



# Rail/Intermodal Roundtable: FULL HEAD OF

**The nation's railroads have pulled out of the downturn in solid fiscal shape, proving that they've mastered the art of cost management. To offer a comprehensive look at the new state of the rails, we've gathered four top analysts to share how volumes, rates, and game-changing regulation could alter how shippers manage the mode.**

BY PATRICK BURNSON, EXECUTIVE EDITOR

**W**hile the recent recession has been declared the worst economic downturn in nearly a century, the nation's freight railroads never missed a beat. In fact, they continued rolling on a bullish path, spending \$21.8 billion of their own private capital in 2008 and \$20.2 billion in 2009. As a consequence, the 140,000-mile rail network serving shippers has not only been maintained—it's been modernized.

But now there's a new worry in the shipping community: new regulatory laws. Opponents argue that unbalanced legislation will result in lower rates for some, while penalizing others. Add to this the concern that railroads will suddenly put a halt to new investment as a hedge against more

unforeseen intervention.

To put the rail market into better perspective, we've gathered four leading analysts to share their perspectives and help rail shippers better understand how they'll need to plan their rail and intermodal moves heading into 2011.

Joining us are: Tony Hatch, principal of New York-based ABH Consulting, a transportation and financial advisory firm; William J. Rennie, a partner in Oliver Wyman's corporate finance practice; Brooks Bentz, a partner in Accenture's supply chain management practice; and Jay Roman, president of Escalation Consultants, Inc., an energy and rail advisory firm. Here's where they see the market today and a few years down the line.



# STEAM

LONNIE BUSH/THIRD EYE

**LM:** *How would you define the current state of the rail business?*

**Bill Rennie:** On the revenue side, the carriers are gradually pulling out of the downturn with traffic growth outpacing the overall economy. Improved service levels and tight truck capacity support both traffic and revenue growth. The railroads continue to make significant strides in efficiency and cost control. In fact, improved service levels and tight truck capacity support both traffic and revenue growth.

**Jay Roman:** I agree, but what's interesting about the current market is that railroads have not been in lock step with the business models they're using to increase profits. Some railroads are aggressively going after competitive business where shippers have options for moving traffic. These railroads are primarily looking to increase profits by

protecting and improving their market share. Other railroads still have a business model that is geared to increasing profit by going after pre-determined profit levels from their customers.

**LM:** *So, they've chugged out of the storm and are in pretty good shape?*

**Tony Hatch:** I would say yes. It's kind of like *Great Expectations*. The rails thrived in the last cycle but really proved the "rail renaissance" thesis during the "great recession" when they held margins so well. Wall Street, while generally optimistic about the rails, has missed earnings expectations both all the way up (2003-2007) and all the way down (2008-2010) as they will again in the recovery.

The rails have a great opportunity in front of them, and they have certainly spent capital dollars—through the

recession—to get themselves in position for the brave new world of market share opportunities. Now they only have to execute to achieve it.

**Brooks Bentz:** I would characterize it as fairly remarkable. You have what is arguably the worst economic climate since 1929, which was devastating to the industry, and yet all of the carriers have come through very well. There have been no bankruptcies or even conditions approaching financial failure. It's been quite the contrary. The carrier community has proven that it has mastered cost management and has been able to maintain—and in some cases improve—profitability.

**LM:** *What's been the biggest driver to the increase in volumes?*

**Bentz:** I think you can subdivide it into two major buckets: carload and

intermodal. Intermodal volume has recovered very nicely. The question is whether it is sustainable over the next six months to nine months. There is some thought that it is mainly a replenishment of inventory that had been drawn precipitously low and that a weak peak season will cause it to sag significantly in the first quarter.

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—Bill Rennie, Oliver Wyman

The other element driving intermodal growth (or recovery) is that shippers are looking at it much more seriously from the standpoint of additional capacity. The trucking industry pared back capacity in a fashion similar to the railroads and has not added it back as rapidly as volume has risen. The other factor is the carbon footprint impact. It makes good press, as well as good ecological sense, to use intermodal more.

The carload recovery seems to be driven by some of the same factors, but is less robust. The acid test will be what happens in the first quarter and what the winter weather will do to coal loadings.

**Rennie:** Brooks is right. In recent months one of the fastest growing segments of rail volume has been domestic intermodal. It's quite possible that truck capacity may lag demand particularly where the new investment is required. The large number of motor carrier failures has reduced bank appetite for motor carrier investments.

**Roman:** Yet, all of the railroads appear to have been hedging their bets on a vibrant and growing economy. This is best shown with the change in the average revenue per car, excluding fuel surcharge revenue.

**Hatch:** But let's admit that the recovery in the general economy is still bigger than the secular story here. When examining the short term, we see a big year-over-year volume gain well over the past.

**LM:** *What should rail shippers keep their eyes on over the next 12 months?*

**Hatch:** I am not hearing anything about a double-dip, but it will be shippers who will tell us about that. Over the longer term, shipper worries can be broken down into two related things. First, getting what some are wishing

for, even without modal share growth, will require continuing access to large amounts of private capital.

**LM:** *Are there any particular regulatory obstacles shippers may be facing?*

**Rennie:** One of the most troubling obstacles to the ability of rail to keep up with demand is the growth of local resistance to railroad expansion both in the form of increase frequency on a line or the building of new facilities.

Not in my backyard (NIMBY) resistance, law suite, local permitting issues, and political pressure may create capacity shortages that might not have been expected by shippers. From Massachusetts to California, railroad expansion projects are being blocked. Even in blighted areas of the rust belt, residents are blocking not only the rail facilities but shipper distribution and transload facilities.

**Roman:** Most shippers have been very interested in the proposed rail legislation S.2889, which would re-authorize the Surface Transportation Board and update federal rail policy. Nothing has been heard about this legislation lately and it has been off the front burner in the press and in Congress.

**Hatch:** Well, the obstacles would be fairly large for most shippers if the subgroup of shippers in chemicals, coal, and a few other commodity categories actually prevail in Washington and get S.2889 passed. We can remember the dis-investment cycles of the 1970s, but I do not think that is likely.

for in terms of the Rockefeller bill that could choke off capacity investment. The second concern is the rail's ability to execute in terms of service.

Domestic intermodal growth is entirely dependent on a higher level of service than the rails have ever shown before, at least consistently; however, they've proven that they're up to it. That service level is also the key to making investors happy, not just from above-GDP volume growth, but for creating operating leverage and making regulators content.

**Rennie:** I would suggest that shippers keep their eyes on the fundamental changes in capital markets' credit processes, which underpin the North American rail network. While

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**LM:** *But the Rockefeller bill could throw a wrench in the works?*

the government, railroads, and shippers recognize that the North American freight network is almost totally funded by the private sector, there is no coordination on what could be the public policy role in fostering access to low-cost private capital. The \$400 billion of installed infrastructure and year 2035 and beyond growth require-

**Bentz:** It's safe to say that the Rockefeller bill may potentially change the rules of the game, but no one knows for sure how or when. If some form of re-regulation forces rail rates lower, which is usually the intent, then the investment options will be more limited

and the capital shortfall that is anticipated will be greater—unless the funding comes from somewhere else. I also don't think it's entirely clear or entirely settled as to what the security regulations will be for import cargo, but a supposition that costs will not go down is probably not misplaced.

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**LM:** *Considering these conditions and regulatory possibilities, how should rail shippers be re-adjusting their strategies on the rails?*

**Hatch:** I think shippers should consider adding rail service and “wallet share” to ensure capacity in the next cycle, reduce overall logistics expense, guard against another fuel price spike, and comply with coming carbon emissions changes. Rail is on a modal share upswing, and shippers need to be ahead of the coming wave if at all possible.

**Rennicke:** While shippers should continue hard negotiations with the rail carriers, their strategy must recognize that the maintenance of existing capacity and any future growth must come from the railroads cash flow and the ability to obtain low cost capital from the major financial markets.

Shipper/carrier partnerships are more in line with a constructive direction than adversarial positions. One of the most effective strategies that I've observed in the last several decades was from a utility that worked with the carrier to jointly engineer cost out of the services and obtained better rates and higher levels of service than their competitors in the end.

**LM:** *While we've focused on domestic issues, do you have any thoughts for shippers on how to improve cross-border and international trade?*

**Hatch:** Intermodal and globalization go hand in hand with one another; there really couldn't be one without the other.

Could you do big-box retailing without big boxes from China on a railroad? On cross-border, rails already operate on a North American, continental network; and as border issues get ever more complicated, rails have yet another modal share opportunity.

As for outsourcing and globalization,

rails are prepared to continue their double-stack growth from either ocean's ports, west or east. International intermodal, including transload, will continue to grow well above the regular rate of economic growth. If near-sourcing does indeed take off, the rails are well positioned to handle that, too.

**Bentz:** I'd add that the international trade business is in something of a transitional stage with a lot of unanswered questions: Will the Panama Canal have any impact on trade routes and, if so, what? Slow steaming is lengthening already long supply chains, often significantly with vessels getting down to

in various parts of the supply chain without having the shipper make a large investment in a remote operation.

**Roman:** I'd quickly add that shippers need to decide what they want from railroads before they get into competitive traffic.

**LM:** *With this outlook in mind, what advice can you offer shippers that will help them better manage freight over the next 12 months?*

**Bentz:** I think shippers need to be observant, and, if they're not already doing so, begin to plan for the long term. I don't think we'll see any radical shifts in the next year or two, although I do expect freight rates will rise, regardless of mode. Despite some who think or expect otherwise, they can't go down forever.

Over the long haul, however, capacity will be an ever-present issue and it won't just be things like “are there enough trailers, tractors, drivers, railcars, locomotives, ships or planes?” It will also be is there enough infrastructure capacity to accommodate the predicted growth of the population. Between now and 2050 we're predicted to grow from 300 million to 420 million people, mostly in the coastal areas (East, West, and Gulf), where the greatest congestion already exists.

Transportation operators know that efficiency is driven by asset

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as slow as 10 knots. If labor in China continues to rise, and the supply chain gets longer, will near-shoring retake a significant portion of what left U.S. shores?

**Rennicke:** The domestic and intermodal carriers can combine in partnership with the shipper to build cross-border services. Often the carriers can provide effective process management

utilization or asset turns and congestion is anathema to that. So, barring anything dramatic, efficiency will degrade and costs will rise unless something is done on a broad and meaningful scale—a scale beyond what private capital can finance. □

—Patrick Burnson is Executive Editor of Logistics Management