RAILROAD WEEK IN REVIEW

April 13, 2018

"Short lines have grown their business with us through innovation and entrepreneurship. The Class I roads have been the beneficiaries of those shortline initiatives." — BNSF Chairman Matt Rose, ASLRRA Annual Meeting, April 10

BNSF Chairman Matt Rose wrapped up the 2018 Annual Meeting of the ASLRRA with a wide-ranging *Wall Street Week*-style interview with association president Linda Bauer Darr. Says Rose, short lines have grown their carload volumes through innovation, entrepreneurship, and more attention to customer service, and the Class I roads have benefited greatly in the process. Moreover, the shortline local presence gives them better visibility to local governments and officials than the Class Is enjoy.

He specifically called out the short line industry safety record. The personal injury ratio has vastly improved over the past few years from a point where their numbers were worse than those of the Class Is to the point where they are equal to or better than the Class Is.

The Amazon approach to supply chains is a game changer, and, as a result, BNSF's volumes with Fed Ex, UPS, and others in that space have increased markedly. "The challenge is doing things we don't do and aren't geared up for. Amazon, for example, wants two day service LA to Chicago. We don't do two days; we do three. To our advantage, Amazon doesn't do business through third parties — they deal directly with carriers." They want short transit times, high consistency and low variability. BNSF must find a way to balance three day service with the other two key needs.

On truck size and weight, the individual states "are picking off BNSF" one by one. The highway Trust Fund "user pays" system isn't keeping up with highway maintenance needs, largely because heavy trucks not paying their fare share. Worse, the prospect of platooning and driverless trucks pushes the User Pays scheme farther away. Yet "the same people pushing driverless trucks are insisting on two men in the cab. That's crazy."

The present focus on railroad operating ratios and shareholder returns is a great disservice to the industry. The quickest way to decrease the OR is to raise rates. But that irritates the very people who pay the bills. Another way to cut the OR is to furlough people and lay up locomotives. But that leaves you short when the economy improves.

You can increase shareholder returns by cutting capex and increasing share buybacks. But cutting capex leaves one vulnerable in terms of having the assets to serve the customer. Share buybacks don't do anything for the railroad in terms of reliability and resiliency. Better to manage the cost of capital, and reinvest in the railroad — scoring against return on invested capital (ROIC) is the only way to go.

Rose said that BNSF's taking the rap for unitizing the single-carload franchise is flat wrong. Growing the carload business is critical to replacing the lost coal business, maintaining capacity and resiliency, and increasing ROIC. Yes, unit trains are fine where they do these things, but this one shoe doesn't fit all feet.

Rose concluded by saying that the merchandise carload franchise remains a single-car entity and BNSF is committed to it. [As an aside, BNSF finished the 2018 first quarter with a ten percent gain in merchandise carload volumes, best of the Big Six Class I railroads.]

This ASLRRA meeting was unique in that it was short on big-room presentations from the 30,000 foot level, and long on small-room conversations at the individual shortline level. The fifty or so breakout sessions covered a whole gamut of topics, including Engineering & MOW; Finance & Administration; Human Resources; Legal matters; Legislative & Regulatory; Marketing; Mechanical; and Safety.

Since the short lines exist to create customers and put carloads on the tracks, I found the four marketing sessions particularly helpful — three on commodities and one on relationships with the Class Is. There were no surprises in the commodity discussions, but the Class I discussion confirmed many themes you've seen before in WIR and added a few new ones. A sampling:

** The Class I insists we have an ISA but too often they don't show up where and when they're supposed to. We point this out and the Class I replies that their crews reported compliance. Turns out that's because the crews are reporting tasks not done as completed to keep their numbers up.

** We have a potential short-haul move with another short line that requires a Class I overheard move in the middle. The same crew that makes the pickup can make the delivery on the same shift. Yet marketing prices it with all the bells and whistles of a regular move on them end-to-end. It's incremental revenue, of which virtually all falls to the bottom line. So why do this?

** There are many times when we find potential customers with medium-value commodities like food and lumber where Class I rates or transit times or both are not competitive. When we inquire, the market manager tells us the numbers come out of a computer and govern such moves. There seems to be little room to bring in the institutional knowledge or How Things Are Supposed to Work. We both miss an opportunity to gain new incremental income as a result.

** Our Class I will not let us create a backhaul move for a car made empty at one of our customers and which can be repositioned for reloading with another on-line customer. The Class I gets a load in and a load out. Again, "the computer" will not permit doing so at a reasonable price.

There is no doubt the Nashville program was vastly expanded, improved, and made more-user friendly than what we've seen in the past. Yet the focus, in my opinion, remains too inward. It seems to be largely about measuring what we do now and how can we measure it better tomorrow.

We all know about the importance of safety, the 45G program, the legislative outreach, locomotive performance, and so on. Yet many attendees spoke with me quite candidly about what they saw as a Class I trend toward de-marketing merchandise carloads. You can sure see it out on the railroad. Used to be boxcars dominated train consists but now covered hoppers dominate.

The difference is that covered hoppers carry raw materials —plastics, chicken feed ingredients, sweeteners and meals for food products, etc. The finished goods in boxcars are sorely lacking because they are in dry vans out on the interstates. The ASLRRA can help get them back.

The first shoe has dropped for the CSX line sale program. The *Progressive Railroading* rail news website reports that HGS Railway Holdings, a wholly-owned OmniTRAX subsidiary, is in the process of buying two line segments from CSX. Once acquired, HGS subsidiary HGS-ATN will lease 121 miles in Alabama to the OmniTRAX Alabama & Tennessee River Railway, and HGS-FCR will lease 55 miles to the OmniTRAX Fulton County Railway in Atlanta.

Line segment end points are not given; however, it is safe to say the rail segments being acquired are contiguous or nearly-contiguous properties for the existing OmniTRAX properties. This arrangement allows the new entities to rely on the resources of the leasing railways, rather than creating their own locomotive fleets, MOW and shop resources, plus all the back-office stuff that goes with setting up a new short line. Congratulations to OmniTRAX and CSX.

The reports of the demise of coal, like the demise of Mark Twain, have been greatly exaggerated. Anthracite coal in northeastern Pennsylvania is alive and well. The 320-mile Reading & Northern has won the ASLRRA's highest marketing achievement award (for the fourth time) thanks to its efforts to create a new railroad customer: Atlantic Coal in Hazleton, a major anthracite coal producer. A joint agreement between Norfolk Southern and the R&N made it possible for the short line to serve this facility, local to the NS, and on a line segment over which the R&N has operating rights.

Long known as "The Road of Anthracite," the R&N expects to move more than 2,000 annual cars of new Atlantic Coal business to the NS interchange. Last year alone the R&N and NS interchanged some 7,300 cars, with the R&N acquiring a fleet of 1,200 coal hoppers and a weigh-in-motion scale in North Reading to do it. Kudos to the R&N and NS.