RAILROAD WEEK IN REVIEW

December 8, 2017

“So much of our manufactured environment testifies to carelessness. Things are developed to be different, not better.” — Sir Jonathan Ive, Apple Inc.

“The technology that’s inexorably changing our lives has been built by uniquely gifted people who are passionate about what they do… Steve Jobs craved products that didn’t force adjustments of behavior, that give a feeling of gratitude that someone else actually thought this through in a way that makes your life easier.”— David Remnick, The New Yorker

“Any new object should be innovative, useful, aesthetic, understandable, unobtrusive, honest, long-lasting, thorough, and environmentally friendly.” — Dieter Rams, German designer

There’s a stunning story about Sir Jonathan Ive, chief designer at Apple, in *The New Yorker* (excerpts above). Throughout it all I kept thinking whether or how these themes might be applied to the railroad industry. Then, right on cue, Stifel lead rail analyst John Larkin hosted a telephone conference call on “A New Rail Growth Strategy,” featuring Lee Clair, Managing Partner at Transportation and Logistics Advisors, LLC. His talk dives into why the railroads are missing the boat. Excerpts from the transcript (*my edit comments in brackets*):

> We did some research and analysis on what’s really going on in rail, what do we think, what’s happening, and where is this heading? We ended up breaking this into three different time frames. The first addresses railway industry performance pre-deregulation. The next covers deregulation through 2004, and the third examines the fundamental change in the industry starting in 2004 and running into 2014. We wrap with a look at recent developments.

He opens with a slide showing how the rails allowed their own freight rates to drop drastically vs truck. [*I suspect price was the only thing they had to sell*.] Starting in the early 2000s railroads changed strategy, focusing on improving operating ratios and earning their cost of capital. By the start of 2017, merch carload vols had never fully recovered from 2006 high, while truck RTMs kept going up. The railroads were left in the dust compared to the gains posted in both industrial production and industrial production plus imports.

Operating costs (excluding fuel) per RTM have been increasing since the early 2000’s, and particularly since 2006. Railroads can no longer count on cost savings to drive earnings. [*Could that cost focus be partly the reason why we sense rates going up faster than expenses, thereby lowering the OR?*] Clair maintains that railroads can grow share if they shift to a growth strategy — recovering merch vols alone would add 12.5% more non-coal carloads to the system, or 8.2% to total carloads. [*If so, why do the Class Is keep pushing back on shortline growth initiatives?*]

There are few economic barriers to rail growth. Most share loss occurred post Great Recession, when rail cost competitiveness was improving. Yet rail carloads are trending down even as truck tonnage increases. Going forward, the outlook for trucking is for continued cost increases, but that alone is unlikely to reverse rail's share decline. Trouble is, the railroads can't just wait for truck costs to go up and reap the benefits. Truckers always cope. Thus the rail share shrinks.

For railroads to regain lost share, they must reassess all aspects of their marketing strategies – simply cutting rates to grow is not an option. [*The tracks are there, the trains are there, the crews are there. But they're not where they need to be to compete with the trucks on timeliness and dependability. Rigid railroad RVC targets and contribution per car-mile rules inhibit new thinking to get customers just to* <u>*try*</u> *shipping by railroads.*]

Carload growth is possible using existing services and networks. Continuing to use the old strategy (longer trains, fewer way freights, etc.) is a losing proposition in a world that craves shorter, more frequent trains to more places. Railroads must develop new service offerings to create value and capture volume. True, there are significant barriers that to-date have prevented new rail services from coming to market, yet the barriers are not rail costs.

The barriers include shippers not being current on what rail carload service *can* do, not providing the capital and facilities to develop the new customer-directed service, and failure of senior management to embrace change. Worst of all, doing business with a railroad is not easy.

Unfortunately, if the only way to buy carload freight is by calling the serving railroad, you're stuck. Your competition uses millennial-friendly apps, third parties, and franchise sellers. Not doing likewise perpetuates loss of share. [*There IS a way out, and that's tapping the the short lines' service area knowledge, and not putting obstacles in front of every new business lead. See above re right RVC targets.*]

To wrap on a strong point, during the Q&A the presenter noted that only CN has gotten to the point they can walk the supply chain partnership talk. They've gotten past using the OR to measure effectiveness and more toward boots on the ground to create more customers. And guess what? They create more happy, sticky customers and the OR goes down almost by itself.

All this tells me there is a parallel between what Jony Ive at Apple is doing to create customers and what railroads could do if they only got out of their own way to design products that are better, not just different. (If interested, I can forward the Lee Clair slides.)

On Monday last I was the guest of CP at their spanking new HQ campus in Calgary to discuss matters of mutual interest. We wanted to build on the RailTrends remarks of CP Chief Commercial Officer John Brooks concerning CP access to markets. In response to a question from the audience, he said he sees short lines as presenting "untapped opportunities to extend market reach." And that was the core of our Calgary session.

Fact is, CP is largely a heavy-haul bulk railroad operating mainly west of Chicago and Toronto. They can make ten customer calls in their heavy-density areas and generate hundreds of RTMs of business. So why waste one's time in the east where pickings are slim and where one might make ten calls and get a pittance if RTMs? Because the the business is there — CN, by comparison, reports a booming carload business in the territory. And short lines are coming in with merchandise carload growth rates greater than their connecting class Is.

The short lines do so because they know their markets, the supply chain requirements of existing and potential rail customers in those markets, and are in position to generate incremental first-mile/ last-mile RTMs. And so it was that in Calgary our discussions were wide-ranging, from how to extend market access with short lines to best practices for eliminating shortline dwell times to taking wasted time out of Class I transit time between OD pairs.

I took with me a fairly lengthy wish list of actual shortline opportunities to extend the organic CP reach. As we reviewed each, I came away with a sense that CP is prepared to help fill in the gaps in the Class I-short line data chain in order to create customers. They are eager to show off what they're best at and why, where they want to go and why, how the short line community can help CP, and how CP can help the short lines in return.

ASLRRA is Accepting Submissions for 2018 Marketing Awards. The entry deadline is Friday, December 15, 2017. The Marketing Awards competition recognizes Class II and III railroads that have implemented the most innovative and successful marketing and customer service initiatives in the short line railroad industry. A panel of experts who understand how short lines work and how they can expand their horizons will do the judging. Go to the ASLRRA website to view the requirements and submit your entry. Contact Cara Boyle at cboyle@aslrra.org or (202) 585-3447 for more information.

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