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North American railroads brace for limited increases in pre-holiday shipments; weak consumer sentiment exacerbates shrinking corn and coal loads

Railroads have long been viewed as a gauge for the U.S. economy

Railroad & Policy Updates

North American railroads from Warren Buffett's Burlington Northern Santa Fe to CSX Corp. (CSX) are bracing for limited increases in pre-holiday shipments as weak consumer sentiment exacerbates shrinking corn and coal loads.

BNSF, which moves imported Asian consumer goods from West Coast ports, hasn't seen a measurable gain in holiday-related volumes, Chief Marketing Officer John Lanigan said this week. CSX, the biggest carrier in the eastern U.S., and Canadian Pacific Railway Ltd. (CP) both forecast a "modest" advance.

Railroads have long been viewed as a gauge for the U.S. economy, a connection that Buffett cited in 2009 when his Berkshire Hathaway Inc. announced that it was buying the rest of Fort Worth, Texas-based BNSF. Railroads have long been viewed as a gauge for the U.S. economy, a connection that Buffett cited in 2009 when his Berkshire Hathaway Inc. announced that it was buying the rest of Fort Worth, Texas-based BNSF.

The peak rail-shipping season, which usually boosts second-half profits, is under threat after the Midwest drought scorched crops and U.S. consumer confidence fell the most in 10 months in August. Retailers and manufacturers may be deferring orders like they did last year pending evidence that spending will pick up.

"There's too much caution in the supply chain across the retail and tech industries, where there is reluctance to stock anything resembling excess inventory," said Matt Troy, a Susquehanna Financial Group analyst in New York. "Lack of confidence in the economy and market is fueling a lot of fear. Fear breeds inertia. People sit on their hands."

Rail volumes traditionally start to peak in the last two weeks of August as shipments of consumer products bound for store shelves converge with the U.S. harvest and coal for utilities' winter stockpiles.

'Muted' Peak

Union Pacific Corp. (UNP), the largest U.S. railroad, forecast a "muted" 2012 peak, with volumes rising 5 percent to 8 percent over previous months' levels. That contrasts with a 10 percent to 12 percent jump in previous peaks, Eric Butler, marketing and sales executive vice president, said on a July 19 earnings call.

Executives weren't available this week to discuss Omaha, Nebraska-based Union Pacific's outlook ahead of Dahlman Rose & Co.'s Global Transportation Conference in New York starting Sept. 5, said Tom Lange, a spokesman. That event will give investors a chance to evaluate industry leaders' outlook.

"The real question is whether they're optimistic or just hopeful," said Donald Broughton, an Avondale Partners LLC analyst in St. Louis who has a market outperform rating on Union Pacific, CSX and Norfolk Southern Corp. (NSC), the largest publicly traded U.S. carriers.

Customers are "managing inventories carefully as they enter the traditional holiday selling season"

Any projection now for a seasonal peak "is more hope than it is optimism," Broughton said in a telephone interview.

Inventory Management

"We do not anticipate a strong peak season this year," BNSF's Lanigan said in an e-mailed response to questions, without quantifying the size of any gains. Customers are "managing inventories carefully as they enter the traditional holiday selling season."

CSX cited the drought's role in damping volumes as part of its prediction for a "modest" peak. Second-half growth in intermodal shipments, which can move by train, truck or ship, will be similar to the first half at Jacksonville, Florida-based CSX, according to an e-mailed response to questions. The first-half increase was 8 percent.

Canadian National Railway Co. (CNR), whose network includes U.S. lines running from the Canadian border to New Orleans, said it foresees "somewhat higher" seasonal shipments, without giving details. That forecast came on a July 25 earnings call, the same day as Canadian Pacific's projection of a "modest" peak.

A 52-week high in intermodal volumes earlier [in August] still isn't enough to produce a "significant fall peak"

The lack of a traditional peak may not be significant, according to Norfolk, Virginia-based Norfolk Southern. Pre-holiday shipping now starts in the summer, when costs are lower, Chief Marketing Officer Donald Seale said in an e-mailed response to questions.

Not Traditional

"We expect volume growth with both share shifts and seasonal retail demand, but not in the sense of what we used to see in traditional peak season," he said. A 52-week high in intermodal volumes earlier [in August] still isn't enough to produce a "significant fall peak," Seale said. Shippers have been shying from overstocking in the years since the 2008 financial crisis as they improve their ability to balance freight flows over time, said David Vernon, an analyst at Sanford C. Bernstein & Co. in New York.

"The traditional wait, wait, wait and ship-it-all late model -- they've been burned too many times," Vernon said in a telephone interview.

Benchmark Index

The Standard & Poor's 500 Railroads Index (S5RAIL) is trailing the S&P 500 Index in 2012, reversing the year-earlier results. The rail-carrier index's 9 percent gain in 2012 through yesterday compared with an 11 percent advance for the broader S&P 500.

"Every day that passes that [a peak] doesn't arrive casts further doubt that

In 2011, the shipping peak didn't take shape until late September, as the

it ever will arrive… If your date is supposed to pick you up at 7 p.m. and it's 7:30 p.m., they may be late. Somewhere around 9 p.m. you realize you've been stood up. If by mid-September we haven't seen a surge, then the economy is being stood up."

U.S. summer months ended with concern that the nation was headed for a so-called double-dip recession. Shippers that began the pre-holiday season with leaner inventory then stocked up for holiday sales.

Intermodal shipments, which are often consumer goods, rose 4.6 percent in 2012 through Aug. 25, the Association of American Railroads said [in August]. The increase a year earlier was 5.8 percent.

Total carloads are down 1.3 percent, the Washington-based trade group said, with declines of more than 8 percent for coal and grain. Utilities have pared coal shipments as they substitute cheaper natural gas as a fuel, and the worst U.S. drought since 1956 curbs agricultural cargoes. Broughton, the Avondale analyst, said he remains on watch for signs that a peak shipping season will materialize.

"Every day that passes that it doesn't arrive casts further doubt that it ever will arrive," he said. "If your date is supposed to pick you up at 7 p.m. and it's 7:30 p.m., they may be late. Somewhere around 9 p.m. you realize you've been stood up. If by mid-September we haven't seen a surge, then the economy is being stood up."

Read the entire article:
http://www.bloomberg.com/news/2012-08-31/buffett-railroad-sees-economy-sapping-pre-holiday-peak.html

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Mechanical Brief with Steve Christian

There is no substitute for experience

Recently, I was at a customer's plant and was asked to look at a car that was pushed through a rail stop on a dead end track. The stops are the "wheel contact style" that are attached to each track individually. The lead wheels climbed the stops and ended up on the other side of the stops. The stops ended up wedged between the side frame and the inside of the lead wheel. The center plate jumped out of the bolster bowl and the car body continued about three feet beyond. The two inch center pin received two 90 degree bends and was catapulted out of the bolster bowl. There was considerable damage to the hopper slope sheets and gates as the car body slammed into the wheels. To make things worse, this was the second such incident at this same rail stop in a year.

Even with extensive training, "stuff" happens

Obviously there are some switching issues that need to be resolved with the team that place the cars on that track. Someone should have watched the end of the cars when they were backed into the dead end track. Even if they are coupling into a cut of cars already on the track, it is critical that personnel know what is happening to the cars you are coupling into. Best practices should always allow at least a car length between the end of the string of cars and the stops.

So what can we really take away from this? Even with extensive training, "stuff" happens. I have seen cars pushed through stops on Class I railroads, grain elevators, railcar repair shops and numerous industrial plants. No one is immune. With that in mind, how can you plan for someone pushing through your stops? I learned the answer to this many

Experience is a great teacher; it's how we learn from it that counts

Tealinc strives to create value for our customers in many ways. Sharing our extensive and varied experiences is one of them.

First 34 weeks of 2012, US railroads reported year over year cumulative volume down 2.4 percent

Year over year Eastern railroad carload volume down 3.5 percent; Western railroad carload volume up 0.9 percent

years ago. Cars slamming into steel rail stops of any style will probably result in extensive damage to the car and track. A string of cars slamming into an earthen berm at the end of a track causes minimal damage. In my experience with earthen berms, the cars will usually pull back on the rail easily using minimal truck steering using a come-along. You may perform some minor repairs, if any, to the car and dress up the berm for the next time it happens (and it will).

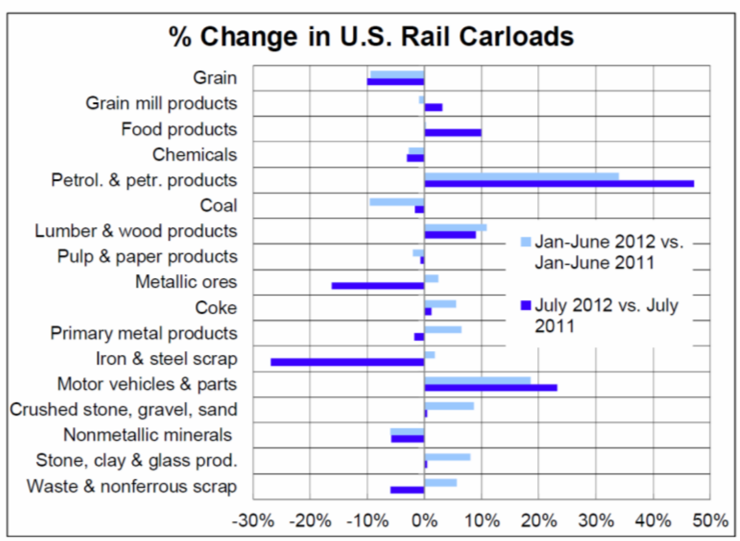
Of course, I recommended the building of an earthen berm for this and all dead-end tracks at this customer's plant. BNSF has an excellent print of an earthen berm in their "DESIGN GUIDELINES FOR INDUSTRIAL TRACK PROJECTS" on page A-13. It can be found online at http://www.bnsf.com/customers/pdf/indytrkstds.pdf.

Experience is a great teacher; it's how we learn from it that counts. As with every customer we have the opportunity to work with, I hope this customer benefits from mine. Tealinc strives to create value for our customers in many ways. Sharing our extensive and varied experiences is one of them.

Steve Christian is the Manager Value Creation-Railcar Performance Manager for Tealinc, Ltd. You may contact Steve directly out of our Nebraska office at (308) 675-0838 or via email at ***steve@tealinc.com****.*

Railroad Traffic

The Association of American Railroads (AAR) reported on August 30, 2012 mixed weekly rail traffic for the week ending August 25, 2012, with U.S. railroads originating 297,042 carloads, down 0.8 percent compared with the same week last year. Intermodal volume for the week totaled 248,364 trailers and containers, up 5.2 percent compared with the same week last year.



Ten of the 20 carload commodity groups posted increases compared with the same week in 2011, with petroleum products, up 55.7 percent; farm products excluding grain, up 26.5 percent, and lumber and wood products, up 20.8 percent. The groups showing a decrease in weekly traffic included metallic ores, down 17.5 percent, and waste and nonferrous scrap, down 14.5 percent.

Year-over-year cumulative Canadian railroads volume up 2.9 percent; trainers and containers up 7 percent

Year-over-year cumulative Mexican railroads volume down 1 percent; trainers and containers up 18.8 percent

Considerable uncertainty exists regarding the size of the economically recoverable U.S. shale gas resource base and the cost of producing those resources

Weekly carload volume on Eastern railroads was down 3.5 percent compared with the same week last year. In the West, weekly carload volume was up 0.9 percent compared with the same week in 2011.
For the first 34 weeks of 2012, U.S. railroads reported cumulative volume of 9,597,499 carloads, down 2.4 percent from the same point last year, and 7,977,680 trailers and containers, up 3.6 percent from last year.

Canadian railroads reported 79,853 carloads for the week, up 3.9 percent compared with the same week last year, and 53,277 trailers and containers, up 3.2 percent compared with 2011. For the first 34 weeks of 2012, Canadian railroads reported cumulative volume of 2,604,023 carloads, up 2.9 percent from the same point last year, and 1,734,063 trailers and containers, up 7 percent from last year.

Mexican railroads reported 15,030 carloads for the week, down 0.1 percent compared with the same week last year, and 11,135 trailers and containers, up 32.6 percent. Cumulative volume on Mexican railroads for the first 34 weeks of 2012 is 485,255 carloads, down 0.6 percent compared with the same point last year, and 327,671 trailers and containers, up 18.8 percent from last year.

Combined North American rail volume for the first 34 weeks of 2012 on 13 reporting U.S., Canadian and Mexican railroads totaled 12,686,777 carloads, down 1.3 percent compared with the same point last year, and 10,039,414 trailers and containers, up 4.6 percent compared with last year.

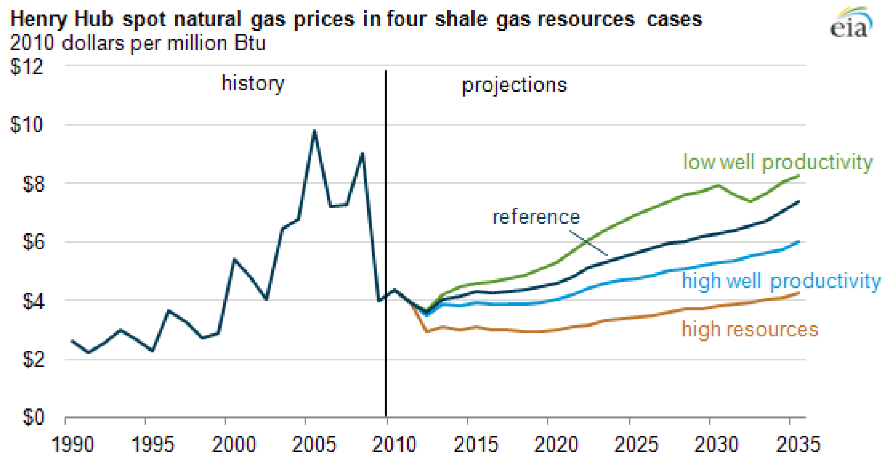
Read more at: **http://www.aar.org/AAR/NewsAndEvents/Freight-Rail-Traffic/2012/08/30-railtraffic.aspx**

Graph adapted from:
http://www.aar.org/NewsAndEvents/~/media/aar/railtimeindicators/2012-08-rti.ashx

Industrial Inside

Considerable uncertainty exists regarding the size of the economically recoverable U.S. shale gas resource base and the cost of producing those resources. Across four shale gas resource scenarios from the Annual Energy Outlook 2012 (AEO2012), natural gas prices vary by about $4 per million British thermal units (MMBtu) in 2035, demonstrating the significant impact that shale gas resource uncertainty has in determining future natural gas prices. This uncertainty exists primarily because shale gas wells exhibit a wide variation in their initial production rate, rate of decline, and estimated ultimate recovery per well (or EUR, which is the expected cumulative production over the life of a well).
If a resource assessment of a shale formation relies on "sweet spot" production rates, where wells produce at rates higher than expected elsewhere in the formation, then the productive and economic potential of the entire formation could be exaggerated. On the other hand, future technological improvements that reduce production costs and/or enhance well productivity, along with closer well spacing, would increase the economic potential and resource recovery of the U.S. shale gas formations.

Projected natural gas prices depend on shale gas resource economics



Source: U.S. Energy Information Administration, Annual Energy Outlook 2012.

AEO2012 includes an analysis of varying future shale gas well production estimates and the associated EUR, along with a change in shale gas well spacing, to test the influence of shale gas resource uncertainty on future natural gas prices. In addition to the reference case, the three AEO2012 shale gas resource scenarios are:

- **Low well productivity case** (green line in chart). The EUR per shale gas well is assumed to be 50% lower than in the Reference case, nearly doubling the per-unit cost of developing the resource. Unproved shale gas resources are reduced to 241 trillion cubic feet (as of January 1, 2010), as compared with 482 trillion cubic feet of unproved shale gas resources in the Reference case.

- **High well productivity case** (light blue line). The EUR per shale gas well is assumed to be 50% higher than in the Reference case, nearly halving the per-unit cost of developing the resource. Unproved shale gas resources are increased to 723 trillion cubic feet.

- **High resources case** (orange line). The well spacing for all shale gas plays is assumed to be 8 wells per square mile, which increases the well density in about half the shale gas plays, and the EUR per shale gas well is also assumed to be 50% higher than in the Reference case. Unproved shale gas resources are increased to 1,091 trillion cubic feet, more than twice the unproved shale gas resources in the Reference case.

These cases do not represent a confidence interval for the shale gas resource base, but rather illustrate how different assumptions can affect projections of domestic production, prices, and consumption.

U.S. natural gas prices are determined by supply and demand conditions in the North American natural gas market

U.S. natural gas prices are determined by supply and demand conditions in the North American natural gas market, in which the United States constitutes the largest regional submarket. Future natural gas prices reflect the cost of developing incremental production capacity. Because shale gas production is projected to be a large proportion of U.S. and North American gas production, changes in the cost and productivity of U.S. shale gas wells have a significant effect on projected natural gas prices. In the Reference case, for example, shale gas production accounts for 49% of

Because shale gas

production is projected to be a large proportion of U.S. and North American gas production, changes in the cost and productivity of U.S. shale gas wells have a significant effect on projected natural gas prices

total U.S. natural gas production in 2035.

In 2031, natural gas prices dip in the low EUR case as model results reflect completion of an Alaska gas pipeline, which would transport about 1.6 trillion cubic feet per year of gas from the North Slope to the lower 48 states. Because an Alaska gas pipeline would make up for some of the reduction in lower 48 states' shale gas production, the difference between projected prices in the Reference and Low EUR case is reduced after the pipeline is completed.

Read the entire article at:
http://www.eia.gov/todayinenergy/detail.cfm?id=7710

Financial Focus

Federal Reserve Chairman Ben S. Bernanke said August 31, 2012 that the central bank plans to respond forcefully to the nation's sluggish recovery and mounted a powerful defense of the Fed's actions to date to keep the economy growing.

In his widely anticipated remarks at the Jackson Hole economic summit, Bernanke did not say that action was imminent, but he used uncharacteristically direct and forward-looking language to suggest that the Fed could soon act to bolster growth and lower unemployment.

Federal Reserve Chairman says the central bank plans to respond forcefully to the nation's sluggish recovery

The Fed chairman said the central bank intends to be "forceful . . . in supporting a sustainable recovery." With Europe's financial crisis and the United States' looming budget cuts and tax hikes posing major risks for the recovery, he said, economic growth is "far from satisfactory," and he pledged the Fed will take additional steps to help the economy as needed.

As is common of Fed pronouncements, Bernanke hinted but offered no certainty of action to come. Still, the urgent tone of his remarks will leave investors disappointed if the Fed does not launch new stimulus at its Sept. 12-13 policymaking meeting. Investors seemed hopeful, with stocks trending up by about 1 percent in the early afternoon.

"We must not lose sight of the daunting economic challenges that confront our nation," Bernanke said. "The stagnation of the labor market in particular is a grave concern, not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years."

"We must not lose sight of the daunting economic challenges that confront our nation," Bernanke said. "The stagnation of the labor market in particular is a grave

"The Federal Reserve has acted to support economic growth and foster job creation," he added, "and it is important to achieve further progress, particularly in the labor market."

Bernanke's speech seemed carefully designed to build on two other suggestions this month that the Fed is strongly considering new action. After an early August policymaking meeting, the Fed declined to take new steps to stimulate growth but committed itself to doing so if needed to help the economy. Minutes from that meeting released last week said that many

concern, not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years."

Fed officials favor more action if the economy does not improve soon.

In September, the government will release its unemployment numbers for August. A disappointing report — fewer than 100,000 or so new jobs added to the economy — would likely tip the Fed toward stronger action. Robust data showing more than 150,000 new jobs added could prompt the Fed to wait longer.

Also in early September, the European Central Bank will announce details of the steps it is taking to alleviate the continent's financial crisis, a major drag on the U.S. economy. If the ECB takes dramatic action, it might reduce the burden on the Fed to act.

The lion's share of Bernanke's comments August 31, 2012 made up a robust defense of the Fed's actions over the past four years to help the economy, which have included bringing short-term interest rates to historic lows and launching a range of unconventional programs to try to push growth.

Learn more at:
http://www.washingtonpost.com/business/economy/bernanke-fed-intends-to-be-forceful-in-supporting-recovery/2012/08/31/47a5c396-f373-11e1-adc6-87dfa8eff430_story.html

The Edge

It's often quoted in the rail freight industry that rail traffic is a leading indicator of future economic health of our industries. The rail freight traffic indicator most closely watched is weekly originated traffic trends of major U.S. railroads.

Looking at the cumulative 34 weeks ending August 25, 2012 (www.aar.org) freight carloads originated are at 9,597,499 down 2.4%, or 234,063 carloads, from the same time period in 2011. The losses are led by coal at minus 402,237 originated carloads and in second place is grain at minus 75,764 originated carloads. Not surprising the leader in the gain side of the equation is petroleum products at plus 94,562 originated carloads followed closely by motor vehicles and equipment at plus 89,427 originated carloads. The third place gainer is crushed stone, sand and gravel with plus 39,553 carloads. Of interest to economic measures is that lumber and wood products are trending up with a positive gain of 11,911 carloads when compared to the same 34 weeks in 2011. The balance of the commodities is somewhat stagnant when comparing originated carload statistics.

So what does this tell us about the United States current and future economic health?

Let me first qualify this question with what I'm about to espouse. I'm no economist. I believe statistically economists are right only 50% of the time, it seems in the past four years that number may be closer to 25%. So far I've been right a bit more than the economist.

If we segregate these carload origination indicators into two broad categories reflecting better economic times and two broad categories reflecting worse economic times we get a better picture of the economy and what's likely to occur in the future.

Upside Indicators

Basic Industries. On the growth side one will see the petroleum industry is driving growth in crude oil shipments and considering the time, cost and political agenda that it takes to get a pipeline in place will continue to do so for the foreseeable future. Notwithstanding originated rail carloads a pipeline may cause some downside if we don't increase refining capacity by simply moving supply closer to a chokepoint. This industry is also partially supporting growth in stone, sand and gravel shipments in the developments of infrastructure for drilling and accommodations for workers.

Consumer Confidence. Outside of basic industries it's somewhat surprising to see motor vehicle growth up so significantly. This tells me there was either pent up demand that was held back during the early recession of 2009 – 2010 or we're gaining consumer confidence. I'm hoping it's the later but we'll see if the numbers continue to be supported. Lumber and wood product shipments are up 11,911 railcar loads and are a reflection of a small upswing in housing starts as well.

Downside Indicators

Weather. We have some 40 states in drought condition in the United States. That has a major effect on the small grains and whole grain supply. The number one feed grain is corn in this country and although it isn't harvested yet is projected to be significantly less than projected in January of this year. It may end up at a record low harvest. The largest impact corn has is the price of foodstuffs and protein feeding. In addition it may have an effect on gas prices as when distilled into an ethanol additive. There's nothing we can do about weather but deal with it the best we can in our individual situations.

Competing Products and Politics. Coal originations are off some 400,000 railcar loads. Coal accounts for the single most carloads of any commodity transported by rail. It pays for the infrastructure of the rail systems in this country. Coal is being affected by natural gas prices being low and projected to remain so for the near future. However if left to normal capitalistic pricing coal and natural gas will eventually find a price and supply equilibrium that is beneficial to the consumer. Coal is also being negatively affected by political agendas and special interest groups as well – only time will tell what impacts these decisions will make.

Up To the Challenge

We live in a country abounding with resilient people. This Labor Day weekend, we celebrate you, workers of America, for the contributions you make to motivate, inspire and provoke positive changes in today's economy. Let's stay engaged.

We look forward to earning your business!