RECENT RAILROAD EARNINGS announcements feature robust intermodal volumes prominently, and there’s every expectation that 2012 will exceed the record volumes of 2006.

As the intermodal industry gathers for the 30th Annual Intermodal Expo in Anaheim, Calif., it’s interesting to look at the parallels between intermodal’s history and that of Disneyland, just across the street from the expo.

While intermodal traces its lineage back more than 100 years, its epochal moment may have been the introduction of the container in 1956, just a year after Disneyland opened its gates.

Although Tomorrowland suffered from a lack of funding in Disneyland’s early days, it has been successfully retooled several times since. The intermodal industry followed a similar trajectory. Like Tomorrowland, intermodal in its early days promised a shiny future beyond its rather unexciting start.

Over the past 30 years, both have been part of dynamic change so rapid that the innovations envisioned for tomorrow have quickly become the status quo of today. (Walt Disney Co. made fun of this paradox in its film “Meet the Robinsons” — released in 2007 and set in the year 2037 — with a mundane, Todayland amusement park.)

Intermodal has grown because it offers an attractive product to shippers. Nothing demonstrates the current intermodal fervor more than the insatiable interest of private equity in almost all things intermodal. Many strong companies are for sale, but some recent transactions could make one believe it’s possible right now to sell anything. For these financial masters of the universe, intermodal is truly the “next big thing.”

The Underlying Economics

The intermodal value proposition is that using multiple modes is less expensive than using just one. Rail linehaul sandwiched between local
pickup and delivery (drayage) has been successful for two primary reasons. Linehaul efficiency of railroads and drayage has improved. Service — including transit times, reliability, equipment and damage — has met the criteria of being “seamless” and “looking like truck.”

Effectively providing truck-like service has allowed the intermodal business to grow on its own merits — positioning it to benefit from to data from the Intermodal Association of North America.

Many hopes ride on international volume. The first might be labeled “Can Anyone Bust California?” After 25 years of rapid and unimpeded growth, the ports of Los Angeles and Long Beach endured several horrible years in the mid-2000s that threatened their previously unassailable industry lead. Prior to that, through a number of favorable economic and

its favorable economics and benign environmental impact. Intermodal has grown as certain externalities (fuel prices, driver availability and regulatory changes, for example) caused truck costs to increase at a comparably faster and greater rate.

Beyond the economy, which affects all transportation modes, most of the trends are positive. As long-haul trucking faces mounting challenges, the intermodal industry awaits the opportunity to increase market share. According to FTR Associates, the domestic intermodal share of long-haul shipments (those greater than 550 miles) was 8.1 percent in the second quarter of 2012, an increase of 33 percent in four years.

**International and the Southern California Gateway**

Marine containers have long constituted the core of intermodal volume. For years, this segment grew faster than the rest of the market, just as the growth in trade exceeded overall economic growth. Its development slowed in recent years, however, as domestic containers became intermodal’s growth engine. Nevertheless, marine containers still accounted for 55 percent of 2011 volume, according geographic advantages, complemented by a never-ending ability to create additional terminal capacity, San Pedro had achieved supremacy.

Suddenly, a slew of Pacific ports with big dreams sought to become alternative intermodal gateways. These ranged from former champs (Oakland) and previous contenders (Seattle, Tacoma and Vancouver, British Columbia) to rookie challengers (Prince Rupert). Although there were small successes, San Pedro soon reclaimed most of the diverted traffic, and then some.

This happened for several reasons. As vessel sizes increased, the San Pedro ports were the obvious destination. At the same time, Southern California became a transload center, driving domestic intermodal volumes as well as international. During the 1980s, liner trains and double-stack facilitated a transformation of North American intermodal flows. Transloading did the same. As Southern California replaced Chicago as the continent’s load center, it became increasingly difficult to achieve loaded balance.

At certain times of the year, the demand for empty domestic equipment in Southern California is seemingly insatiable. To support this peak demand — which historically becomes the new base level of business — railroads and their bimodal partners increasingly resort to empty repositioning. Such a practice is anathema to any carrier, but rail’s cost advantage over trucking in this capacity — and the ability to move large numbers at once — has changed the game.

**The Panama Canal’s Siren Song**

While other West Coast ports fight for California’s crumbs, different battle lines are forming on the Atlantic and Gulf coasts. The expansion of the Panama Canal will increase canal capacity and permit larger ships to transit. A number of ports believe they will be well-positioned to accommodate these post-Panamax vessels. Unresolved questions on this front include:

- Will all-water volume increase faster than overall trade growth? It seems unlikely because if there were any shipper benefit, diversion already would have occurred.
- Will inland cargo be diverted from the West to East Coast? See above. The benefits accrue to carriers, not customers, and customers route cargo.
- Will deep water rule? Hard to tell, because some “shallow” ports already handle 8,000-TEU vessels.
- Will north-south intermodal develop on the East Coast? It seems just as unlikely that Northeast points will be served over Southeast ports and vice-versa.

The question, then, is this: If the canal expansion isn’t going to “change everything,” why is so much money being spent in anticipation? The answer may be twofold. The canal expansion was a rational capacity enhancement by the Panama Canal Authority that was necessary for the canal to remain relevant — and increase Panama’s hemispheric logis-
tics importance. Several years from now, many East Coast ports (and other disappointed investors) may look and see an economic bubble that went undetected at the time, camouflaged by common wisdom.

**Chassis As an Early Indicator**

Ocean carriers support many customers shipping containers to and from the U.S. with two significant cross-subsidies: providing chassis and ocean rates that include intermodal services paid for by the ocean carrier. Both are legacies of a regulated industry where imitation was common. Neither of these services are compensatory on a marginal cost and revenue basis — and neither takes place anywhere else.

Liner shipping companies are trying to stop providing chassis, a tortured process that is progressing steadily. If carriers can accomplish this effectively — and overcome customer objections, railroad obstacles and competitive challenges — they will likely seek to end intermodal services.

At such a time, transloading likely would increase, and shippers insisting on intact import movement would pay much more for the service. For example, they would need to pay close to the true marginal cost of inland movement, including the empty cost, just as they do everywhere else.

**New Markets**

For intermodal to continue its strong growth, it must find new markets. This could be challenging. The 8.1 percent intermodal long-haul market share probably requires closer scrutiny. Intermodal may face great difficulty competing at 550 miles, the lower length of haul.

Not only is the regional truckload carrier, which was designed for that length of haul, a fierce competitor, but rail circuitry and schedules also may make it hard for railroads to offer a viable alternative. The exceptions involve corridors truckers seek to avoid (Miami) or port locations where
If the canal expansion isn’t going to “change everything,” why is so much money being spent in anticipation?

Although that’s a small share of the truckload market, it’s still an immense market. Challenges that must be considered are:

- Are all loads “pure truckload”? As less-than-truckload carriers focus more on regional networks, a certain amount of long-haul LTL has been converted to truckload with multiple pickups and deliveries. This may deconstruct long-haul transportation into a series of short-haul moves unsuitable for intermodal.

- What about other equipment types? Intermodal is a dry van business. Intermodal penetration of perishables is microscopic, and other equipment types — flatbeds and tanks, for example — face resistance from the railroads because of handling and safety concerns.

- Who will sell to actual shippers? Or, the age-old question “Is the intermodal marketing company (IMC) dead?” Although many IMCs have been looking for private equity players to
acquire them, this may be more about wealth management than the genre’s future. Many smaller IMCs have been successful with customers too small for major carriers, and, given the high cost of sales and service from major intermodal providers, these commercial relationships seem unlikely to change.

**Margin Call**

I think the industry’s major challenge is to surmount its success and Wall Street’s increased attention. Railroads and other carriers have their operating results dissected every quarter, with the slightest deviation from consensus earnings causing concern. In this environment of fear, volume deviations may be explainable, but price reductions are inexcusable. That is, lower volume and higher yield is acceptable “to the Street,” but higher volume and lower yield isn’t. The financial community expects constant price increases as “legacy contracts” expire.

Although there are many current intermodal customers who could convert their residual truckload volumes, real growth will require wholesale conversion. Two challenges come to mind.

- Are trailers welcome? It seems hard to believe, but less than a generation ago, there was doubt that domestic containers would ever replace trailers. Now it’s increasingly difficult to ship trailers. Shippers or motor carriers can drive modal diversion. If motor carriers are going to use intermodal, they will likely insist on trailer service initially. Of course, once converted to intermodal, trailer conversion to container is much easier. Railroads that insist on handling containers may find themselves at a disadvantage.

- Is pricing sufficiently aggressive? Historically, intermodal diversion has always been about price. There’s no indication this has changed. With robust price discipline — enforced by Wall Street — can intermodal providers continually attract new business? This challenge increases inversely to length of haul. Some believe market externalities such as fuel, driver demographics and regulation will drive intermodal’s cost advantage, but this has been intermodal’s mantra since the 1970s or earlier.

The intermodal industry is healthy. Future success requires continued innovation and attention to detail, so that 30 years from now we’re looking at a new, improved Tomorrowland that was built on the successes of today.

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