In the March/April 2013 issue of Crossties, ABH Consulting’s Tony Hatch told readers that railroad capital expenditures (Capex) were expected to slightly exceed the record levels set in 2012.

Although 2014 is still young and data are still being analyzed, we wanted to learn from Hatch his initial expectations for Capex for the year. Hatch shares his insights with Crossties below.

What are your expectations for 2014 Capex?
Capex will increase again in 2014. Initial reports suggest as much as 9 percent and on average 5 percent. The rails will once again top 18 percent of revenues on Capex versus 3 percent for average industrial.

It is possible that numbers could go even higher, given the emerging perceptions of safety and service concerns, as well as new revenue and market share opportunities that could occur. The Association of American Railroads puts total rail expenditures on maintenance of way, including compensation, in the United States at $26 billion for 2014. That sets another record for railroad Capex by 4 to 5 percent.

If we don’t include Burlington Northern Santa Fe (BNSF) and the small growth projected by Kansas City Southern (KSU), the railroads spent about 60 percent of their free cash flow on Capex in 2013. The numbers are slightly skewed by Canadian Pacific’s (CP) 85 percent rate and KSU’s 78 percent since neither had share buy-back plans last year. CP has those plans in place now, committing to some $800+ million in share repos at today’s price.

KSU was the only Class 1 to project a drop in year-over-year Capex plans, while BNSF has both the largest amount and largest year-over-year increase. Don’t make the mistake of thinking they don’t have a dividend responsibility, though. It is just that they have only one shareholder to please. Plus, BNSF is caught in the middle of the Bakken vortex [service issues, etc.], but they aren’t ignoring the concerns, spending well over 20 percent of revenues.

How do service and safety factor into Capex plans for the year?
The decline of the rail service measured by average velocity in the recent past is now well known. It’s a good news, bad news story. First, the good news is that BNSF and others experienced simultaneous growth in all four categories—cyclical (forest products), secular (domestic intermodal), episodic (agriculture roaring to life after the lingering drought effects) and brand new—crude by rail (CBR). But that’s also the bad news; with growth came service issues raised by shippers, re-regulation lobbyists and others just as the service requirements for some of the newer business types, such as domestic intermodal, are becoming even more exacting.

Thus, internally the emerging competitor for free cash flow dollars is more Capex. Before, it was investor calls for direct shareholder spend, such as the share repos and dividends. But that was under the assumption that service would at least plateau at a high level, not experience decline. That said, it is safe to say that never before in rail history has consistent service become such a critical requirement—the driver of both productivity and market share in an ever more challenging freight transportation world.

With the national eye on railroads to prove their safety record, the correlation between Capex and controllable safety is also crystal clear.

What about crude by rail (CBR) and its effect on Capex?
The new business of CBR creates new freight flowing often on former light density track or through some hubs that were already approaching their saturation point.

### Railroad Capital Expenditures

<table>
<thead>
<tr>
<th>Railroad</th>
<th>13 Capex</th>
<th>14 Capex</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>BNSF</td>
<td>$4.3B</td>
<td>$5B</td>
<td>16%</td>
</tr>
<tr>
<td>CNI</td>
<td>$2.1B</td>
<td>$2.2B</td>
<td>5%</td>
</tr>
<tr>
<td>CP</td>
<td>$1.3B</td>
<td>$1.3B</td>
<td>0%</td>
</tr>
<tr>
<td>CSX</td>
<td>$2.2B</td>
<td>$2.3B</td>
<td>5%</td>
</tr>
<tr>
<td>KSU</td>
<td>$0.6B</td>
<td>$0.6B</td>
<td>-7%</td>
</tr>
<tr>
<td>NSC</td>
<td>$2.0B</td>
<td>$2.2B</td>
<td>12%</td>
</tr>
<tr>
<td>UNP</td>
<td>$3.6B</td>
<td>$3.9B</td>
<td>8%</td>
</tr>
</tbody>
</table>

Source: Association of American Railroads

“Capex will increase again in 2014. Initial reports suggest as much as 9 percent and on average 5 percent. The rails will once again top 18 percent of revenues on Capex.”
Railroads are, as they did with the ethanol build out, allowing their shippers to participate in most of the capital requirements (i.e., terminals, cars) to mitigate costs, but shippers don’t participate on overall network expenditures. Thus, Capex increases will occur to fulfill the network improvement required to accommodate the new business.

Tell us how rail cars are influencing Capex.

Its déjà vu for railroads with rail cars. For example, deep within BNSF’s massive $5 billion Capex budget was a plan to buy 5,000 rail cars. All of the intensity around the tank car issue is not directly a railroad issue per se, as they don’t own the tank cars in question. The debate therefore is between the interests of the production company, the leasing companies and the OEMs.

For the most part, rail car ownership dropped over the decades as railroads put emphasis on network improvement. So, one question that arises is whether BNSF’s tank car announcement is a sign of the future, or a statement of commitment to the CBR market and/or to the DOT to get its new regulations out now. In some of those scenarios, depending on how it plays out, it could be followed later by a quiet announcement of a fleet sale/leaseback.

What about highway infrastructure?

Does this play into the railroads’ spending plans?

The national infrastructure is in terrible shape, and the list of available public finance options is rather small in a no-tax increase legislative environment. Those who live by public funding and subsidies will suffer for the lack of them as the highway system buckles under the load of traffic. Meanwhile, the rail industry is hard at work spending their way to resolution of the perceived safety and service issues. Because of this, by the time the weather warms, the hope is to measurably turn the corner on perceptions and reality.

Those who are concerned about the increase in Capex should watch ROI, which continues to improve. Capex investments in service and safety are really good business decisions.