THE RAILROAD WEEK IN REVIEW

November 13, 2015

"Financialization is characterized by the accrual of profits through financial channels (share buy-backs, e.g.) as opposed to accrual of profits through trade and the production of goods/ services." — Joan McCullouch in Mauldin "Out of the Box," Oct 28

BNSF third quarter sales slipped five percent to $5.3 billion on 2.4 million revenue units, up two percent. Average RPU was off seven percent. Total quarterly revenue including "other" revenue was $5.6 billion, also down five percent. There is no detail on fuel surcharge for the quarter; however, year-to-date FSC through Sep 30 was roughly 13 percent of freight sales, leaving an estimated $4.9 billion total revenue less fuel surcharge for a quarterly guesstimate.

Operating expense in the quarter dropped 13 percent, largely on fuel though every other line item but materials, supplies and other ("MSO") showed decreases. As a result, operating income rose 12 percent to $2.1 billion. Net income also grew 12 percent to $1.2 billion. Looking at nine months, on the other hand, gives a better feel for the expense trends: payroll up four percent on headcount and wage inflation; fuel expense down 39 percent on lower per-gallon price; depreciation off five percent on the full amortization of proprietary software.

By commodity, Industrial Products sales dropped 13 percent on weakness in crude oil carloads and crude-related supplies, as well as lower steel product volume and lower average revenue per car/unit. Ag products sales inched up four percent, thanks to higher domestic grain shipments, which drove quarterly vols up 11 percent. Coal car-counts gained five percent on demand, though sales dropped six percent on RPUs down ten percent.

Q3 consumer products revenue (intermodal and auto) was three percent lower. The revenue decline reflects lower average revenue per revenue unit, partially offset by volume increases of five percent. And though the official BNSF reports don't break out intermodal and auto, a glance at Week 39 quarterly vols shows auto up a point and intermodal up four points. Not surprising — intermodal is 31 percent of total freight sales, most of any North American Class I.

Moreover, BNSF moves more intermodal units than any of its peers, capitalizing on the fact that intermodal demand is running at a three percent growth rate vs. less than two percent GDP. BNSF runs the fastest intermodal service — 15 percent faster than the US weighted average intermodal train speed through October, 2015. And the strong intermodal story bodes well for the merch carloads sector because faster intermodal means faster everything else.

Genesee & Wyoming October total North American carloads were down 13 percent and same-store vols were off 15 percent. The new rails are the Arkansas Midland Railroad, the Prescott & Northwestern Railroad, and the Warren & Saline River Railroad. These railroads contributed

1,078 carloads of minerals & stone traffic, 498 carloads of lumber & forest products traffic, 422 carloads of chemicals/plastics traffic and 426 carloads from all other commodities.

Sorted by percentage of total carloads (ex-other, which I don't count because vols here have little to do with GWR's commodity trends), four of the seven commodity groups comprising the top 80 percent of loads were down vs. last October. Coal and coke were off a third on volume slippages in the Midwest, Ohio Valley, Mountain West and Central regions, while metals traffic decreased in G&W's Southern, Ohio Valley and Northeast regions. Forest products (both STCCs) slipped generally.

It's a good news-bad news story. Good, because GWR is an excellent proxy for the non-Class I railroad sector, being a mix of handling line, switch carrier, and ISS roads. Bad, because what takes GWR down takes everybody else down. GE Transportation's Week 39 RailConnect Index of 422 roads (including many GWR lines) shows weakness in 11 out of 14 commodity groups, mirroring precisely the GWR experience.

I'm pleased to see GWR coal decreasing as a percent of the whole and suspect GWR, like the Class Is, will settle at a coal base load roughly 60 percent of was it was historically. Forest products, like coal, are finding a base load where lumber reflects housing starts and paper is a function of packaging for mail-order sales.

As for metals, AAR's Dan Keen writes in the latest *Rail Time Indicators* (Nov 6), "U.S. railroads originated 34,041 carloads of primary metal products (mainly steel) in October 2015, **down 8,790 carloads (20.5%)** from October, 2014. That's the **ninth straight year-over-year decline and the biggest percentage decline since October 2009**, when the recession was decimating steelmakers' order books. Weekly average carloads of 8,510 in October 2015 was the lowest since November 2010." [emphasis added - rhb]

Though the Class Is seem at times to be running off business that doesn't meet internal long-haul margins ("The message to feeder railroads is to feed CN high-rated commodities traveling long distances in private equipment." — WIR Nov 6), a reader who's been in this business a long time has an even better message for short lines: Push short-haul carload service. It's where the trucks live.

Unfortunately, says he, the Class Is have not designed their networks to serve these markets, so transit times are slow and unreliable. The challenge is to get the Class Is to to address these real growth opportunities and make money doing so. As is, shortline traffic, according to the the GE Transportation RailConnect Index, seems to be declining at a faster rate than the Class I average because short lines are not major players in intermodal and automotive. This does not a good partnership make.

My reader recalls an instance a few years ago where a Class I wanted to build their carload franchise on a low-density core route. But they did not redesign the main serving yard hub to provide an improved level of service. It was an incremental approach to the market, rather than a direct assault on the business. Better service is key to this business *to drive equipment utilization* as much as for customer service. To provide better service, the Class Is must minimize yard dwell times in yards by pre-blocking from originating local to destination serving yard, block swapping in the intermediate classification yards, and tightening connection schedules.

The goal is to minimize complexity by finding a direct movement from shortline interchange to the local serving yard. This means either moving the shortline interchange to a serving yard location or treating it like one so the move is: Local (shortline or Class I), Line-haul (Class I), and Local (shortline or Class I). Three trains and done.

This is the *magic sauce* — running serving-yard-to-serving-yard trains. Recall the early days of direct intermodal service, when intermodal 'sprint' trains were the first to use two-person crews. Perhaps it's time for the Class I's to start some new serving yard to serving yard merch trains using one-person crews. Doing so shifts the focus from the train start to equipment utilization, just as was done for short haul intermodal movements. Then maybe we could realize car cycle times of a turn a week.

Feeder lines will have to convince their Class I partners that this business is in their best interest by identifying the target business, pre-blocking the cars for the Class I serving yard, and providing minimum volume guarantees that will make it worthwhile for the Class Is. After all, short lines were created 30 years ago because the Class Is were not sure of the outlook for the carload sector.

Instead, the Class Is wanted to focus on their intermodal, automotive, and unit train franchises. These areas were all successful, but the current drop off in single-carload traffic suggests that now, more than ever, new approaches are needed to grow the business to fill the gaps created by the declining coal business.

There are vast portions of the network which have seen traffic declines and have surplus capacity. The parked locomotives and laid-off employees in 2015 are indicative of this underutilized capacity. So the shortline challenge is to identify what it takes to win back short-haul carloads and educate their Class I partners accordingly. The good news is that most of the short lines have the ability to talk to upper level managements at the Class Is. But they better have done their homework and put together a convincing story before they pick up the phone.

Re CP and NS: Too many moving parts, not enough real data to comment. Stay tuned.