

RAILROAD WEEK IN REVIEW

September 22, 2023

“If you were expecting August rail traffic to provide a definitive statement regarding the state of the economy, well, get used to disappointment. As in June and July, rail traffic in August was relatively evenly balanced between categories with carload gains and those with declines.” — AAR Rail Time Indicators, September 9

“People can call it PSR, people can call it whatever they want, but those five tenets of how you operate a railroad safely in the proper way are there. That’s what I live by and when they look at the operation and we’re going to continue to do that.” — Jim Vena, Union Pacific, Morgan Stanley Conference, September 11

Reader response to my review of the STB decision on reciprocal switching last week has been most informative. A long-time subscriber, who is particularly adept at reading between the lines of STB decisions, suggests that “the document was awfully thin,” especially in the light of the Chairman’s strong positions on competition and fairness.

My correspondent references the “micro-directed service orders from decades ago when there were real service issues with bankruptcies and the like” and which really didn’t work the way they were intended. He concludes, “The Board has purposely ignored the issue of competition with what they have established” and the recommendations “will be, in my opinion, unusable, unworkable and unremembered.”

Though I did not mention it last week, the term “captive shipper” has always felt awkward and inappropriate to me. I’m not alone. A reader with considerable experience on the Class I/short line dynamic feels one “should avoid taking shipper industry and STB bait by using the term ‘captive shipper.’” He feels “sole-served” is the more appropriate choice, “especially in those cases where customers might be sole-served by a short line which connects with only class I.”

Then there is the matter of paper barriers. Though, for all intents and purposes, the shortline customer might theoretically have access to more than one Class I, the short line may be hog-tied with a paper barrier prohibiting any interchange with a second Class I that they happen to touch. The argument for abolishing paper barriers goes that if they got access to the second Class I the customer would no longer be “captive.”

My correspondent concludes, “Sole-service from one railroad does not make a customer captive. Most customers, if not all, have options. Too often the debate really revolves

around the sole-served customers wanting lower rates. But if the short line were truly listening to the customer, they could provide a service as good as or even better than customers open to switching. Bottom line, smart and truly customer-focused shortline managements know that their local (aka sole-served) customers' successes are linked to their own long-term success. Maybe that's not emphasized enough, but it should be."

In the final analysis, writes the operator of multiple short lines, "There are actually two areas of concern for short lines. The first is paper barriers. The Board will have to take into account that a reciprocal switch mandate might produce a breach of contract if it results in a paper barrier violation. That should be easy enough to fix. Just include in the regulation that where an alternate service provider is ordered, the paper barrier is automatically waived.

"Then there are the Handling Lines. Normally the short line does not appear on the waybill or in the routing. It is essentially an agent of the Class 1. The Board asked for comments on the potential inclusion of agents in the rule. It's unnecessary. The short line will only be handling the traffic for a short distance within the terminal. If its service is a problem they should handle it on a case by case basis.

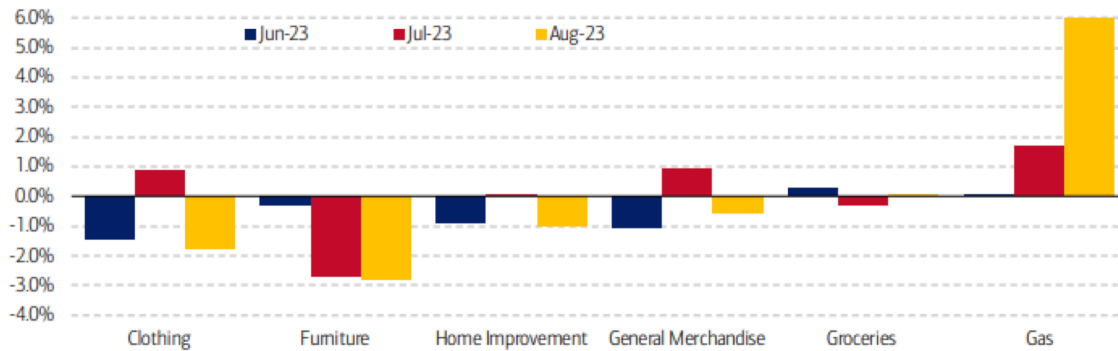
"While this Decision addresses poor service, the Board also should address *no service*, which happens when the Class 1 doesn't quote a rate or its rate won't beat the truck rate. The competing Class 1 should be allowed to get the traffic to the short line." Paper Barriers be damned.

So, in conclusion, I stand by what I wrote last week: that this Decision is a good *start*. My correspondents cited above have added valuable insights which the Board would do well to address.

Railroad freight volumes remain in the doldrums, and until the economy settles down, they are likely to remain so. The first chart shows clearly how all our favorite short line commodities and grain are trending down. These generally fall in the "consumer durables" category that travels by intermodal and carload. Remember that the carload side also includes raw materials to make the finished goods.

Reports like the weekly AAR carload summary are helpful in telling you what has happened. What you really need to know is what is likely to happen next so you can plan accordingly. That's where trends come in. The August spending update is an example of the kind of trend information I intend to provide in these notes. These are all durable goods that move by intermodal as finished goods and by carload as raw materials.

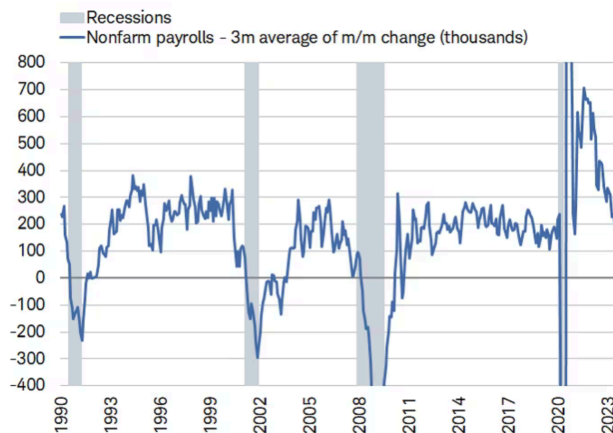
Exhibit 3: Select retail categories card spending per household (%MoM, seasonally adjusted)
Higher gasoline prices led to a spike in gasoline spending in August, up 6% MoM



Source: Bank of America internal data

A big reason for the fall-off is the slowing in payroll growth, all of which shows up in railroad share prices. The right-hand chart is the \$IYT transport index since August and all the Class Is follow this trend.

Payroll growth has slowed markedly



Source: Charles Schwab, U.S. Bureau of Labor Statistics, Bloomberg, as of 8/31/2023.



A similar chart for the trucks looks about the same, though perhaps a little less steep because the truckers are keeping busy, if only by cutting rates. The JETS airline ETF pattern repeats, which is important because share prices here reflect how many tickets are sold. You can bet if consumers are pulling back on durable goods there are going to be fewer expensive vacation trips.

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