

The Short-Line Advantage: Personalized Service that Saves Millions

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Executive Summary

To remain competitive, many companies have conducted extensive reviews of their shipping costs to identify potential savings. Such reviews frequently lead to difficult trade-off decisions between service and cost. Typically, a company emphasizing consistency and speed for its freight has favored trucks, whereas one seeking to reduce costs has favored rail.

Trucks more than doubled their market share in the transportation industry in the latter half of the 20th century, driven in large part by the shift at many companies to “just-in-time” inventories. But trucks also enjoyed gains as their main competitor, the rail network, deteriorated due to onerous federal regulations and failing business models. In fact, railroad bankruptcies became common, and nearly every major railroad faced a bleak financial future.

The fate of the railroads took a dramatic turn in 1980 with the passage of the Staggers Act that deregulated the industry. This legislation is perhaps the most successful legislation Congress ever enacted to stimulate an industry. Railroads have flourished since 1980 with productivity soaring, safety at record levels, and service vastly improved. Rail carriers now offer companies shipping alternatives that are dramatically cheaper than trucks, with a service that is now far more reliable. This is especially true on longer hauls.

A new trend is emerging in the rail industry that could have profound implications for rail shippers. The Class II and Class III railroads – also known as regional and short-line railroads – provide companies even greater savings in

transportation costs and routing options when they connect with two or more Class I's.

In fact, a great competitive advantage lies with companies that have access to two or more Class I lines connected by a short-line railroad. This situation provides a means for a shipper to better manage the risks of service interruptions on one carrier by gaining efficient access to an alternative rail route. It also creates an environment of long-term competitive pricing while opening a wealth of shipping options. In many cases, companies that don't take advantage of these options are spending much more in transportation costs than necessary. Short-line and regional railroads provide dependable, timely, high-quality service at significantly lower transportation costs compared to companies that have only one rail carrier option.

Shipping by Rail

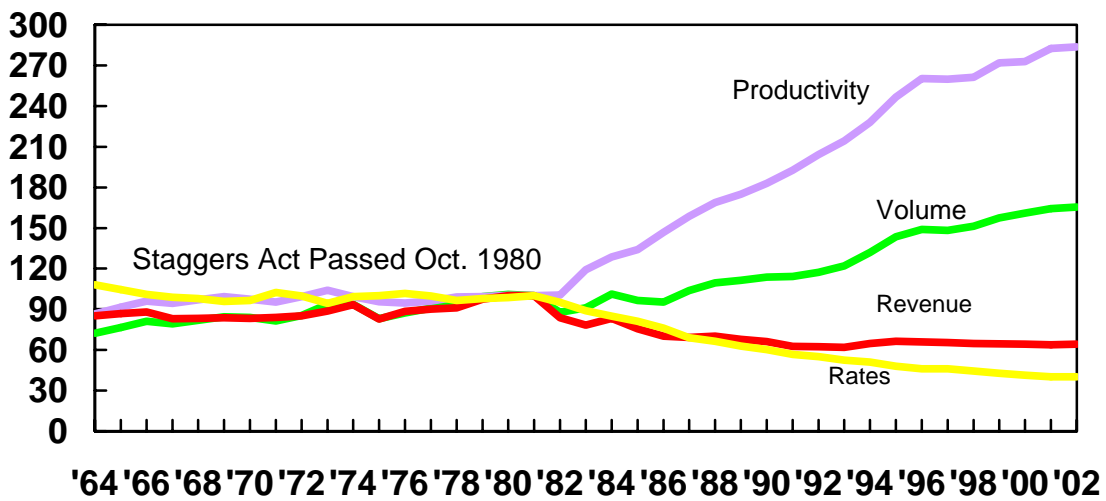
In 1887, Congress passed the Interstate Commerce Act, making railroads the first industry in the country subject to federal economic regulation. For the next 93 years, the government maintained tight control of railroad operations, nearly bringing about its demise. Even though shipping by rail is naturally cheaper and more fuel efficient, rail carriers struggled to maintain their dominance in the marketplace. Those problems were reflected in bankruptcy court: before 1980, one in five railroads was either in, or headed to, bankruptcy.

The Staggers Rail Act of 1980, named for Harley O. Staggers, chair of the House Commerce Committee, brought about deregulation of the industry. To that point, rates, services, car use, and the construction, sales, and closures of rail lines

were all subject to strict economic regulation.¹ With the Staggers Act, maximum rate regulations still provide protection for shippers, but rates are now largely market-driven and not government-enforced.

The dramatic turnaround of the industry is depicted below in statistics shared by the Association of American Railroads².

U.S. Freight Railroads Since Staggers (Index 1981=100)



Source: AAR

These improvements have been reported since the passage of the Staggers Act:³

- Average rail rates have fallen more than 50% on an inflation-adjusted basis (see “Railroad Rates After Inflation” chart on the following page).

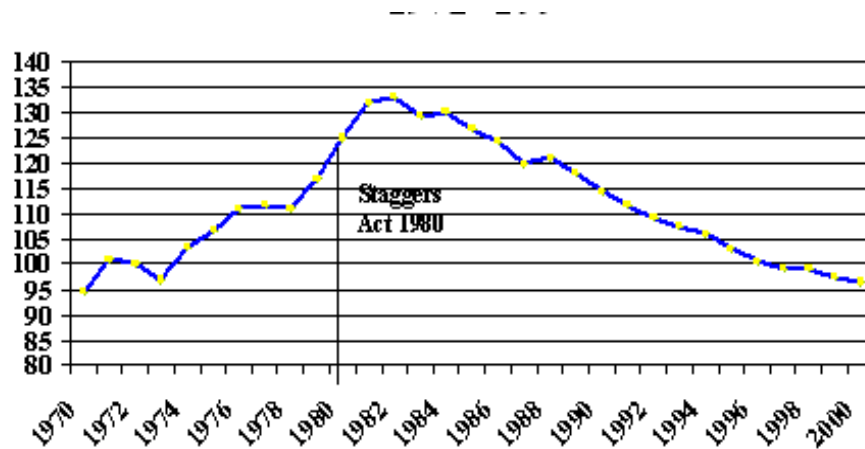
¹ Union Pacific, “Union Pacific Position Paper: Staggers Act: A Boon to Safety & Efficiency,” www.uprr.com

² Association of American Railroads

³ Ibid.

- Major freight railroads have spent more than \$200 billion since 1980 to maintain and improve equipment and track.
- The train accident rate has fallen 68% and employee casualty rates have fallen 67%.
- Productivity of equipment has doubled; productivity of labor has more than tripled.
- The rail share of intercity freight has risen from 35% in 1978 to more than 40% today.

Railroad Rates After Inflation (1972=100)

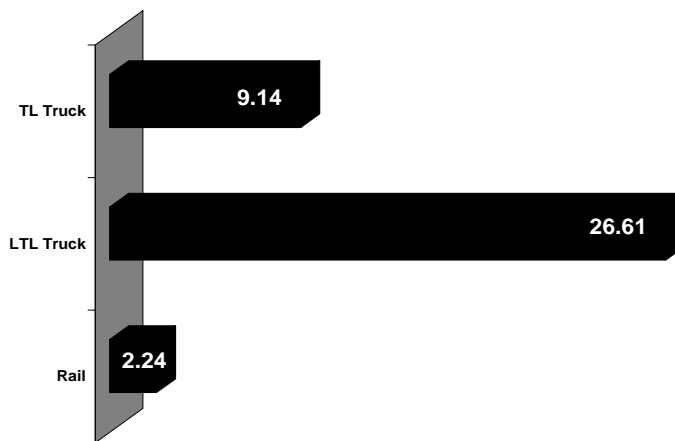


Sources: U.S. Dept. of Labor, Bureau of Labor Statistics, Producer Price Index of Line-Haul Operating Railroads; U.S. Dept. of Commerce, Bureau of Economic Analysis, Implicit Price Deflator for Gross Domestic Product

With these changes brought about by deregulation, rail carriers have regained much of their previous strength. The Association of American Railroads reports that railroads earn \$42 billion in annual revenue, operating 173,000 miles of road.

Trains move 70% of the automobiles produced in the US, 30% of the grain harvested, and 65% of the coal mined. Railroads transport enough lumber to build almost three houses every minute of every day, enough concrete to build 45 miles of new highway every day, and enough microchips and coal to provide more than half the nation's electricity.⁴ In many cases, railroads are reclaiming traffic that had been taken by truck.

Revenue in Cents per Ton-Mile by Mode (2001)



Source: *Transportation in America*

For example, the Indian Southern Railroad recently was honored by the American Short-line and Regional Railroad Association (ASLRRA) for its service package with Peabody Coal Company, which has taken approximately 110 trucks daily from the highway. Peabody enjoyed a substantial decrease in transportation costs as well, and area communities enjoy the many benefits of fewer trucks passing through.

⁴ Association of American railroads, "Class I Railroad Statistics," www.aar.org 2003

Another example: Ag Processing Inc. (AGP), the largest farm co-op in the country, is completing a new export facility at the Port of Grays Harbor in the state of Washington. This project is the first bulk grain handling facility built on the West Coast in more than 20 years. The facility is on the Puget Sound & Pacific Railroad, a short-line that connects to both BN and UP. This dual access will help AGP solve a significant congestion problem it was experiencing, as well as create a long-term competitive freight advantage.⁵

Class I Consolidations

Class I carriers are defined as those with revenues in excess of \$262 million; these railroads operate about 120,000 miles of road (see the chart below). As recently as 1976, there were 50 Class I carriers in the US; today there are only 8. Of these eight, four dominate the freight rail traffic, garnering 95% of the load.⁶

Railroad	Characteristics	Number	Miles
Class I	> \$262 million	8	120,957
Regional	> \$40 million > 350 miles	35	20,978
Short-Line	< Regional #s	517	28,937
Total		560	170,872

This consolidation has brought about enormous changes. For instance, merged companies are able to shed redundant assets and dramatically reduce costs. At the same time, the single expanded network is more fluid and enables the carrier to provide enhanced service to its customers. Perhaps the greatest benefit, though, is the reduction in freight rates that took place as the rail carriers passed on their savings. According to an article in *BusinessWeek*, inflation-

⁵ Timmons, "In the marketing game, short lines can really play," *Railway Age*, August 2003

⁶ St. Pierre, "Asleep at the Switch," *BusinessWeek*, April 2, 2001

adjusted rates have fallen 45% since 1984.⁷ To regain leverage with the Class Is, a new strategy has emerged: locate on a short-line that connects to two or more Class I carriers so that the carriers must compete for the traffic. One such company that pursued this strategy is Guardian Glass Industries.

Guardian Glass Industries built a new, \$125-million, state of the art facility on the Finger Lakes Railroad (FLR) in upstate New York.⁸ This is the largest manufacturing project in New York in the last 20 years. The railroad made a major investment in land and construction costs to serve the plant site. FLR now enjoys the advantage of having access to markets served by both CSX and Norfolk Southern, the two connecting Class I railroads.

The Emergence of Short-Line and Regional Railroads

If short-lines are an emerging solution to rising freight costs, some background might be helpful. According to the ASLRRRA, short-line and regional railroads operate and maintain 29% of the nation's railroad mileage, account for 9% of the industry's freight revenues, and employ 11% of the nation's railroad workers.

⁹The number of short-line railroads has grown from 220 in 1980 to about 520 today.

Part of this growth came about directly as a result of the Staggers Act, which allowed Class I carriers to disaggregate their networks. Before the Staggers Act, Class I railroads owned thousands of unsustainable branch lines; the light traffic on these lines made it financially prohibitive for these carriers to operate them.

⁷ St. Pierre, "Asleep at the Switch," *BusinessWeek*, April 2, 2001

⁸ Timmons, "In the marketing game, short lines can really play," *Railway Age*, August 2003

⁹ Freeze and Morton, "Small Rail Shippers: The Big Picture," www.tdmagazine.com

After the Staggers Act, these Class I carriers sold many of these lines to short-line and regional railroads.

And so, short-line and regional railroads have emerged as major players in the shipping industry, especially in smaller communities. They serve shippers in ways that Class I carriers economically are unable to do, and in doing so, they fulfill shipping needs that heretofore were inadequately fulfilled.

Benefits of Using Short-Line and Regional Railroads

Short-line and regional railroads have many benefits for shippers. Some of these benefits have been touched upon already. Among them are

1. When a Class I carrier's service deteriorates, they offer alternative rail options when they connect to multiple Class I carriers
2. They are a means to gain competitive rates when they connect to multiple Class I carriers
3. They provide quality and timely service.
4. They make decisions at the local level.
5. They provide links to communities and companies.

Offering Alternative Rail Routes

The service levels on Class I carriers has risen and fallen over the years, often with little warning. For instance, the Union Pacific was overwhelmed by increased traffic volumes throughout 2004 and struggled mightily to meet its customers

demands. Their struggle was well documented by the press and to their credit, UP was very candid publicly describing their situation and steps they were taking to remedy the service crisis. Despite Herculean steps by the UP, customers with no alternative rail options were faced with car shortages, chronic transit delays, and highly erratic service.

In contrast, those customers that enjoyed access to multiple Class I carriers via a short line connection had the option of focusing rail shipments to a rail carrier that had a fluid network. Car supply issues were moderated and low cost rail options were retained in their traffic mix. The insurance of having immediate rail shipping options has paid big dividends to hundreds of customers. Conversely, being limited to a single carrier has resulted in grave service failures.

Offering Competitive Rates

It is well understood that when there's competition for services, the customer benefits. When Class I carriers have no sustained competition, their freight charges can rise to any level. Many companies find themselves in the unenviable position of depending on rail for their transportation needs and having only one rail carrier to use. In this situation, companies are sometimes charged excessively high rates or rates that they have no control over because they are held captive by a single rail line. They are left without any negotiating power. At times, a company's rail costs have even exceeded the price of the product being shipped.

However, companies on a short-line where multiple Class I lines connect enjoy the lower rates that come from competition. Stevens Industries is a case in point.

The company, headquartered in Teutopolis, Illinois, manufactures laminated products, from panels to furniture to cabinetry. After a long search, Stevens Industries decided to contract with Total Quality Warehouse's rail facility in Effingham for warehousing and rail transportation services.

"We were looking for a greenfield site with a rail spur in which to build a facility," says national sales manager Todd Wegman. "The competition between the two Class Is (CSX and CN) provided the justification for using a third party warehouse rather than building our own. We used the savings in transportation and warehousing costs, nearly \$700,000, for additional production space." Wegman advises, "If you are starting a new plant and choosing a site on a short-line like the Effingham Railroad Company or a Class 1, it's a no-brainer; choose the short-line. The competition is a huge factor."

Being on a short-line with access to two Class I lines is what led Owens-Illinois, North America's largest glass container manufacturer, to choose Windsor, Colorado as the site for a new, \$120-million bottle plant. The location affords Owens-Illinois optimum pricing for the shipping of its raw materials. Thus, Windsor, a small town in the northern part of the state, will gain 150 new high-paying jobs in a plant that will cover more than 500,000 square feet and produce more than a billion bottles a year.¹⁰

Grain Processing Corporation (GPC), a leading corn wet miller headquartered in Muscatine, Iowa, chose Washington, Indiana as its site for a second production facility for economic reasons as well. Jim Crowder, president of GPC, notes that

¹⁰ Rebchook, "Owens-Illinois to Build \$120M Bottle Plant," www.globest.com

his company researched more than 60 sites in 10 states before choosing Washington. The Indiana Southern Railroad (ISRR), a short-line railroad, runs through Washington.

“Washington provided our best overall project economics,” he says. “The more Class I railroads a shipper has access to, the more options and the more opportunities we have for competitive rates and services. We have good access to three Class I railroads on the ISRR.”

Providing Quality and Timely Service

Customized service has long been a hallmark of short-line and regional railroads. The chairman and CEO of one short-line railroad, David Parkinson of Arizona & California Railroad, likens the service to the difference between a corner drug store and a giant drug store chain. The ability to work one-on-one with customers is a big advantage for short-lines, he says.¹¹

That service advantage was a factor in Daimler-Chrysler selecting a site on the Georgia Central railway for a new \$800 million assembly plant. The plant will be the first auto assembly plant built on a short-line in the United States. Georgia Central Railway is building a 1.5-mile line to the facility and constructing a load-out terminal for the plant. The new construction should be worth it, as initial annual traffic is estimated at 13,000 carloads.¹²

Making Local-Level Decisions

¹¹ Freeze and Morton, “Small Rail Shippers: The Big Picture,” www.tdmagazine.com

¹² Timmons, “In the marketing game, short lines can really play,” *Railway Age*, August 2003

Another factor that makes short-line and regional railroads attractive is the decision-making process that the smaller railroads enjoy. Decisions affecting both cost and revenue are made at the local level, where tradeoff issues are best understood. There's not a long list of bureaucrats who enter the process one-by-one and ensnarl and delay the decision.

Providing Links

Frank Turner, president of ASLRRRA, says that "small railroads are an essential part of the national rail network, linking many small towns and rural communities to the system and providing competitive options for rail shippers."¹³ Smaller railroads help smaller communities, and vice versa. Those links allow shippers options in shipping and gain them access to Class I carriers.

Ideal Location for Short-Line and Regional Railroads

A town with a link from a short-line railroad to two or more Class I carriers provides a good incentive for businesses to set up satellite facilities or to relocate to that town. For example, Krispy Kreme, a nationwide retailer of doughnuts, located a mix and distribution plant in Effingham, Illinois. Krispy Kreme has a short-line rail spur adjacent to its Effingham facility, which connects it to two Class I lines, CSX and CN. "Having access to two rail lines made this location ideal," said Fred Mitchell, Krispy Kreme's Sr. Vice President-Support Operations.

That describes the ideal location for a short-line or regional railroad: a community with two intersecting Class I lines. That's the situation with Guardian

¹³ Freeze and Morton, "Small Rail Shippers: The Big Picture," www.tdmagazine.com

Glass in upstate New York, with Owens-Illinois in Windsor, Colorado, with Krispy Kreme in Effingham, Illinois, and with many other companies that have enjoyed the competitive rates and quality service that results from such situations.

Cardinal Glass Corporation, headquartered in Eden Prairie, Minnesota, chose Durant, Oklahoma over ten other cities to expand their float glass and tempering operations in the southern portion of the US. The new plant site, which will begin operation in May, 2004, is located on the Kiamichi Rail Line, a short-line railroad that is connected to three Class I carriers: Burlington Northern-Santa Fe, Union Pacific, and Kansas City Southern Railroad. Access to the Class I lines via the Kiamichi Rail Line was a critical factor in Cardinal Glass choosing Durant. The Durant plant will employ 250 people when fully staffed in 2004. Tommy Kramer, Economic Development Director explains, "The Cardinal Glass management team is the most professional group of business leaders I have ever worked with in my forty years of business relationships. Cardinal Glass Corporation is making the largest project investment in the history of Durant, Oklahoma."

Towns that are aggressive in their economic development plans and that have two or more intersecting Class I lines along with a short-line railroad have a distinct advantage in their transportation options. Including Durant, towns that are successfully making use of Class I line and short-line connections are

- Durant, Oklahoma (with BN, KCS, UP, and the Kiamichi Railroad)
- Effingham, Illinois (with CSX, CN, and the Effingham Railroad Company)
- Greensburg, Indiana (CN, CSX, NS, and the Indiana Southern Railroad)

- Greenville, Illinois (CSX, BN, and the Illinois Western Railroad)
- Paris, Texas (BN, KCS, UP, and the Kiamichi Railroad)
- Remington, Indiana (BN, CN, CSX, NS, UP, and the Toledo Peoria & Western Railroad)
- Springfield, Ohio (CN, CSX, NS, and the Indiana & Ohio Railway)
- Washington, Indiana (CSX, CP, NS, and the Indiana Southern Railroad)

These eight towns are among the nation's choicest locations for locating plants along the rail lines and for using the existing short-lines for shipping solutions.

Companies within these towns, and within towns like these, should look to meet their shipping needs via rail. And companies outside of towns that do not have short-line links to two or more Class I lines would be wise to consider relocating or building new facilities within these communities.

Summary

Deregulation has resulted in rail carriers regaining their strength in the transportation industry. The advent of short-line and regional carriers has given smaller communities and corporations great incentive to relocate or build new facilities in towns with two or more intersecting Class I lines linked with a short-line or regional railroad.

Companies that locate in towns that have an existing short-line railroad connecting two or more Class I railroads can better manage the risks associated

with reliance on a single carrier and save considerable money by using their multiple options.

Short-lines offer competitive rates while providing fast and high-quality service. They serve as excellent retail freight providers and receive high ratings in customer service because of their streamlined operations, their ability to make decisions without the delays associated with more bureaucratic structures, and because they serve as links to the Class I carriers that can ship freight to distant locations.