RAILROAD WEEK IN REVIEW

April 22, 2022

"The merger transaction is likely to result in important public benefits in the New England region. On balance, the Board concludes that these benefits are more likely achieved through the transaction as currently structured, with commitments, than through an uncertain divestiture requirement with unpredictable outcomes that could have potentially weakened PAS as a viable alternative." STB CSX-PAR Decision, page 21

The case for Bunge starts with higher crop prices. While the Russian invasion of Ukraine has dominated headlines, that's hardly the only factor fueling the trend. Even if the conflict were resolved tomorrow, global markets are still dealing with a major La Niña-driven drought in South America and a fertilizer shortage; the latter favors planting less fertilizer-intensive crops like soybeans. Moreover, as wheat prices have shot up, more farmers have switched to soybean meal for their animals, who don't get a say in menu planning. — Barron's April 18

An unexpected consequence of Russia's invasion of Ukraine was to turn a Gilded Age Texas failure into a modern jackpot. The demand for non-Russian oil and natural gas has ignited the value of 880,000 acres owned by Texas Pacific Land in the energy-rich Permian Basin. — Barron's April 18 (my photo, 2017 Texas trip)

The *Barron's* quotes highlight two Ukraine-driven trends that could very well impact US freight railroads, starting with Union Pacific. On April 8 the railroad sent a letter to customers outlining their goal of removing 15,000 private cars from circulation, ostensibly to address "national supply chain issues." The letter noted that Cars on Line recently topped 300,000 for the first time in 14 years. Slower train speeds have contributed to shippers' need to increase lease fleets to sustain tonnage volumes.

It appears the fertilizer industry will take a severe hit. CF Industries, one of 30 UP shippers getting the letter, has told customers on UP that "railroad-mandated shipping reductions would result in nitrogen fertilizer shipment delays during the spring application season." CF customers in Iowa, Illinois, Kansas, Nebraska, Texas, and

California may face diminished supplies of nitrogen fertilizers such as urea and urea ammonium nitrate (UAN). And since UP says "noncompliance will result in the embargo of its facilities by the railroad," CF may not be able to fill all the orders needed to meet late season demand for fertilizer.

CF adds, "The application of nitrogen fertilizer is critical to maximizing crop yields. If farmers are unable to secure all the nitrogen fertilizer that they require in the current season because of supply chain disruptions such as rail shipping restrictions, the company expects yield will be lower. This will likely extend the timeline to replenish global grains stocks. Low global grains stocks continue to support high front month and forward prices for nitrogen-consuming crops, contributing to *higher food prices.*" (italics added)

The optics are terrible — right on the cusp of the STB grilling of Class I CEOs on "Urgent Issues for Freight Rail Service" (April 26,27). A long-time WIR subscriber writes. "I can't think of a worse way to inflict harm on customer relationships than by forcing customers to ship fewer cars (when in fact more are needed) because railroads can't do the job they are being paid to do. Mr. Oberman will have a field day."

The STB has approved the CSX application to acquire Pan Am Railways and its subsidiaries. I have been through the entire 75-page Decision and come away feeling that CSX really did its homework, crossing all the T's and dotting all the I's as directed by the Board in its instructions. The outcome and conditions are pretty much expected.

The decision commentary is important because it gives a flavor as to how the Board will approach cases. Starting with *Discussion and Conclusions*, page 10, a continuing theme is maintaining competition, safety, and preserving the viability of Pan Am Southern (PAS), the joint venture with NS across the former B&M main across northern Mass.

To begin, the transaction "would not likely cause a substantial lessening of competition or create a monopoly or restraint of trade… There are provisions in the NSR [Norfolk Southern] Settlement Agreement that give NSR the ability to force CSX to sell its interest —either to NSR or a third party — at NSR's discretion, at any point over the next seven years, at a specific price… The filing is sufficient to ensure that CSX does not improperly influence PAS capital decisions in an anticompetitive manner."

Parties have agreed to "maintain the competitive viability" of the Northern Route (ex-B&M Hoosick tunnel route) which will be operated by a specially-created Genesee & Wyoming subsidiary, the Berkshire & Eastern, which in turn "states that it intends to invest $20 million for the acquisition of locomotives and the purchase or lease of maintenance-of-way equipment prior to its start-up on the PAS lines " and that "PAS will

offer price stability for certain VRS traffic." CSX will be required to provide "reports on PAS traffic levels over the Northern Route for at least two years"

The question of 2-1 shippers comes up several times and the STB concludes that the CSX filing adequately addresses the few that may exist and that PAS "will continue to serve as an economically independent rail option in New England." CSX has committed to "keeping all existing active gateways affected by the Proposed Transaction open on commercially reasonable terms."

Vermont was a particularly sticky wicket, addressed by the "Vermont Settlement Agreement" with CSX, NS, and G&W. The Agreement, among other things, stipulates that "PAS will offer price stability for certain VRS traffic… PAS will provide haulage for VTrans between East Deerfield and Bellow Falls… CSX will have haulage rights between Rotterdam Junction and Hoosick Junction."

Naturally, my selective nibbles at the Decision do not attempt to address every concern of every reader. Rather, it is my intention to show the pains to which the Board went to preserve competition and shippers' options, all while protecting the interests of all the entities affected. It's only a guideline to help you jump to the pertinent portions of the Decision — FD36472 — that are of most interest to you.

CSX opened the Q1 earnings calls Wednesday afternoon. Revenue units declined 2.4 percent — merch carload including auto off 3.5 percent, coal/coke down 9.8 percent, and the vaunted intermodal franchise shed 1.3 percent, even though these boxes are 48 percent of all revenue units. Coal/coke is just over a tenth of total units, half of what it was in 2015. Ten of the 17 AAR commodity groups were in the red for YOY comps; Q1 merch vols are down 18 percent since 1Q2015.

The striking thing is that as revenue units went down two percent, revenue including Quality Carriers and accessorial charges increased 21 percent to $3.4 billion. Carload RPUs increased 5-10 percent even as car-counts were down mid single-digits in every commodity. Operating expense increased 25 percent against the 21 percent revenue gain. Ops income rose 16 percent to $1.3 billion; the OR increased 158 bips to 62.4.
Net income increased 22 percent to $859 million

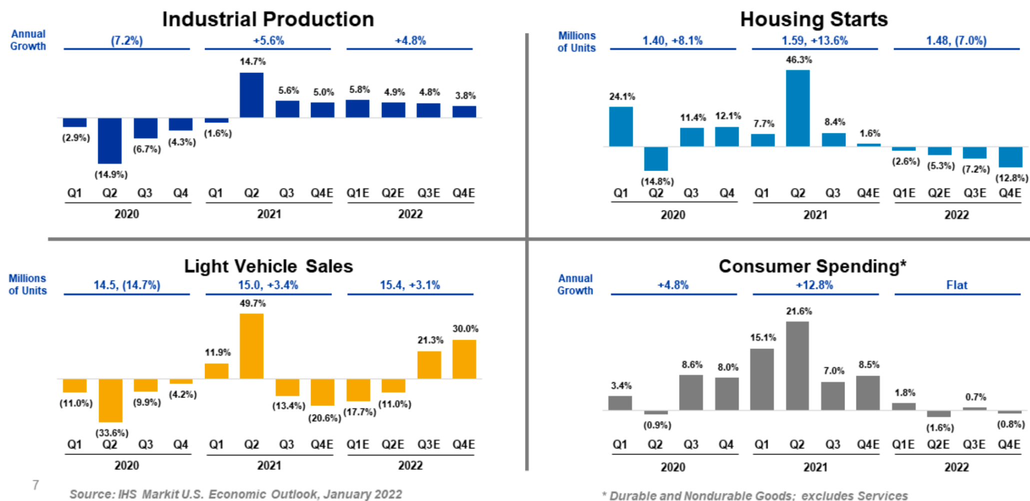
Fuel burn increased a point on two percent fewer GTMs. Gallons/KGTM increased 3 percent. FCF before divs was $968 mm, up five percent. FCF after divs, share repos $(266), $100 mm more in the red than a year ago. Total coal tonnage, down 10 percent, is now 43 percent export vs 41 percent a year ago. Even at the stiff RPU increases, merch earns 64 percent of revenues on 67 percent of RTMs. Unfortunately, the presentation

slides were exceedingly light on comments re volumes, what they hope to generate in new revenue from the ID program, why only 64 percent of carloads make trip plan.

Union Pacific on Thursday posted railroad freight revenue of $5.9 billion, up 17 percent on two million revenue units, up four percent. Merch carload revenue increased 15 percent on 0.7 million carloads. System RPU gained 12 percent to $2,712 each — that's what happens when revenue increases 17 percent on just four percent more units.

Operating income was $2.4 billion, up 19 percent as operating expense was held to a 16 percent increase; the OR was 59.4, a 70 basis point improvement. Fuel burn increased eight percent against a nine percent GTM gain. Cash from operations came to $2.2 billion, up 14 percent; free cash flow after capex was $1.4 billion, off two percent.

As for where we go from here, I still think Kenny Rocker's marketing deck is the most informative and valuable of the lot. As you can see from the top left, the economic outlook for the next three quarters is hardly robust. You've already read my myriad comments on housing starts, vehicle sales, and consumer spending elsewhere.



Thus the successful railroad will anticipate and match customer supply chain goals at a price that reflects the value of the service. I think UP is on its way.

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