RAILROAD WEEK IN REVIEW

March 25, 2022

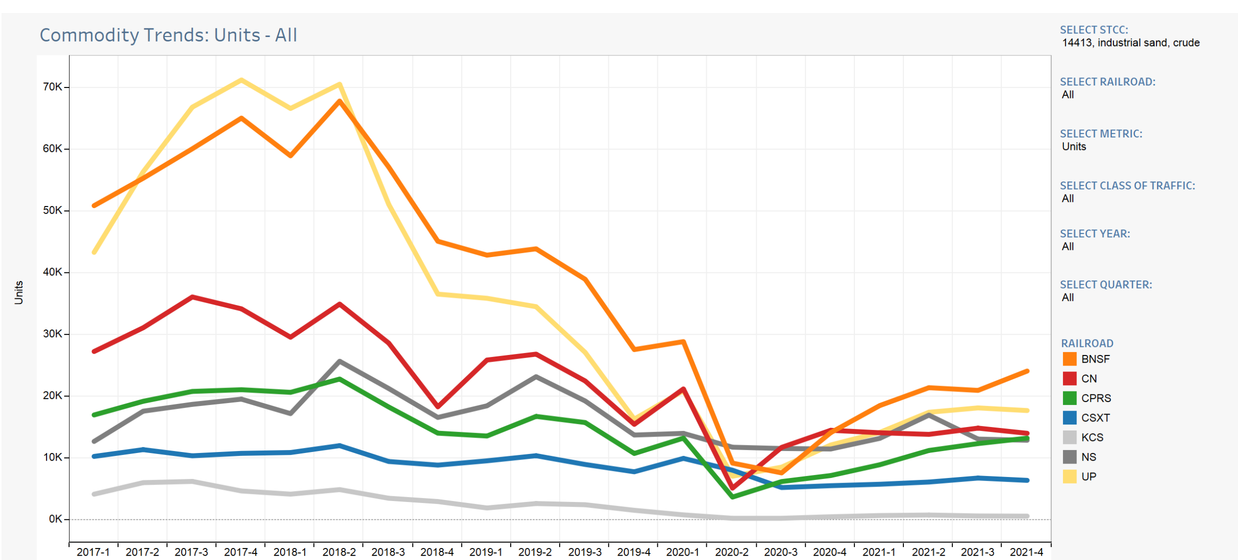
"The Permian's best DUCs are gone, meaning that we'd need more drilling just to offset wells' steep production declines even though the area is now pumping more than five million barrels a day, higher than in past years. While many expect the Permian's output to rise by 800,000 to one million barrels a day this year, it's doubtful all of that growth will materialize." — WSJ, March 22, 2022

Expanded reciprocal switching, in our view, is the best outcome for the present debate. Forget about the individual companies for a minute and view the railroads within the US as a single integrated system, which it is. This network, like any other freight network, is more optimized when as much freight as possible is allowed to travel from origin to destination over the shortest route." — Rick Paterson, Loop Capital Markets, March 21, 2022

"American frackers are raising the number of drilling rigs in oil fields by more than 20 percent, but don't expect a similarly sized increase in production," so said the WSJ on Tuesday. It appears much of the Drilled but Uncompleted inventory of wells in progress (DUCS) has disappeared as drillers brought the best of them on line. The new number of operating wells may add only five percent or so to the available barrels of oil.

The Journal reports that drillers face limits on their ability to add new wells brought on by a limited supply of drilling materials. Moreover, new wells are mostly replacing inventory lost from the original DUCs. As a result, drilling contractors are fully booked through the end of the year.

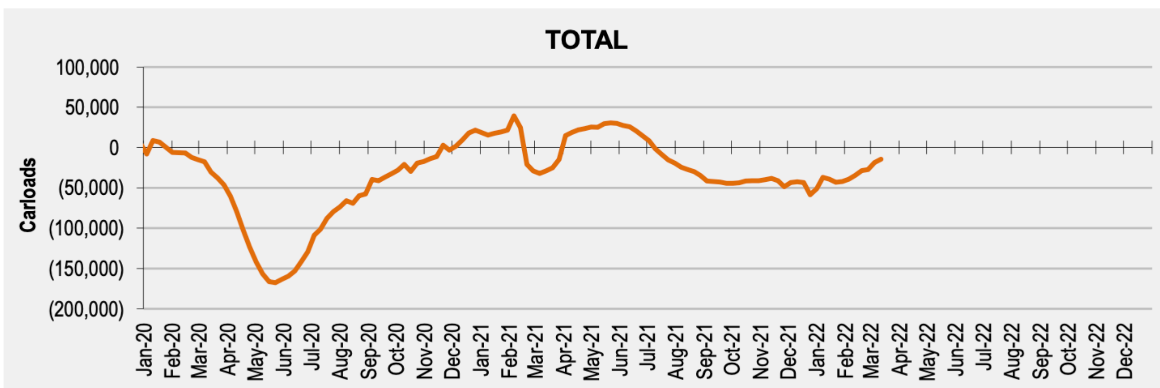
As a result, I don't see any surge in railroad shipments of frack sand or pipe in the offing. The AAR stone, sand, and gravel commodity group is up 19 percent year to date, a continuation of successively higher loadings going back to 3Q2021. The only way to tell exactly how much is frack sand is to dig out the STB waybill samples which, unfortunately, lag the real world by three months.



As you can see frack sand (STCC 14413) is still down from the highs enjoyed in 2017-2019. The Journal concludes, “The challenge is pretty significant here to get back to growth in the Permian, and that’s the only basin that’s going to grow U.S. oil production. If Russia’s oil production and exports are curtailed to the tune of two million to three million barrels a day, shale’s response is a garden hose trying to fill up an Olympic swimming pool.”

The Class I railroads have been talking about their “pivot to growth” for some time now. Frankly, I don’t see it. Last October I summarized carload growth trends 2016 through 2020 and was unimpressed. The CAGR for revenue units was negative 40 basis points; for total revenue it was up 90 basis points. As you can see from Scott Group’s carload chart, it isn’t getting any better.

Rail Carloads (6-Week Rolling Average) Minus 10-Year Average



I think a big reason is the general customer perception of poor railroad service as brought out in the recent STB hearings on Reciprocal Switching (WIR March 18). Lead rail analyst Rick Paterson at Loop Capital Markets picked up up on the Class I comments that their networks are “too fragile” to absorb “the added complexity” of reciprocal switching.

Interestingly, STB Chairman Oberman observed in the Gulf Coast passenger hearings that perhaps the railroads were spending too much on share buybacks and not enough on capex. I grant you that capex vs buybacks may not strictly be within the ASTB purview, but if that’s Oberman’s perception, it must be addressed. And perhaps answer the fragility matter.

The traffic trends I’ve been tracking hardly suggest customers beating a path to their local railroads, per Scott Group’s chart. As Paterson suggests, routing choices ought to be up to the customer — remember the “alphabet routes” of yesteryear? But since the customer has no choice short of going Rule 11, it's easier to call a trucker and skip the railroad entirely.

Drilling down into individual commodity groups, chemicals are a top performer — fertilizers, plastics, industrial chemicals, ethanol. There was a significant volume spike about a year ago, but it was temporary as nothing held up. The high price of nat gas (pushing $5 per million BTU) makes coal more competitive for generating electricity and surging demand for export steam and met coal are keeping the ports busy.

Still, increased dwell times (holding for tonnage?) and decreased system velocity (combining train-starts?) have not been good for customers' supply chains. And, as I look at the monthly trends, the steepest performance decline begins in the first half of 2021 — precisely when all the cost-cutting in the name of "Precision Scheduled Railroading" started. Cut costs, service deteriorates, carloads vanish.

Watco has won a ten-year contract to operate the 63-mile eponymous Corpus Christi Terminal Railroad on the Texas Gulf coast. The railroad was originally created in 1924 to facilitate port access by the MOP, SP, and Tex-Mex railroads.With direct vessel-to-rail loading and unloading, and near-site access, the railroad offered an attractive option for moving cargo in and out of South Texas.

As volume increased, the extant facility was literally outgrown. And so it was the port has recently completed a $12 million expansion plan to add more unit train capacity; expand the bulk terminal rail reconfiguration and add loop tracks; make AMD elevator track improvements; and streamline its industrial park operations. The operation will be under the Texas Coastal Bend Railroad moniker.

Three Class Is service the port today — UP, BNSF, and KCS — and CP will have access once the KCS transaction is completed. The project involved relocating Class I main lines, reconfiguration of the track structure to ease congestion, and increase traffic fluidity. You can see the detailed port plan here. Looks like a win-win-win proposition.