State of the Industry

THIS TOO SHALL PASS

Northwestern University “Sandhouse Gang”

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Summit, Cajon Pass

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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:
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
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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

NS east of Elkhart, IN
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*
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*
This Too Will Pass:
Long Term Issues/Strategies

CP south of Golden, BC
Long Term Strategic Issues:

Markets and Competition

Best days for transportation are behind us
• Costs increasing
• Trip times increasing
• Service quality decreasing
• Trends are fundamental, based on economics and physical constraints
  – Price of fuel still high by historical standards
  – And will increase as recession moderates
• *Rails could be the exception*
Long Term Strategic Issues:

Markets and Competition

• Upward trend in transport costs will alter logistics decisions
  – Seek to reduce use of transportation
  – Manufacture closer to end markets
  – And substitute more efficient modes for less efficient modes
    • Air to ship
    • Truck to rail
• Not all changes will be favorable to rail
Long Term Strategic Issues:
Markets and Competition

- High truck costs mean more potential for diversions from truck
- The prime target market is medium haul (450-1000 miles) truck market
- Conversion mostly to intermodal, but some conversion to transload
- Note: direct railcar will remain stable (grow with GDP)
Long Term Strategic Issues: Markets and Competition

The potential market is huge but:

• Success depends adding lanes and o-d pairs
• Which means a more complex Intermodal network
  – With more switching
  – And shorter lengths of haul
• *Can railroads deliver??*

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*NS west of Pittsburgh, PA*
Long Term Strategic Issues:
Markets and Competition

Some not so good news
• Rails thrive on long haul movements—it’s “what they do”
• Shorter supply lines could dampen growth some historically strong rail markets
  – The Asian trade
  – Western coal
• Result is slower growth, not no growth or decline (post recession)
Long Term Strategic Issues:
The Green Card

- Rail has a *much* lower carbon footprint than truck
- More efficient use of land
  - Consider the footprint in this high density rail corridor

CP east of Thunder Bay, ON
Long Term Strategic Issues: The Green Card

An overall advantage for rail, **BUT not a “slam dunk”**

- Long term threat to coal franchise
- Carbon tax makes transportation more costly
- Communities are resisting new terminals and increased traffic density

BNSF at Palmer Lake, CO
Long Term Strategic Issues: 

Regulation

Economic reregulation is a major uncertainty

• Growing anti-business sentiment
• STB already changing
• More economic regulation possible
• Could reduce capital for modernization and expansion

NS east of Cresson, PA
Long Term Strategic Issues:

Regulation

Greater safety and environmental oversight already a reality

• Railroads will be playing defense
• Some fixes (PTC) very costly
• New/expanded facilities initiatives will be more costly and time consuming
• Especially in urban/suburban areas
Long Term Strategic Issues:

Government Funding

• Railroads now make some use of public funds for freight projects
  – Though amounts are small in terms of overall CAPEX
• Eastern railroads have announced major new public-private partnerships
Long Term Strategic Issues:
Government Funding

- Government *not likely* to be a reliable source of funds
  - Financially, most governments—at all levels—are broke
  - Mounting social demands (social security/healthcare/education)
  - Static/declining per capita income means aversion to new taxes
  - *Rail competes with other needs*—*will often lose*
  - *But highways unlikely to fare much better*
    - *Will get $ for repairs*—*a quick fix influx of capital*
    - *But little will be done to solve long term capacity issues*
  - *Wild card: massive stimulus package focusing on infrastructure*
Long Term Strategic Issues:
The Role of Technology/Planning/Smart Railroading

• Railroads must do more with less
• Technology saved the railroads from becoming irrelevant
• And is the key component of any future growth
  – Throughput on existing infrastructure corridors must be increased at lowest possible cost (capital will limited)
  – Costs must be contained; railroads cannot just keep raising rates
• But there are a lot of underutilized assets
• And a lot of room to improve service quality
• My generation: Rationalize/rebuild the industry structure
• Your generation: make it work
Long Term Strategic Issues:
Bottom Line

• Increased emphasis on efficiency
• The constraints on all modes:
  – Energy/land/money
• Railroads are efficient and thus greatest upside
• But success is not assured
  – Service must improve
  – Cost is always a factor
• Government may be as much a hindrance as a helpmate
• *The Smart and Nimble will prosper*
The State of Rail Passenger

Acela passing an Acela
Where We Are: Corridors

- Northeast, California and PNW are success stories
- Some others (Illinois, Wisconsin) are a “work in progress
- Most others are simply a fantasy
- All depend on government money for operations and capital investment
Where We Are Going:

Corridors

- Availability of public funding is **THE** issue
- Rail projects have long lead times
  - *Current fiscal crisis more likely to benefit highways*
- Corridors should be, but are not, a “slam dunk”
  - Eight years to permit a siding on San Diego line
Passenger
Where We Are:
Commuter Rail

- Existing systems expanding
- New systems coming on line
  - Albuquerque
  - Twin Cities
- Costs are high and public aid essential
- Again, competition with other demands for public dollars
Passenger
Where We Are Going:
Commuter Rail

- Lower gas prices will remove some incentives for commuter rail
- State and local budgets in crisis
- There is broad public support in many urban areas, funding is THE issue
Passenger
Where We Are:
Long Haul Services

- Irrelevant
- Substantial operating losses relative to revenues
- Freight rails subsidize below the rail costs
- Operating conflicts with freight will continue but conflicts are more a commuter and corridor issue
Passenger
Where We Are Going:
Long Haul Services

• No real change, up or down
• New equipment will be funded
• Will remain irrelevant
• Freight railroads will be more accommodating
  – Freights have finally learned that “Amtrak bashing” is a waste of time
Thank you for your time and attention
Questions?

Tehachapi Loop
Reach me at jimmcclellan@att.net

Riding the Coast Starlight near Surf, CA