RAILROAD WEEK IN REVIEW

April 20, 2018

"We are drastically changing the way we operate the railroad by taking millions of unnecessary steps that we have used to run the railroad out of the business process." CSX President and CEO Jim Foote, April 17

CSX was the opening game for Earnings Season, as usual. It was certainly not their finest quarter, but, if the CSX experience is anything like what's happened at CP post-Hunter, performance improves after hitting a low. Freight revenue, $2.7 billion, slipped two percent as total revenue units, 1.5 million, dropped four percent; merch carloads, 642,000, came down *eight* percent (details by commodity line below.) Total revenue was essentially unchanged at $2.9 billion, with a doubling of Other Revenue taking up the slack —- most of which was demurrage collections, which Foote discusses below.

Operating expense, $1.8 billion, was off a commendable 13 percent thanks largely to savings in compensation and materials-supplies-other. (Those wanting more detail are directed to the conference call Q&A, where Foote, every inch the marketeer, explained actions in customer-centric terms — a true breath of fresh air.) Operating income rose 36 percent to $1 billion, the OR dropped nearly ten points to 63.7, and net income nearly doubled to $695 million.

Alone among Class Is, CSX provides in its *Quarterly Financial Report* (downloadable from csx.com/investors) excellent and concise summaries of volume trends by commodity:

** ***Chemicals*** - Declined as a result of reduced fly ash shipments, sustained challenges in energy markets and inventory shortages caused by plant outages reducing plastic shipments.
** ***Automotive*** - Declined primarily due to a reduction in North American vehicle production and the industry's strained auto-rack fleet.
** ***Agricultural and Food Products*** - Declined due to losses in the ethanol market as well as challenges in the domestic and export grain markets.
** ***Forest Products*** - Flat due to gains for panel products from southeastern origins, which were offset by a decline in lumber shipments.
** ***Minerals*** - Declined because last year's mild winter let producers ship ahead of time.
** ***Metals and Equipment*** - Declines driven by a decrease in scrap metal shipments resulting from shifts in the global marketplace and declines in transportation equipment moves.
** ***Fertilizers*** - Declined due main to a plant closure that hurt short-haul rail shipments.
** ***Coal*** - Domestic utility coal declined reflecting strong competition from natural gas. Coke, iron ore, and other related volumes declined, primarily driven by sourcing shifts as producers focused shipments towards the export market, reflecting global demand plus elevated global benchmark prices. The domestic/export coal tonnage mix shifted to 54/46 from 62/38.
** ***Intermodal*** - Domestic declined as rationalization of low-density lanes in late 2017 more than offset growth with existing customers due to tightening truck capacity. International posted gains

with new customers and strong performance with existing customers, more than offsetting losses from the rationalization of low-density lanes in late 2017.

** ***Other Revenue****,* a line item rarely discussed on these calls, more than doubled to $145 million, roughly half of which came from demurrage. Said Jim Foote on the call, “Other revenues increased on … *higher demurrage* (italics mine) and other supplemental revenue. Obviously, we have changed the business practices in this area and are working with our customers to create a more fluid network.”

During the Q&A, a question was asked on “the sustainability of other revenue.” Foote again: “We’re not trying to make tons of money on supplemental revenue. We’re really trying to change the behavior of our customers so that, as we get into seven-day a week service, we get into balance, and that’s what scheduled railroading is all about. We need customer help in turning cars faster.” Once they do, they won’t have to pay these charges going forward.

I came away from the call encouraged and refreshed. The direction is clear: turn the cars and fear nothing. That said, the message still hasn’t gotten through to key managers in the field. My shortline contacts regularly cite chapter and verse about missed interchanges, cars misrouted, new revenue opportunities missed, and of misplaced incentives for these managers. Given the tone of this earnings call, it would appear the tools are in place to correct these faults.

The spring meeting of the Northeast Association of Railroad Shippers (NEARS) convened once again in Newport, Rhode Island. As usual, the focus was on the customer-railroad relationship, only this time on “harnessing technology for rail efficiency.” Appropriately, the first panel presented shipper success stories at Pan Am Rail and Watco. Then we heard from Linda Bauer Darr (ASLRRA) and Todd Hunter (North Shore) on recent shortline-shipper developments.

We also heard about intermodal trends, the shipper impact of locomotive Tier 4 emission rules, how short lines can use Big Data to improve the transportation product in the eyes of the customer, and the usual equipment panel. Cowen Railroad Analyst Jason Seidl and independent analyst Tony Hatch did their tag-team match to tie it all together.

There were nearly 200 attendees, about evenly split between railroaders and those who put goods on the rails — beneficial owners, third parties, and vendors. NEARS also meets in the fall, this year in Tarrytown, New York, just north of the City, September 25-27. Could be a chance for a ride on the ex-NYC Harlem division of Metro North out of Grand Central.

I think this year’s most-effective presentation came courtesy of Watco’s Stefan Loeb on how a short line can create an end-to-end transportation product designed to meet shipper needs and concerns. The hero of the story is the Watco/UP success in their Perishable Express product for western produce to the northeast.

To hear Stefan tell it, the railroad product chain was dysfunctional: 87 terminals on seven railroads, transit times from three weeks to a month, high damage, labor-intensive load/unload, expensive 70-foot mechanical reefers used as rolling warehouses at destination, and intermodal was not an option. Creating the ultimate solution meant jumping every one of these hurdles.

Watco's 359-mile Eastern Idaho Railroad started it all. Located in the heart of Idaho potato country, with its hundreds of eastbound truckloads of spuds every week, the EIRR quickly realized there could be a boxcar market if only the railroads could overcome the objections — a few of which I've noted above. Enter Watco Supply Chain Services, created solely to provide cutting-edge supply-chain solutions for transportation buyers.

The end result is a Watco-owned mechanical reefer outfitted with rollers on the floor and specialized racks designed to accommodate standard pallets without dunnage, making it possible for one man with a fork lift to put four trucks-worth of product into a car in an hour or so. Cars are pre-blocked for a shortline-served cold storage facility in Behlehem, Pennsylvania, interchanged with UP's Cold Connect service, forwarded to NS for movement in intermodal service, and dropped in Bethlehem for the final mile under the auspices of Lehigh Valley Rail Management's "BethIntermodal" service.

OD trains times are 7-10 days, and cars turn immediately. Since the pallet racks go with the car, they can easily be loaded for back-hauls. Craft beer from eastern NY and northern Pennsylvania is an obvious candidate. But the message is clear: if you want to create a sticky customer, create a product around his supply chain needs and at the same time eliminate his present supply-chain headaches. Class Is ought to welcome these initiatives with open arms. UP has.

Short lines in the State of Maine benefit greatly from the Industry Rail Access Program (IRAP). The always-dependable *Atlantic Northeast Rails & Ports* letter reports there are nine rail shipper awardees spread across the state, served by five different railroads. A tenth awardee is Pan Am Rail, for the purpose of improving operations at Portland's Rigby Yard. The awardees, amounts, locales, and serving railroads are:

Fabian Oil, Hermon, $350,000, CMQ
Columbia Forest Products, Presque Isle, $148,776, MNRC (Maine Northern)
GAC Chemical, Searsport, $40,000, CMQ
Huber Engineered Woods, Easton, $127,486, MNRC
Huhtamaki Inc., Waterville, $272,395, PAR
Maine Propane Distributors, Hermon, $141,500, CMQ
NEPW South, Paris, $22,000, SLA
Pan Am Rail, Rigby Yard, $236,250
Woodland Pulp, Baileyville, $172,713, EMRY
Nu-Seed Corp., Houlton $20,868, MNRC

Responding to last week's WIR screed about Class I railroad pricing practices, a reader recently retired from a Class I writes,

> Market managers are stuck with finance-governed parameters that are entered into their costing systems. There is little in the way of massaging, with the exception of perhaps block shipments, and to a lesser extent, unit trains. To revise, pricing folks will need to well-document (and I mean document) everything and make it pass muster by their bosses and, more importantly, the appropriate finance guru.
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> Even if gaining an exception, after-the-fact reporting will often follow the costs plugged into the system. As a result, what's now on paper and producing positive numbers later shows as a deficit move and the emails/phone calls start. Just before departing I had this happen with the same finance guy who approved a special arrangement with the short line only to have him ask questions later. One must keep in mind that knowledge only lasts for a fiscal quarter.
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> I fully understand frustrations working with the Class Is to customize costing and pricing to win new business. I was confronted with the same issues, and, if I unilaterally tried to address them, I was usually slammed for my efforts. With mangers in an already-stressed environment, one can visualize how this plays out when these scenarios are present. Not the right thing to do, perhaps, but it's the reality of how things are done today.

Looks to me like the customer-focussed market manager is being asked to focus elsewhere. Not good for the short lines trying to create the very same sticky customers the Class Is are telling their investors they seek. Class I leadership must take the blame for the disconnect.

Earnings to be continued. NEARS conflicted with the CP and KCS reports and calls so I'll get to them this coming week — along with NS, CP and UP.

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