo & Pittsburgh Railroad for final delivery to the power plant. NS will provide the covered hoppers to start, replaced in early 2016 with a 90-car fleet that Graymont will acquire.

As a footnote, projects like this don't happen overnight. Todd Hunter, NBER head of marketing, tells me, "Five years of my life are into this project." He's had the same marketing counterparts at NS for the duration, and that surely helped. Jeff Stover, head of the JRA, writes, "NS was very cooperative on this move, sharpening their pencils at every step to get the economics right." The NS team in Lock Haven is geared up to make headlight meets with NBER at Lock Haven and the B&P at Driftwood to minimize car-cycle time and maximize annual equipment turns.

So here we have two short lines operating track that was initially built 100 years ago for wholly other purposes, teaming up with a 30 year-old quasi-government organization and a Class I railroad with roots going back 185 years, to support a power-generating technology first introduced less than 50 years ago that will keep new generations of iPhone users powered up.

**Class I railroad performance stats are not good.** KCS is the only US Class I with better dwells than a year ago. Union Pacific has deteriorated the most. Print out the page and with a ruler



draw the slope of each railroad's line from left to right. UP's is the steepest. What's most interesting is the way all US roads started the year in a tight shot-group right around 24 hours and have now dispersed into the 24-28 hour range. This is not good.

Here I am a shipper with 100 tons of goods to move. I ask for a trip plan from here to there and if I learn my goods could be sitting in hump yards along the route for more days than it would take a truck to make the entire trip, I'm not about to pick the railroad. Inventory in a boxcar standing still is part of working capital on the balance sheet, and, as it goes up, my Current Ratio goes down, and with it my credit rating. Worse, long inventory turnover negatively impacts my own company's operating cash flow and financial health. It's not worth it.

Also watch the AAR train speed performance charts; see the link between speed and dwell. For the third quarter to date, BNSF is ahead of its US Class I peers. The dwell slope is in line with NS and CSX and it would be nice to think there is a direct relationship between improved operating performance and increased commodity carloads. As it happens, BNSF among all North American Class I roads is the only one with year-to-date non-coal carloads showing a gain. There are only two reasons I can come up with: easy YOY comps (not likely; 2Q2014 rev units were five percent over 2Q2013) or BNSF is running a more truck-competitive carload network.

I was reminded by a friend just this morning about the way Big Conrail would pull out all the stops to keep cars moving and virtually all current rail freight on the rails. The thesis was more rail freight today begets more rail freight tomorrow. Now, I get the impression that if a proposed new piece of carload freight doesn't meet per-car pricing parameters, it doesn't move. Never mind network effects. As a result, a branch line where low-rated commodities dominate could be at risk because each carload doesn't make the revenue-variable cost hurdle yet all together the branch line operation covers its cost plus a little. And keeps rail freight on the rails.

**Closing thought.** John Mauldin's *Thoughts from the Frontlines* letter this week discourses on the "weapons of misdirection" and the argument has to do with the shortcomings of the GDP as a measure of economic activity. That's key because railroads exist to move stuff and the amount of stuff to move depends on the level of economic activity. Mauldin writes,

GDP has always been a political construction, subject to the ebb and flow of the intellectual and political climate, the need to raise taxes, and the military needs of the day... GDP is a financial construct at its heart, a political and philosophical abstraction. It is a necessary part of the management of the country, because, as with any enterprise, if you can't measure it you can't determine if what you are doing is productive.

So if one wants a growth slope up and to the right, one can create the measurement that gives one that effect. It's instructive to watch as what's included in the GDP ebbs and flows to support the official Narrative. So when a railroad says it's going for "GDP-plus" pricing, you have to ask what definition of GDP is at hand.

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