



2012 Rail/Intermodal Roundtable: Rail's new golden era

Savvy shippers have found ways to put the nation's rails back to work—and the railroads have flourished. But while current market conditions remain favorable for shippers, questions over how the nation's rail and intermodal network will respond when volume ratchets up past pre-recession levels remain.

BY JEFF BERMAN, GROUP NEWS EDITOR

Unlike other modes of freight transportation, which saw peaks and valleys brought on by the Great Recession, railroad and intermodal service providers came out mostly unscathed—especially when compared to their trucking, ocean, and air brethren.

And it certainly appears to be a good time to be a rail or intermodal shipper. For one thing, fuel prices are still heading up, which in turn makes transporting freight on the rails a smart economic proposition. At the same time, rail and intermodal service levels remain strong because volumes for both modes remain below pre-recession levels.

While rail and intermodal have a lot working in favor of shippers, the modes are not without their issues. Some rail shippers still feel that they're powerless when it comes to rates and maintain that higher prices are not always commensurate with better service. In the meantime, the issue of re-regulation is one that's never far from the mind of anyone shipping or working in the market.

Over the next few pages, our panelists, leading rail and intermodal experts, will put the current rail and intermodal market conditions into perspective and offer their stance on volumes, service, pricing, and the regulatory environment. Our panelists include: Brooks Bentz, partner in Accenture's Supply Chain Practice; Tony Hatch, principal of ABH Consulting; and Larry Gross, senior consultant at FTR Associates.

Logistics Management (LM): What is your take on the current state of the railroad and intermodal markets?

Brooks Bentz: Railroading continues to flourish as the recession torques back into recovery, and this will likely continue for quite some time. Domestic intermodal is doing well, and international is sluggish, although an increase in the range of 4.0 percent to 4.5 percent is predicted. Carload is doing

OK, basically tracking close to GDP, with the major exception of coal, which is seeing year-over-year declines. Industry leaders fairly uniformly see it as a one-way slide, with recovery of any magnitude not likely to happen any time soon.

This, though, has not materially dampened the overall rail recovery. Of course, the acid test will be how the respective networks respond when volume ratchets up past pre-recession levels. Virtually all the big guys have continued investing in infrastructure, so it will be interesting to see.

Tony Hatch: From where I sit, the railroad market is mixed, and this reflects not so much on the economy as much as the strange story in the bulks, with coal down due to weather-related factors, as Brooks mentions, along with cheap natural gas and grain down due to various near-term factors. Everything else—including intermodal—is doing fine in 2012.

Larry Gross: Overall, the rail carload and intermodal sectors are making good progress. Although GDP growth is modest, volume growth is being supported by the high freight content of the recovery. Service levels are looking excellent, as the rail network appears to be operating very smoothly.

LM: While carload volumes are still below pre-recession levels we do see them beginning to rise. Do you feel things going in the right direction on the carload side?

Hatch: Yes. Even housing-related stuff is beginning to show signs of life. A big factor, of course, is the double-edged sword that is shale. There are also growth components that come along with it in the form of sand, infrastructure materials, and in some cases (particularly the Bakken) oil-by-unit trains or rolling pipelines—and it has completely changed the game for the domestic chemical industry, perhaps even steel. Beyond shale, the automotive recovery has been impressive.

Gross: Tony is spot on. The modest level of overall carload growth is masking some excellent progress across many

commodities. Total volume has been held down by lackluster performance in the important commodities of coal and grain. Carload activity is showing broad-based strength indicating an improving economic outlook.

Coal is suffering from a combination of immediate and long-term issues. In

increase in the price of natural gas will make coal competitive again. With a slow-down in exploration and drilling of natural gas, sand and clay carload volumes have also fallen off. When housing starts and industrial construction begins to bounce back steadily, the traditional carload business—dimensional

to intermodal service. Therefore, we expect intermodal growth to continue, provided that adequate service levels are maintained.

Hatch: Intermodal will be a secular growth story for years to come. Why? It's really a combination of the usual suspects: poor highway infrastructure, driver issues, fuel, and carbon.

Bentz: Larry and Tony are both correct. I don't think that there are any short-term obstacles to intermodal growth. Railroads and ports are continually investing in improving and expanding infrastructure, so it will take a major trade spike to overwhelm the network.

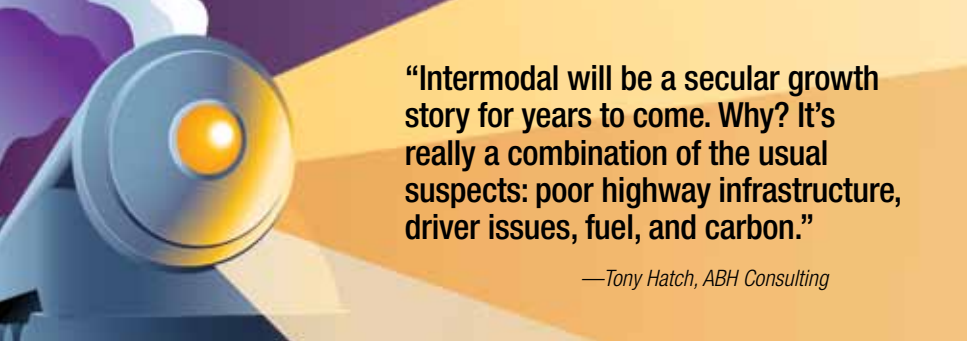
And that does not seem to be in the immediate offing. George Patton said, 'Don't fire rifles at enemy tanks.' For one, it has no effect. For another, it tells the enemy you don't have an anti-tank weapon. Intermodal is not in that situation. The weaponry to handle fairly significant increases in volume seems to be mainly in place and being augmented.

LM: Where do railroad and intermodal service levels currently stand in light of current market conditions, and what can shippers expect in terms of service over the next year?

Bentz: The overall network fluidity is better now than at almost any time in memory. In part that was due to the lower volumes of the recession, in part due to continuing investment by the big guys in capacity expansion and augmentation, and it part due to operating more effectively as a result of the "diet" everyone went on through the recession.

Gross: There was actually a significant improvement in rail service metrics as 2011 came to a close. While mild winter weather surely helped, it cannot account for all of the improvement. Train speeds have reached levels not seen since 2003. This is impressive, given that in 2011 volumes were quite a bit higher than they were back in 2003. Yard dwell time also improved in late 2011.

Cars online are down versus prior year even though volume is up. Car productivity in terms of loads per week



"Intermodal will be a secular growth story for years to come. Why? It's really a combination of the usual suspects: poor highway infrastructure, driver issues, fuel, and carbon."

—Tony Hatch, ABH Consulting

the near-term, coal carloads are being hurt by the warm winter weather and weaker export coal demand as competing international sources come back on stream. Long term, utility coal will be constrained by growth in natural gas generating capacity fueled by low-priced natural gas. Grain shipments have also been affected by weaker export demand. On the plus side, strong growth is being recorded in motor vehicles and metal products, while oil-shale related development is fueling strong growth in shipments of petroleum, and hydraulic fracturing sand.

Bentz: In general, I think carload is headed in the right direction. Again, it seems to be tracking roughly at pace with GDP growth. However, there are some things looming on the horizon that may blunt the recovery a bit. For instance, with the price of oil advancing each year and the giant reservoir of natural gas, a shift is occurring and that will eventually impact oil movements by rail as well as coal, probably for the long-term.

Coal is already losing ground and many think it will continue to do so, although a relatively small

lumber, plywood, asphalt shingles, sand, and gravel—will do better.

LM: Intermodal volumes, particularly domestic containers, continue to outperform carload volumes and have been for a while. That said, how much staying power does intermodal have?

Gross: Although intermodal has always offered shippers the opportunity to reduce cost versus over-the-road, it formerly came with an associated price tag of unreliable service that made the cost/service package unpalatable to many shippers. What has changed in recent years is that although intermodal service is still slower than truck, the all-important reliability of the service has achieved an acceptable level.

Intermodal is less sensitive to many of the factors that are working to increase trucking costs, including lower reliance on the driver pool and greater fuel efficiency. As truck capacity continues to tighten over the next few years, intermodal will provide an important alternative. Meanwhile, substantial investments are being made in new terminals, particularly in the eastern region. These will serve to open up new territories and shorter lanes



per car appears to have been on a general upswing throughout most of 2011. Given the significant level of investment that the rails have made in their networks and that carload volume is still below pre-recession levels, we expect good performance to continue. Our only caveat would be that, historically, the industry does not handle big spikes in volume very well, and in the event the economy were to recover more quickly than we expect, we could see shortages in crews or power that would impair performance.

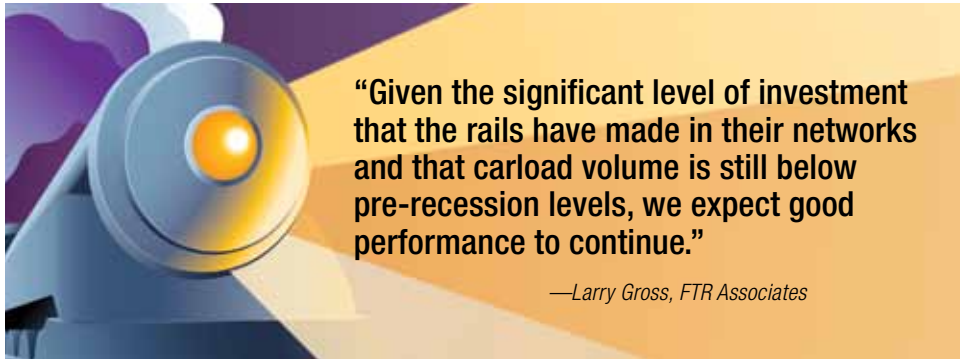
Hatch: Railroad and intermodal service levels are at all-time highs, particularly with Canadian Pacific out of its funk. But these service levels must continuously improve for domestic intermodal to grow in the short-haul lanes.

LM: In what ways are market conditions affecting capacity and rates for rail and intermodal?

Bentz: Probably the largest single driver of pricing and capacity is the cost of fuel. An increase in the price of diesel fuel of 15 percent has a much different net effect in cost per mile of a 53-foot box being towed by a tractor getting 8 miles per gallon than 200 of them on a stack train moving each box something like 500 miles on a gallon of the same stuff.

There's an inherent leverage there that favors rail and the leverage will continue to increase as fuel prices continue to rise. You can make something of a similar case for carload, although the market dynamics are considerably different.

Gross: In the meantime, the market for international containerized cargo movement is in turmoil, but this is due to conditions on the water and not on the rail. The ocean carriers are introducing massive amounts of capacity in the form of new mega-sized ships. These capacity additions are far greater than would be required given even the most optimistic near-



“Given the significant level of investment that the rails have made in their networks and that carload volume is still below pre-recession levels, we expect good performance to continue.”

—Larry Gross, FTR Associates

term growth forecasts.

This excess capacity is putting substantial downward pressure on ocean rates. And with that, there should be plenty of capacity for intermodal movement of international cargo on the rail. The 2011 peak was still about 15 percent below the all-time peak in intermodal revenue moves that occurred in 2006. Since then, there has been substantial investment in network capacity by the rails in the form of double-tracking and new terminals. On the domestic side there may be a concern with regard to the adequacy of the supply of 53-foot domestic containers.

Large acquisitions of equipment in 2011 left intermodal providers with excess boxes. Consequently, most are planning only modest additions in 2012, if any. Strong growth in domestic container movements could therefore put a squeeze on supply, with consequent upward rate pressure.

LM: Is pricing where it needs to be, given that rails are on the hook for the lion's share of their CAPEX, which is at record levels three years running?

Hatch: Pricing must continuously beat rail inflation, for I suspect that the CAPEX story is not going away either. The rails will need to provide more and more capacity for this to work, and that comes at a greater cost that requires an investable ROI.

Gross: The railroads have demonstrated that they are highly disciplined rate makers. Rates have been moving steadily higher, and I see no reason to

expect that the trend will abate.

The operating ratios of most rails have been moving steadily downward, signaling improved profitability, due to a combination of increased efficiency and higher rates. I believe that there's still significant room for improved efficiency even given the progress that has been made to date, so rail financial results will not depend solely on rate increases for improvement.

Bentz: I think prices are probably OK. The big challenge is that in the post-deregulation era, prices, in general, dropped considerably and consistently for more than 20 years. That's been true for the other modes, too. As a supply chain guy, it was easy to look really smart for a very long time. Prices, largely driven by fuel, have been rising for a while at the TCO level and that's not going to change. It's just a harder and less pleasant story to tell the boss than when prices were falling.

I believe we will see sustained price increases, with some temporary exceptions, in all the modes for quite some time. The recession blunted some of this, but, even in the recession, prices managed to rise a bit. So, the railroads will continue to do well, in part because of the ability to raise prices judiciously and because they did such a good job of managing cost control during the recession that they are leaner and more efficient than at the outset.

LM: Maybe it's because it is an election year, but things have been very quiet in terms of railroad re-regula-



tion and antitrust. Will the drum resume beating on those fronts at some point?

Hatch: I see it on the wane, but it's like a pendulum. Shippers see the need for capacity, however, and that keeps those interested in some form of re-regulation from actively joining those who have historically been all about that as their only issue. As long as service and capacity are taken care of, re-regulation talk will remain an irritant and not a terror.

Bentz: I think this will always be on the horizon when you have limited competition and rising prices. Re-regulation is essentially re-distribution of wealth: 'I'm going to take this money out of your pocket and put it in mine.' The entire rail industry is smaller and less profitable

than some of those entities agitating to re-regulate it, so on balance I think it will remain problematic. There are instances where it may make sense, and certainly abuse can't be condoned. Fairness needs to rule and in some cases it takes an objective third party to pass judgment on exactly what is fair.

Gross: I agree with Tony and Brooks. At the moment we don't expect major changes in rail regulation. This could change depending on how the elections in November turn out. If the Democrats were to make gains then the potential for increased regulation would increase.

LM: How will the rail and intermodal markets look five years from now?

Gross: I don't expect drastic changes. With regard to rail carload, the marketplace has already done a very good job of allocating traffic between

rail and highway. We don't expect major shifts in share between rail carload and highway barring dramatic changes in the environment or regulation.

Bentz: I see more significant growth as fuel continues rising and highway congestion continues worsening in key markets. The caveat is that the railroads continue expanding infrastructure capacity. Network congestion has been absent over the past couple of years, mostly due to the fall-off in volume with the onset of the recession. Long-term growth forecasts still predict network congestion as capital requirements fall short of capital needs.

Hatch: My forecast is simple: Both markets will be better, bigger, and stronger and will be a larger part of the continental—and global—supply chain.

—Jeff Berman is Group News Editor,
Supply Chain Group

