State of the Industry
THIS TOO SHALL PASS
Northwestern University “Sandhouse Gang”
November 18, 2008
Summit, Cajon Pass
Jim McClellan
Woodside Consulting
Agenda

- Focus on freight
- Focus on North America

In terms of
- Where we are
- And where we might be going
Setting the Stage:
The Nature of the Beast
(Econ 101)

• Railroads move large quantities from A to B very, very efficiently

• But as volumes decline and origin-destination pairs expand, rail loses to truck and automobile
The Nature of the Beast
(Econ 101)

• Is a *batch process* mode, with negative impact on flexibility/quality
• Is an *inconvenient mode* in society that values--and pays for--convenience
• But the world is changing, as we shall see
Where We Are

NS at Chattanooga

THIS TOO SHALL PASS
Where We Are:

Markets

• Rapid increase in rail rates
  – Fuel surcharges
  – Renegotiation of legacy contract
• Rapid acceleration of truck costs gave rails “pricing power”
• And they used it
## Current Traffic Levels versus 2006 (%)

<table>
<thead>
<tr>
<th>Item</th>
<th>last 4 week average</th>
<th>YTD</th>
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</thead>
<tbody>
<tr>
<td>Coal</td>
<td>5.6</td>
<td>2.7</td>
</tr>
<tr>
<td>Intermodal</td>
<td>7.7</td>
<td>5.2</td>
</tr>
<tr>
<td>Grain</td>
<td>1.2</td>
<td>4.6</td>
</tr>
<tr>
<td>Food</td>
<td>7.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Forest</td>
<td>19.0</td>
<td>21.2</td>
</tr>
<tr>
<td>Chemicals</td>
<td>4.1</td>
<td>3.1</td>
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<tr>
<td>Metals</td>
<td>21.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Autos</td>
<td>23.6</td>
<td>23.6</td>
</tr>
<tr>
<td>Total</td>
<td>5.6</td>
<td>4.2</td>
</tr>
</tbody>
</table>
Where We Are:

Pricing

- Rapid increase in rail rates
  - Fuel surcharges
  - Renegotiation of legacy contract
- Rapid acceleration of truck costs gave rails “pricing power”
- And they used it
- But how much pricing power in a recession?
Where We Are:

Financial

• Majors have strong balance sheets
• With strong cash positions
• And robust earnings despite downturn in traffic
• Protecting the balance sheet is “job 1”
Where We Are:

Physical Assets

- Fixed plant: good to excellent
- Capacity: adequate, limited choke points thanks to lower traffic levels
- Locomotives: good to excellent
- Cars: most good to excellent, box cars are exception
Where We Are:

Service

- Bulk unit trains: good to excellent
- Intermodal: Good, sometimes excellent
- Carload: Fair to good
- Further improvements needed to divert traffic from trucks (especially in medium to short hauls)
Where We Are:

Industry Structure

- Six relatively balanced large systems
  - Plus KCS
- Fundamentally stable
- Major changes neither *needed nor likely*
- And regulatory risks are substantial
Where We Are:
Regionals and Short Lines

- Infrastructure and equipment: Good to marginal—or worse
- Often “one trick pony” in terms of customer base—risky
- Some dependent on public funding -also risky
- Often weak balance sheets
- Expect some casualties

Vermont Railway south of Rutland, VT
Near Term Strategies:
Back to Basics

NS at Lilly, PA
Near Term Strategies:

**Commercial**

Hold prices firm

• **Rationale:**
  – Carriers have similar cost structures—price wars do not work
  – Can rarely influence retail price anyway
  – Trucks high cost mode
  – *Service, not price, is the key to gaining share*
Near Term Strategies: Operations

Back to basics:

• *Good times shifted focus away from operations/cost control*

• Now, cost control must be king:
  – Slow pace of hiring
  – Reduce SOME train speeds
  – Consolidate trains
  – Manage the network better

CSX west of Chattanooga, TN
Near Term Strategies:

Investment

- **Stretch** capacity related investments
- **Accelerate** investments that improve efficiency
- Defer maintenance on the “edges of the system,” not the core
- **A robust core is always essential (Do NOT burn the furniture!)**

NS north of Chattanooga, TN
Near Term Strategies: Service Quality

- System is less congested, more fluid
- But pressure on costs can degrade service
- Now is the time for market segmentation-- focus on service where it can improve volume, revenues or both (scalpel, not meat axe)
Near term Strategies:

*The Sky Is Not Falling*

- Some continued traffic decline
- Followed by slow growth
- Lower volumes are not all bad:
  - Less need for capital investment
  - Room to experiment with
- Slow growth or even no growth is not the end of profitable railroading
  - *Carriers are right sized and profitable at today’s - or lower-- traffic levels*