Special Report:
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CapEx Still Crucial To Successful Rail Renaissance

Railroads have learned through trial and error over the post-Staggers period to increasingly spend strategically rather than tactically, which is a good thing given the very long lives of the assets. Rail CapEx of more than $13 billion this year suggests another record year, as would the estimated total spend of $24.5 billion.

Staggers Leads To First CapEx Revival

Before the Staggers Act of 1980 and railroad deregulation, capital expenditures were sporadic at best. Given the poor returns that railways generated, cash was siphoned from them into other portions of the conglomerates that the railway holding companies had become, in the investment fashion of the times.

Staggers changed all of that, allowing a return to health of the industry. CapEx increased in the years just prior to and then immediately after the 1980 passage of Staggers.

One aspect of Staggers was the allowed creation of the modern short line industry, whereby low-density lines were sold or spun off (to new locally based entrepreneurs with lower cost structures) with the effect of reducing Class One mileage to the longer haul main-line core network. The main-line core network absorbed a higher percentage of the increasing CapEx dollar in order to:

- Bring the decayed networks back up to a normal level;
- Increase safety standards;
- Retain what business they could versus onslaught of the subsidized and deregulated trucking industry; and
- Chase a small but increasing number of new business opportunities.

1990s: Consolidation & The First Stirring Of The Renaissance

As railroads reduced expenses, they began to show signs of the revival that would later be called the "renaissance," as intermodal intervention spread from international to domestic (the JBHunt deal, etc.) and Mexican opportunities began to be developed and more.

By far, the major driver of the next jump in CapEx was the consolidation of the era. Each merger created CapEx need and opportunity, from new jointly served market opportunities, to new route development, to IT spend, to massive need for network rehabilitation (SP).

Most of the mergers were neither on time (in terms of normalized not to mention accretive operations) nor on budget (in terms of stated in ICC or STB documents), which led to massive upset for shippers, regulators and investors.

One response was to spend. And, after the conclusion of the merger issues, the resulting euphoria bred an "if we build it they will come" attitude just in time for the end-of-the-century recession.

21st Century: The Maturation Of The Railroad Renaissance & Strategic CapEx

The modern rail era brings with it a revived, growth hungry industry, recapturing market share of value added goods while participating fully in globalization—and in the near-sourcing/Mexican opportunity.

The resulting rail boom led to growth in CapEx and the newfound "luxury" of thinking of CapEx in strategic terms (replacing ties on time) rather than tactically.

Also, deferred maintenance is simply too expensive and doesn't fit with strategic plans. Other positive factors:

- A growth boom in new segments (domestic intermodal) and regions (North Dakota, Mexico) and new car types (tankers, auto racks) and IT (beyond PTC) that has led to new spend in new regions.
- Politically, the rails cannot afford any other service meltdowns such as those of 1995-99 or 2003-05, which caused massive press and government scrutiny and shipper anger.
- Investor patience as ROI grows, and rails earned cost of capital (CoC) for the first time as an industry in 2012.
- Buffett purchasing BNSF, adding very patient capital to the competitive mix.
- The highest ever service standards (domestic intermodal, etc.) are leading to development of service-related CapEx such as sidings and terminals.
- Passenger growth—the recent re-embracing of passenger rails, whether high speed rail or, more likely, higher speed rail.

2013: Another Record Year For CapEx?

It appears that 2013 CapEx will slightly exceed 2012 record levels, helped by BNSF's whopping $4.1 billion plan.

The net result in any case is a vast improvement in safety and in service as measured by the AAR metrics, and thus vastly improved financial returns and economic opportunity.

Can that last forever? Are there enough growth projects? Should one shrink CapEx and harvest cash? Is UNP's $100 million or so decline in YOY CapEx a strategic shift, or is it the timing nature of some projects?

As long as ROI remains huge and unobstructed by regulation (or execution failure) the industry will continue to invest in both maintenance and growth. Should anything change, CapEx would be an early victim.

CapEx Notes By Class I Carrier

- CSX announced a slight increase to a record $2.3 billion (+$100 million) and a reduction of 100-200bps to 16-17 percent of revenues. 54 percent was infrastructure.
- UNP announced a $3.6 billion plan, down slightly (The warm weather in 2012 moved some projects forward, further distorting the YOY picture). $1.675 billion in

infrastructure, $670 million in capacity, $610 million for locos and equipment, $195 million for IT and $450 million for PTC.

- NS reduced CapEx by $241 million, some of it timing, to $2 billion. $831 million will be for roadway improvements..
- KSU kept CapEx for this year at 18 percent of expected revenues
- CNI increased planned CapEx $100 million to $1.9-$1 billion on track/ infrastructure.
- CP, going through a slimming program, announced that CapEx would be held at about $1 billion for the next few years, leading to what should be pent-up demand for service and capacity projects.
- BNSF, on the other hand, increased its CapEx program by $450 million to $4.1-$2.3 billion to improve its core network and $1 billion on rolling stock and growth. ■

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