RAILROAD WEEK IN REVIEW
July 30, 2021

"The Agricultural Transportation Working Group (ATWG) urges the Board to adopt the initiatives that the Executive Order identifies to enhance rail competition and prevent railroads from abusing their market dominance. We believe that enhanced competition is an important vehicle through which the Board can address pervasive challenges faced by rail shippers, including poor rail service, and unreasonable rail rates and practices." — ATWG letter to the STB, July 20

"Too much authority in one company to somehow keep two companies competing against each other that have significant service overlap and too soon because allowing the trust creates a new floor purchase price for any other potential competitive bidders for KCS railroad." — Representative Peter DeFazio to the STB, July 26

We had one major property that resulted in a $55 million gain and it represents 200 basis points off the operating ratio improvement this quarter." — Mark George, CFO, Norfolk Southern

"Moving on to merchandise, the energy chemicals and plastics portfolio saw revenues increase 16 percent. Excluding crude, ECP volumes exceeded expectations, hitting plus 18 percent as demand for products such as gasoline, asphalt, and LPG all rebounded from 2020 lows. I expect strength in ECP to continue as recovery does into the second half of the year." — John Brooks, Chief Commercial Officer, Canadian Pacific

The ATWG is not to be trifled with. Membership includes some three dozen agricultural producers and agribusinesses that rely heavily on freight rail service. They make the case that trucks and barges simply cannot fulfill their transportation needs because "they have significant limitations that prevent them from providing effective competition on all but a narrow range of movements."

The organization zeroes in on the "extensive consolidation in the railroad industry," saying that the resulting eastern and western duopolies may have rationalized railroads capacity but in the process have "increased railroad market power such that many shippers no longer have access to the competition necessary to promote efficient service, reasonable rates and charges, and fair practices."

CSX, for its part, responded immediately with a letter from Sales & Marketing SVP Arthur Adams, a straight-shooter of the first water, who points out that CSX is "committed to a culture of service excellence and this includes having deployable resources to meet our customers' needs, proactive communication with our customer base, and continuous investment to ensure freight is delivered safely and reliably."

The letter goes on to describe in detail the aggressive T&E hiring program, operational changes "to avoid congested areas," and pre-blocking. Partly as a result, "the average number of chemical and fertilizer cars held over 48 hours has been cut nearly in half since the first quarter." Adams concludes with an invitation to customers to "contact us directly with unresolved issues."

So there you have it. CSX acknowledges their service hasn't been all it should be and that customers should speak up. I would put short lines in the same boat as customers in that they really are customers using a service provided by CSX. And if you get pushback from your CSX contacts, read them the quotes from this letter and ask why the disconnect between what Adams is saying and what you're seeing.

The Honorable Peter DeFazio, Chair of the U.S. House Transportation and Infrastructure Committee, has filed a letter with the STB taking exception to the CN Voting Trust in the KCS transaction. He writes, "Putting two formerly competitive businesses under a single holding company immediately reduces the parties' incentives to engage in competition." And this of course flies in the face of STB Chairman Oberman's desire to see enhanced competition in the freight rail space.

DeFazio cites the VTs used in the merger madness 30 years ago, and is concerned that that "the STB is engaging in business as usual, despite the requirement to consider the public interest, and could launch a new round of mergers." Moreover,

> Approximately 300 current customers overlap on the CN and KCS networks. A single holding company responsible for this traffic would likely change rail traffic patterns in the significant areas of parallel service overlap and that would reduce the rail service options these 300 customers currently enjoy.

He concludes by noting that he is also troubled that this proposed transaction "will exacerbate U.S. job losses from cross-border trade agreements that prioritize profits over people and inflict harm on worker's rights, consumer safety, and the environment." The book-makers on Wall Street seem to be divided about equally between those that say the VT is a *fait accompli* and those that say no way. That STB decision is expected at some point in the next few months.

Norfolk Southern reported total Q2 revenue of $2.8 billion, up 34 percent, on 1.8 million revenue units, up 26 percent. Merchandise carloads increased 29 percent to 580,000 carloads, generating $1.7 billion in freight revenue, up 29 percent. Merchandise carload RPU was unchanged at $2,900.

Operating income rose 11 percent to $1.6 billion for an OR of 58.3. Here I have to take exception. Buried in the conversation is a $55 million credit taken for a real estate sale. NS presents operating expense of $1.6 billion, up 11 percent, for operating income of 1.2 billion, a near double, and a 58.3 OR. However, if you add back the $55 million to operating expenses, the OR becomes 60.3, exactly the 200 basis point spread CFO George cites in his remarks.

Each of the four merch commodity groups — ag/forest/consumer; metals/construction; chemicals; automotive — posted double-digit revenue and carload gains. Only four of the 17 AAR commodity groups posted year-over-year declines: farm products ex-grain; petroleum (STCC 13 only; the 29s are in chems); the STCC 26 paper group, and Other.

Double-digit carload gains were in STCC 24, metallic ores, metals/products, and ferrous scrap. Note how three of the four all relate to the steel industry. Chief Commercial Officer Alan Shaw says the steel franchise (raw materials in, finished goods out) was up 67 percent on "record levels for steel prices and elevated demand." Shaw concludes, "increased manufacturing, coupled with record low retail inventories, high savings rates, and increased consumption all set the stage for continued growth in the second half of the year."

Cindy Sanborn seems really to be getting the operating side under control: volumes up, work force and loco count down, fuel efficiency up, train weight and length both up. She spent some time on yard and local service — rarely does one see this area of ops singled out. From that I conclude there will be less irregularity in shortline interchanges. Please keep close tabs to see if this come true.

Freight revenue is 60 percent merchandise, 28 percent intermodal, and 12 percent coal. This being the case, zeroing in on local merch service seems a good idea. Finally. Given the commercial outlook (Shaw, above), it all bodes well for the carload side of the house. In all, it was a positive presentation, especially if one was listening between the lines.

Canadian Pacific rounded out the conference call earnings season Wednesday afternoon. It was a very clean presentation with no hidden debits or credits. Total revenue units and freight revenue increased 15 percent, the former to 723,500 and the latter to C$2 billion. Merchandise carloads including automotive increased 14 percent to 364,800; merch revs were up 11 percent to C$1.4 billion.

Within the carload commodity groups, grain, potash, and forest products produced modest results, though US grain jumped 40 percent on exports from the PNW. ECP (energy, chemicals, plastics) and MMC (metals, minerals, consumer goods) increased 21 and 35 percent respectively. Within the former, carloads ex-crude oil increased 18 percent. Crude will get a jump on the first movements of DRU[1] crude to the US Gulf Coast; volumes are anticipated in the 15-20 trains a month starting in Q3.

Forest products revenue increased to new highs on lumber and the trend is likely to continue. MMC revenues uncreased by a third mainly on frac sand supplying the recovery in drilling activity. Steel and metals are up to the extent that CP has added 150 mill gons to its fleet. Automotive carloads leapt 141 percent as builders recovered from the chip shortage.

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[1] Diluent Recovery Unit. Used to make heavy Canadian crude suitable for rail transportation

Total revenue including “non-freight” fees increased 15 percent to C$2.1 billion, though operating expense was up 21 percent so operating income rose just seven percent to C$820,000. The operating ratio slipped three points to 60.1, however. That said, car-miles per day increased by four percent and trip plan compliance increased to 80 percent. Fuel burn was up 13 percent against GTMs up 13 percent. Fuel efficiency remained at an industry-leading nine-tenths of a gallon per thousand GTMs.

Net income was a near-double to C$1.2 billion, thanks largely to the C$845 million merger termination fee from KCS. Absent that, net income increased 25 percent to C$689.000. Free cash flow after capex but before dividends tripled to C$1.8 billion. There were no share repurchases.

I think that perhaps the CP team is really showing off what a precision scheduled railroad can accomplish if ALL the tenets of PSR are scrupulously observed. That’s how one gets sustainable top-line growth, margin improvement, and earnings growth, all the while running the railroad efficiently and safely.

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