2005: A TIPPING POINT FOR SHORT LINES

Editor's Note: Mike Smith of Finger Lakes Railway Corp. delivered the following speech at the Annual RTA Convention in Montreal.

The title of my presentation is "2005: A Tipping Point." I guess the question is why this is a tipping point. For the railroad industry, it has been a pretty good couple of years. We are being described as the savior for all the transportation problems that North America is facing. But, this year, we are at a point where we could go one way or the other. In particular, I think the Class 1 railroads have convinced themselves that the future lies in a shorter-term market strategy involving coal and intermodal trains, high-volume and high-density corridors, a concentration on large volume customers, and higher return investments and services as defined by their costing systems. Class 1s are aggressively pursuing this particular strategy or vision, as it may be. And since it seems to be working, it is very difficult to criticize what it is that they are doing.

On the other hand, the short lines and regional railroads are pursuing a different type of business plan, which is a little bit of a longer-term plan. We tend to think about it having an impact on our operation about 10 years down the road instead of meeting—what the Class 1s have to do—the quarterly requirements of the investment community. So, our business plan is based upon the pursuit of single and multiple carload business. That's our bread and butter. It is key to us. Establishing close customer and government associations. Providing innovative services. And placing an emphasis on rapid growth by taking advantage of our available capacity and supported by cost models based upon what we often thought of as traditionally a high fixed-cost, low variable-cost industry so that particular calculation we have taken advantage of and our business has grown spectacularly. It is double-digit growth, and it has been going on for a couple of years.

The tipping point that I am going to describe is based upon the conflict that is associated with these two different visions. They are very different business plans, and they will come in conflict. There is a fellow who used to work for the Long Island Railroad. Many of you might remember Dan Cleary. Unfortunately, Dan passed away a few years ago. But he had a great observation, which has particular meaning today. He used to say, "You know it's not the bigger they are the harder they fall. It's the bigger they are the harder they hit." And the Class 1s are big, and they can hit very hard.

If there is a difference of opinion in what markets we pursue or what services we offer, our price, our car supply, even our opportunities, the Class 1 view is going to prevail. They are that big and that controlling. That having been said, I think we need to convince them that our business plan has a merit to it perhaps more than their own. Specifically, we are going to require solid arguments supporting our plan and, critically, I think we are going to need allies like this group here to voice their support.

To start, we are going to review where the industry says we are. This is the result of the last 80-plus years as far as ton-miles, and you can see that in recent years it looks pretty good. Basically, we are approaching and have set new records in the past four years. And that trend seems to be continuing.

One thing about it is that there is an awful lot of Powder River coal in these numbers, which impacts the number of ton-miles. Also, there are a lot of coast-to-coast intermodal trains in these numbers, and that greatly influences ton-miles. If we look at market share by ton-mile, we start to see a slightly different pattern.

You can see that in 1929 we had almost 75 percent of the total ton-miles that moved in this country. Today, we seem to have stabilized in the 41 to 43 percent area. That's still pretty good, and it gives us a good argument with government and with our customers in terms of how important we are to the overall transportation market. But, still in all, 42 to 43 percent of the total market may not be good enough.

By the way, you might want to ask why 1929 is still in there. Well, 1929 was basically our last good year when you think about it. When we started the 20th century, we were the biggest industry in the United States. But by the 1920s, the auto industry had edged us out. And, right now, we are duking it out with the dog food industry in terms of total revenue. That kind of describes how we have responded to the tremendous growth in this particular economy.

Now, this is where we get into some stuff that will hopefully capture your interest, because I think that will really tell you where we are and what we have done. Going back to 1929, you can see that we originated almost 1.4 billion tons. Now, think about how small the 1929 economy was in comparison to the economy that we have today. I mean this economy is—I don't know, does someone want to throw a number out—a thousand times bigger than it was then. Probably pretty close to it. Our population growth went from about 120 million in 1929 to about 300 million today. And if you look at our tons originated, we are approaching 1.8 billion. From 1929 to 2003, we only grew 32. 9 percent in total tonnage handled.

I think we look pretty good in ton-miles. But, in tons originated, I think we look terrible. And, I think that while this represents a problem it also presents an opportunity for us. Now, look at these bureau of transportation statistics. Basically, what this says is that the total market in 2002 was 11.7 billion tons, and our share was 1.94 billion tons. But let's take a look at it from another perspective—mileage. In this slide, we see that the blue is the under 500-mile market. The red is the over 500-mile market. Well, in the under 500-mile market, rail had about a 10 percent market share. And, in the red—the 1.94 billion market—we did a 43 percent market share. If you look at these graphs, I am sure you will see a pattern of our participation. Big market, small involvement in part of the railroad. And, in particular, a lack of competitiveness in the biggest market of all, the under 500-mile market.

Can railroads compete in the under 500-

mile market, which is where the business is and where the revenue is that we are not chasing? Right now, our average length of haul is 902 miles. Not only are we not competing in the largest market segment for our services, we are running away from it. If you go back to 1947, I think on average haul and our market share was much higher in those days is a little less than 400 miles. The quest for greater efficiency with longer hauls is limiting our ability to compete in the bigger market.

Now, let's take a look at what is going on in the market. Here, I have a study that a major brewer with six major production facilities put together. Nobody is centralizing anymore. Manufacturers are going regional. Regardless of whether we are talking about steel mills, paper mills, etc., most production facilities are going regional. So, the longer-haul opportunities for most manufacturers are not out there. Basically, they are concentrating in regional markets, which, by definition, are under 600 miles. The brewer has six production facilities with lots of distributors that are served by rail. Sidings rail is very competitive; we can get three truckloads in one carload. That gives us an edge. The average shipment is about 500 miles, so they are in that area that we should be interested, and they ship more than 7.9 million tons. Now, these are the results. Look at 294,000 shipments by truck, 45,000-pound trucks, 6.6 million tons. You look at the rest of shipping patterns that they follow and, while we do pretty well—and only in carload, by the way, we get 952 tons—we are not really a factor with this company. Their growth in business and their distribution plan involves trucks, which hurts us.

Based on these numbers, what do you think that they are telling us? Well, I think one thing is that their trucks are overwhelming us. If the market shifts for them, they shift their practices, policies and prices, and equipment availability. They are very quick on their feet. And this is one of the advantages that the short lines also have. We can respond to truck competition faster than larger railroads. The bigger the institution becomes, the less able they are to respond. But, truckers gain customers just as fast as can be. If we make an adjustment, they make an adjustment. And, if the market shifts, they always respond faster than we do. So they are overwhelming us. We have to get more competitive with them.

The second thing is that intermodal rail traffic isn't the long-term answer to growth. It certainly isn't the case with this brewer. Intermodal doesn't address the domestic transportation market. It is not competitive. We handle more carloads out of that brewer than we handle intermodal loads. And when you look at intermodal growth, it is not domestic; it is international. And the length of the haul of intermodal is growing all the time. There are press releases out how we have extended the length of the haul by concentrating on the high-density stuff. And that can be good, and it can be valuable. But the intermodal impact on the general transportation market, the domestic transportation market today, I would say is virtually nonexistent.

Here's an example. *Trains* magazine made an effort to quantify this issue by looking at truck shipments vs. intermodal rail shipment between the Northeast region and the Southeast region. In other words, between the biggest industrial area in the world and the fastest growing region in the United States. Here is the month of January 2004. There were 9,000 southbound movements and 10,000 northbound intermodal movements. That works out to be about 300 loads in each direction each day. That's a pretty pathetically low volume for those of you who travel on I-95 and some of the other interstates where you just see trucks going by one right after the other and parked on the sides of the road waiting to make their deliveries. A rail market share of about 300 loads a day in each direction is incredibly low. Now, can we do something it? I think so. Our little railroad—and we are not unique in this regard out with about 5,600 car loads. But we are now at 16,000 car loads. Fifty-four percent of our business moves fewer than 300 miles, 62 percent fewer than 500 miles. We have 4 percent of our business—that's 600 cars—move fewer than three miles. Most people say that railroads aren't good in the short-haul business. We can beat the trucks up in that business; three miles is a no brainer. Truckers hate handling that type of traffic, and customers hate shipping that kind of traffic in trucks. Three percent of our cars move fewer than 80 miles. We have one move with CSX that is 12 miles and is regarded as a profitable move. The Class 1s are smart operators. I don't always agree with their strategies, but they know what they are doing and they hardly ever put together a rate that isn't profitable. So, I think our example demonstrates that they can compete in this lower-mileage business and can compete effectively.

Finally, why is all of this important to you? Well, we can go back to 1929. Look at all the crossties you produced in 1929. Or, for a little more current look, consider 1955. Look at all of the crossties you produced in 1955. As the U.S. railroad industry has retreated in the marketplace it has impacted your industry just like it has impacted ours. Every time we lift a piece of track, whether it is a siding or a second main line or a branch line someplace, we have in essence reduced your market by 3,000 ties per mile. Your market size is going to shrink if we keep shrinking. So, when I ask for allies in this whole thing, I guess what we are looking for is a fresh approach, and we are looking for people who will stand with us in terms of generating interest and support for the carload business. It is the only way we are going to compete for the bigger market you saw in the pie: all of those billions of tons that are out there that we can handle. We know that we can handle it. Every one of the railroads here handles that stuff, and everyone one of the Class 1s can do more of this business if we convince them it is the right thing to do. We need to recognize that we are ignoring the biggest market and, in fact, are running away from it and that we need to change that. §