

CSA: Good Intentions, Unclear Outcomes

Sector Rating: Trucking & Intermodal, Market Weight

Company Name	Rating	Price	FY EPS		FY P/E	
		11/04/11	2011E	2012E	2011	2012
Trucking & Intermodal						
Arkansas Best Corp. (ABFS)	2 V	\$19.91	\$0.45	\$1.68	44.2x	11.9x
Con-way Inc. (CNW)	2 V	28.03	1.64	2.11	17.1x	13.3x
Heartland Express, Inc. (HTLD)	2	13.64	0.77	0.82	17.7x	16.6x
Hub Group, Inc. (HUBG)	2	31.49	1.55	1.97	20.3x	16.0x
J.B. Hunt Transport Services, Inc. (JBHT)	1	41.93	2.06	2.49	20.4x	16.8x
Knight Transportation, Inc. (KNX)	2	15.19	0.72	0.88	21.1x	17.3x
Landstar System, Inc. (LSTR)	2	44.56	2.31	2.59	19.3x	17.2x
Old Dominion Freight Line, Inc. (ODFL)	1	37.23	2.29	2.57	16.3x	14.5x
Ryder System, Inc. (R)	1	51.24	3.35	4.07	15.3x	12.6x
Swift Transportation Co. (SWFT)	1 V	8.98	0.76	0.98	11.8x	9.2x
Werner Enterprises, Inc. (WERN)	1	23.61	1.37	1.54	17.2x	15.3x

Source: Company data and Wells Fargo Securities, LLC estimates 1 = Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile,
 * = Company is on the Priority Stock List NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful

- **SUMMARY:** As we approach the one-year anniversary of CSA 2010, an initiative developed to improve bus and motor carrier safety, we continue to find various aspects of the program problematic. And, while we applaud the original intent--to reduce crashes, injuries and fatalities--it is still not clear to us whether the carrier safety performance measures accurately portray either the risk profile of individual carriers or the likelihood of an accident. As such, our confidence is not high that improving scores actually predict reduced crashes, injuries, or fatalities. In fact, according to our analysis of the 200 largest carriers in the CSA database, we find no meaningful statistical relationship between actual accident frequency and BASIC scores for Unsafe Driving, Fatigued Driving or Driver Fitness. Regardless, carriers must still bear both direct and indirect costs of compliance. For example, one indirect cost that we find particularly troubling is the undeniably wide range of inspection frequency. Above-average inspection rates could disproportionately reduce carrier productivity and potentially create a negative feedback loop. In this note, we examine the various performance measures and explain why we feel BASIC scores should not be used exclusively in assessing carrier risk and that they may, in fact, provide misleading information.
- **IN COMPLIANCE:** The FMCSA established 5 primary BASIC (Behavior Analysis and Safety Improvement Categories) categories in order to assess carrier safety. According to current data, the carriers in our research universe are all within the maximum threshold for each of the five categories, although various carriers have occasionally exceeded a BASIC threshold for a short period. Several have commented that once they breach a threshold, it can be quite challenging to return to compliance because additional scrutiny (i.e., inspections) appears to align with increased violations. Our findings appear to support this observation.
- **WHAT COULD BE WRONG:** First, CSA is a federally implemented program enforced at the State and local level with overarching jurisdictions and greatly varying enforcement policies. Second, composite score severity weights are not entirely intuitive and may not accurately capture carrier/driver crash risk. Finally, there does not appear to be a mechanism in place to account for these and other inspection variances (i.e. inspection frequency, mode of haul, etc.).

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Summary

The Federal Motor Carrier Safety Association (FMCSA) introduced the nationwide CSA (Compliance, Safety, Accountability) safety program in December 2010. We believe the intent of the program was to reduce crashes, injuries and fatalities by utilizing a broader and more comprehensive data set to measure carrier and driver safety. In turn, this data could be used by FMCSA and carriers to take corrective action and to allow FMCSA to focus its resources on the more troublesome carriers and drivers. We believe the idea was to identify behaviors that were thought to lead to accidents and to proactively address those behaviors before accident occurrence.

While it may be too early to determine whether or not the program is successful against its admirable mission, we can say at this time that we find certain aspects of the program troublesome. Although it is beyond the scope of our resources to offer solutions, we do feel it is important for us to make investors aware of the potential shortcomings in the program.

What We Found

The FMCSA collects data in order to assign a composite score in seven categories, five of which are made public. Each category has numerous subcategories that are each assigned weights. The sum of these weights results in a BASIC (Behavior Analysis and Safety Improvement Categories) score for each category. There is a corresponding “limit” threshold whereby, if a carrier breaches, corrective actions must be taken to remedy the violations. Serious or persistent violations can result in enforcement actions against either carriers or individual drivers.

As we approach the one year anniversary of the program and after examining the data on the 200 largest carriers in the database, we remain convinced investors and other interested parties should NOT rely exclusively on a carrier’s composite BASIC scores to assess accident probability or overall risk. Indeed, we believe the composite scores can be misleading. Specifically, we did not find a meaningful statistical relationship between a carrier’s actual accident incidence and the BASIC scores for Unsafe Driving, Fatigued Driving or Driver Fitness. This is the same conclusion we reached in our original study published March 28, 2011 when we observed only the top-20 carriers.

It is not clear to us why there is not meaningful statistical correlation between Unsafe Driving or Fatigued Driving BASIC scores and actual incidence. Certainly it is intuitive that “unsafe driving” or “fatigued driving” behaviors should be prone to higher accident incidence, but that is not what our analysis suggests. We also found no meaningful correlation between accident frequency and the BASIC score for “Driver Fitness”.

Based on our discussion with various sources, we think the following factors may contribute to the discrepancies and make the composite scores less relevant in risk assessment;

- CSA is a Federal program but violations and inspections are done at the State level. Because States have a wide variety of enforcement and inspection protocols, individual carrier’s exposure to a particular State may result in disproportionate and disparate outcomes. For example, one carrier explained that over the past year it was inspected 26x more often in one State (on an equivalent mile basis) versus another. While this may not be the norm, we nonetheless found a wide disparity between States. TransCore Freight Solutions, examining 166,000 for-hire carriers, found “carriers domiciled in certain States appear to be scored more stringently than carriers domiciled elsewhere for Controlled Substance, Unsafe Driving, Fatigued Driving and Vehicle Maintenance”.
- Severity weights given to each subcategory may not accurately capture driving behaviors that lead to accidents. For example, in the Unsafe Driving categories a severity weight of 7 is given to “not wearing a seatbelt” but “following too close” and “improper lane change” are each assigned a 5. In the Driver Fitness category severity weight is high for failure to have a valid Commercial Driver License (CDL) but a suspended CDL could be the result of missed Child Support (certainly not admirable but not likely related to safety). In our Appendix, we list the severity weights for Unsafe Driving, Fatigued Driving and Driver Fitness.
- A negative feedback loop may have been created for carriers with unfavorable BASIC scores. Indeed, the only correlation analysis that we ran that showed a high correlation and significant r-squared (i.e., predictive ability) was with the relationship between Unfit Driver BASIC scores and inspection frequency (Inspections per Power Unit). This relationship was the strongest using a smaller 20 carriers sample size. We also observed that the bottom-third of inspection frequencies within our 200 carriers sample had BASIC scores that were on average 45% better than the top two thirds. It is not

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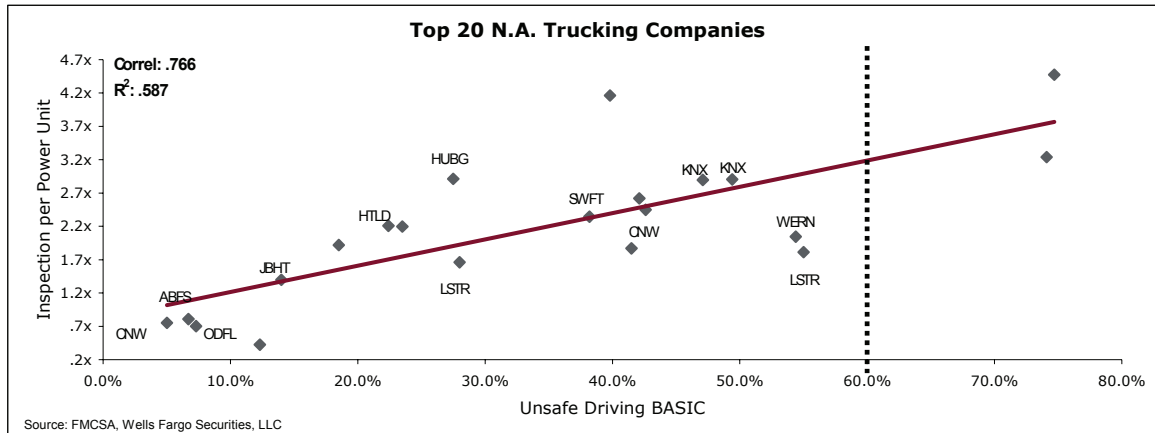
clear which one may lead to the other, but there is a meaningful relationship between high Unfit Driving scores and inspection rates.

- Inspection variability as measured per power unit or per million miles driven is fairly broad, in our view. None of the BASIC score methodologies account for differences in inspection frequency.

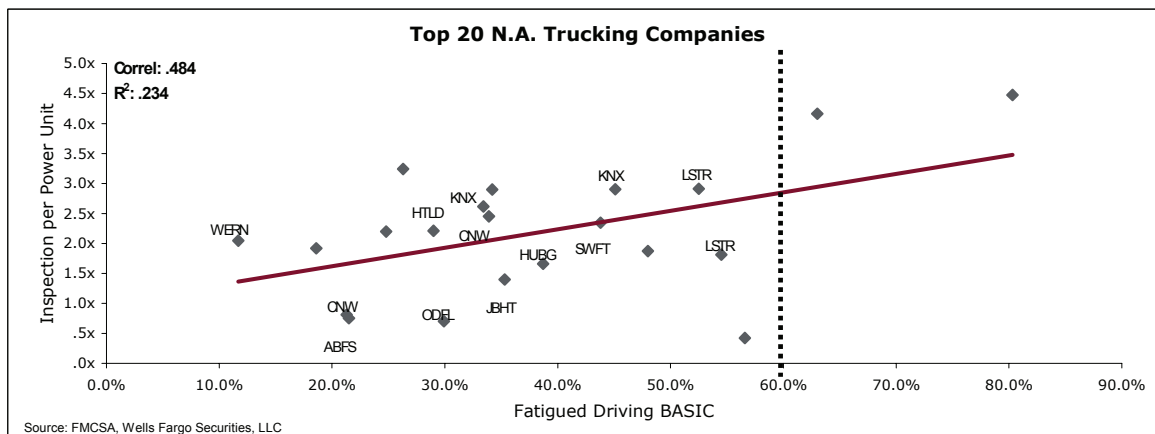
Other Important Considerations

- A *Commercial Carrier Journal* analysis published in January 2011 noted that only 12% of the 758,682 carriers in the FMCSA database had enough inspections to be included in any safety event group. Our concern is that if smaller carriers are not eventually captured in the CSA regime, it may leave the door open for unsafe drivers to move to smaller carriers who have sidestepped this oversight. This suggests large carriers will bear the greatest cost of compliance and regulation.
- We believe our 200 carrier sample size is statistically significant. However, it may not be sufficiently diversified and the results from large carriers may not correspond to findings at smaller carriers.
- CSA captures a broad range of trucking companies, including, moving companies, large parcel carriers such as UPS and FedEx, as well as traditional less-than-truckload and truckload. All of these companies are given composite scores that may not adequately distinguish between the nature of their operations. Indeed, even within a category such as truckload there are distinct safety differences between over-the-road operations and a dedicated operation. A generic composite score, particularly for carriers with diversified operations, may be misleading when compared to other carriers.

With a correlation of .766 and r-squared of .587 we find a significant relationship between Unsafe Driver scores and the number of Inspections per Power Unit.

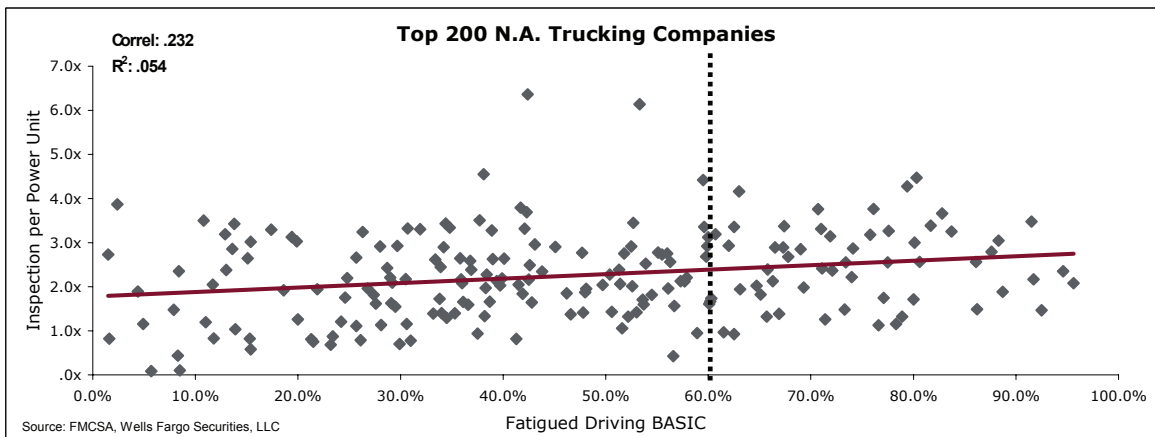
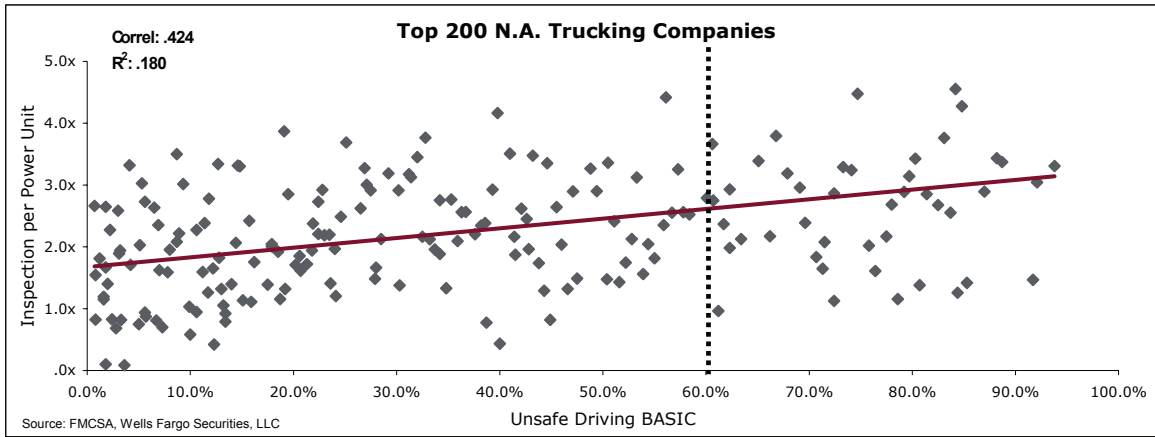


This relationship was not as strong using the Fatigued Driver score but nonetheless had a higher correlation and r-squared than any other relationships.

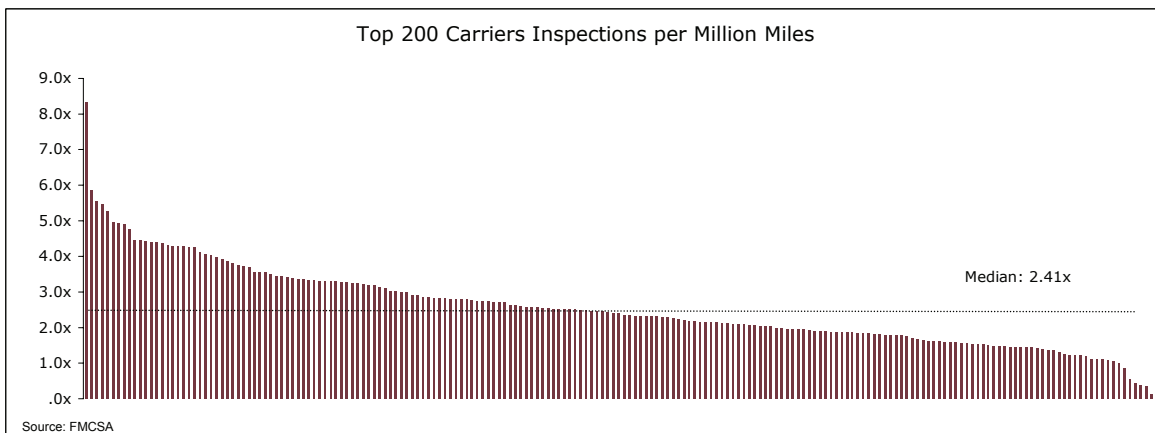


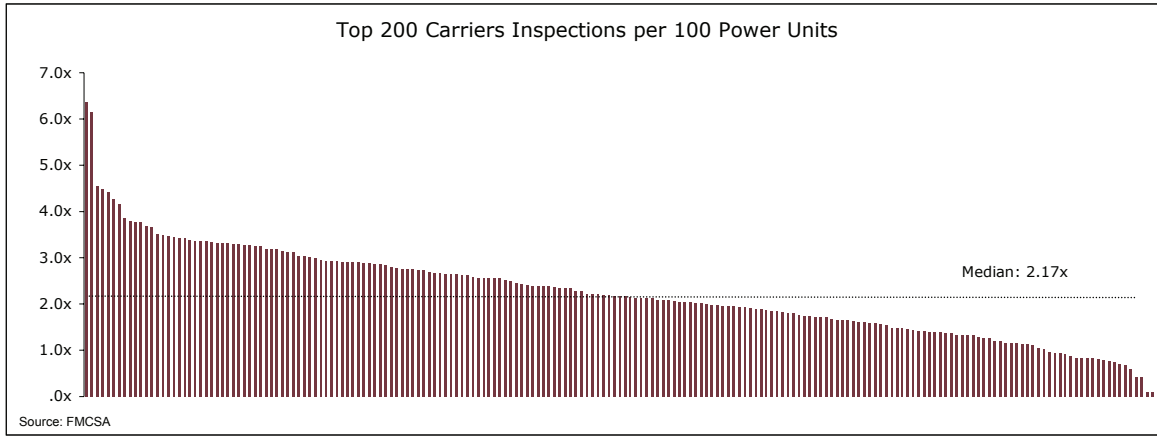
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Using a larger sample size we did not find statistical data that supports the notion that increased inspection frequency impacts Unsafe Driver scores. However, we did observe that the carriers in the bottom third of inspection frequency had Unsafe Driver scores that were 45% better on average than carriers in the top two-thirds of inspection frequency.

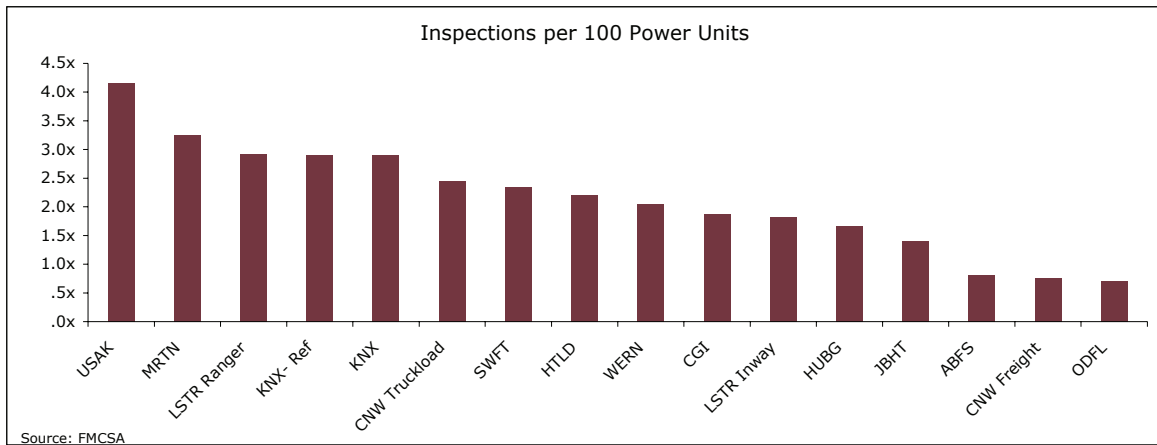
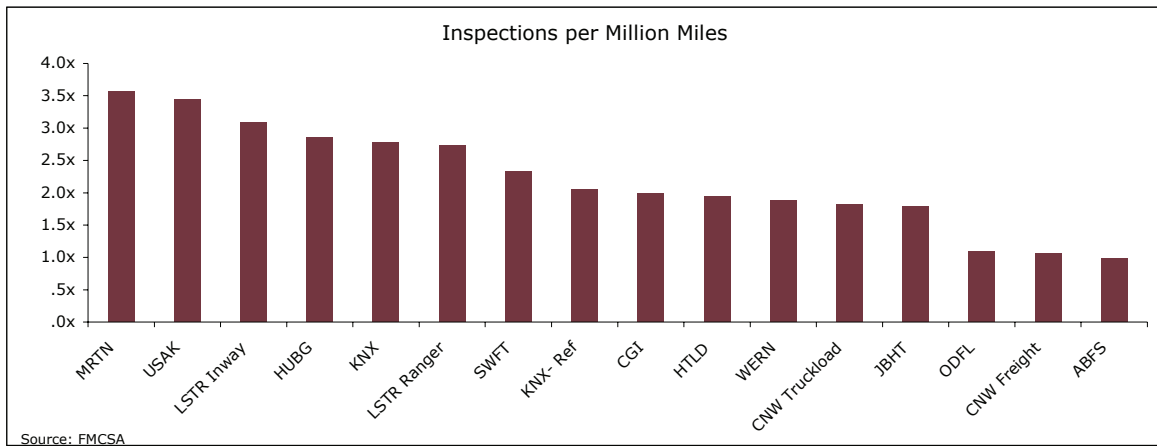


The relationship between Unsafe Driver scores and Inspection Frequency is problematic, in our view, because inspection rigor seems to vary by State. Moreover, there is a wide range of inspection frequencies among carriers.



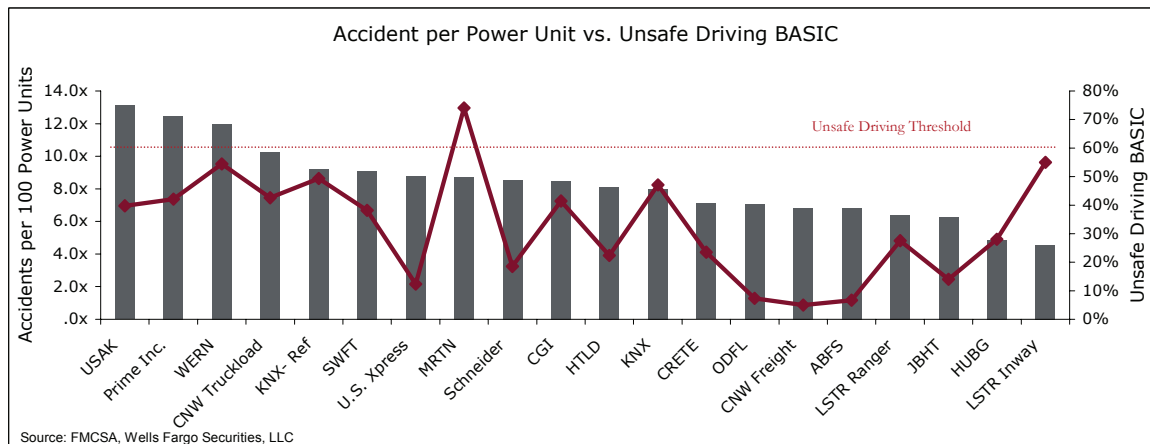
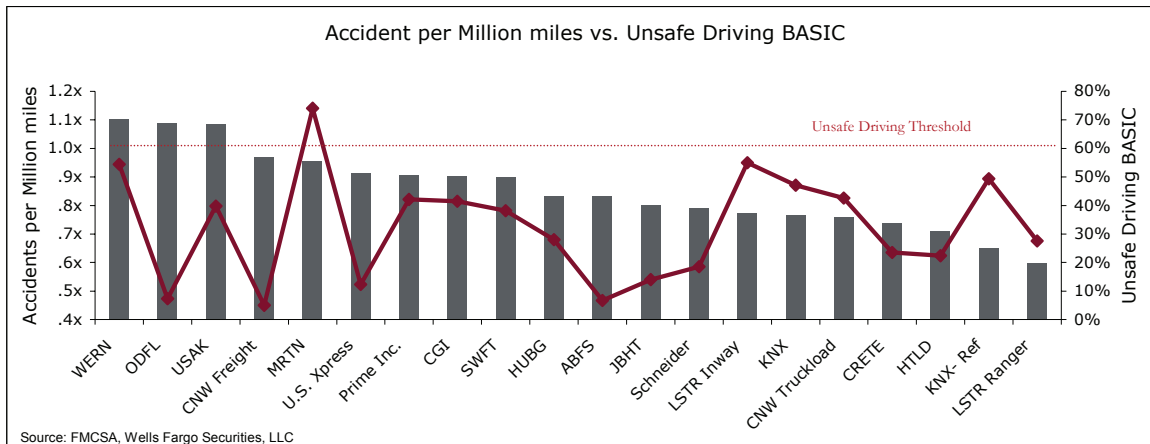


LTL carriers seem to have far lower inspection rates as compared to truckload carriers. And within the truckload universe there is also a variety of frequencies.

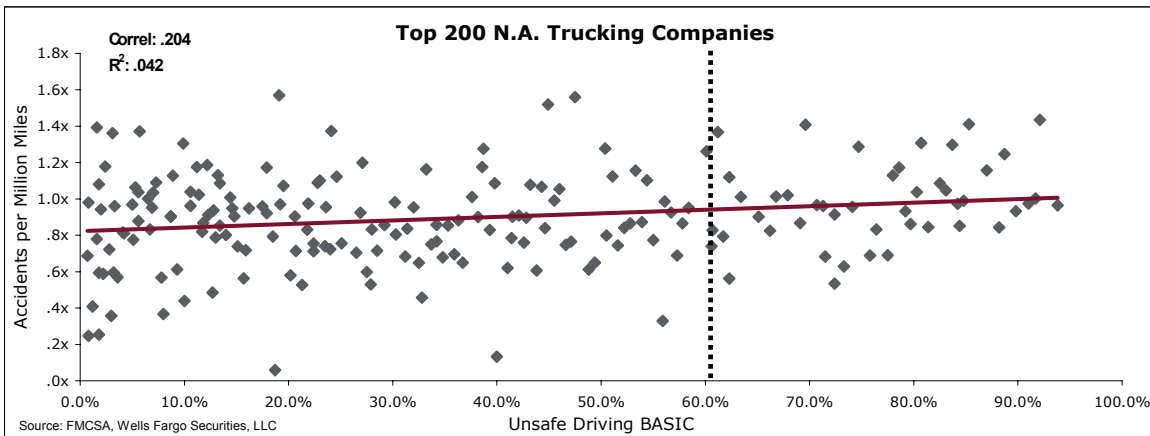


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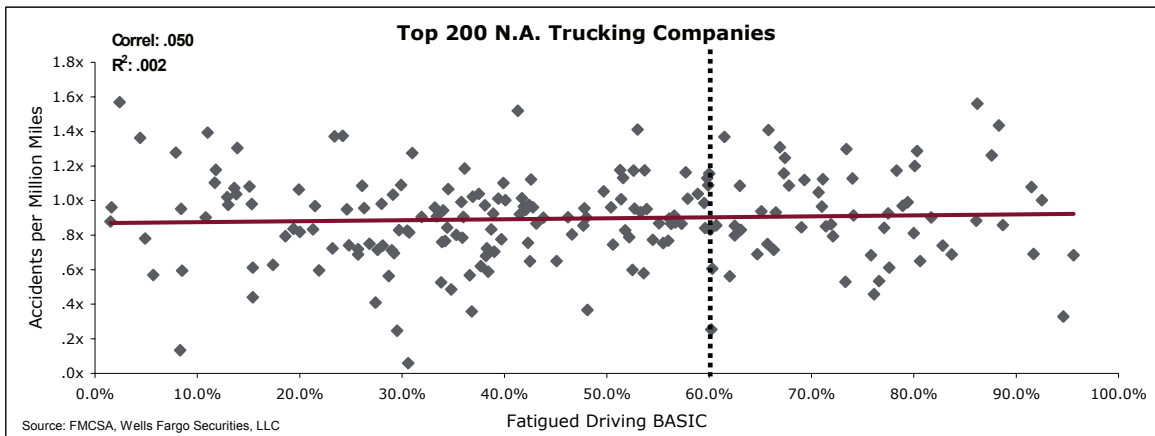
Carriers with low accident rates do not necessary score well using the BASIC methodology for measuring Unsafe Driving. This makes us question the reliability of the BASIC methodology.



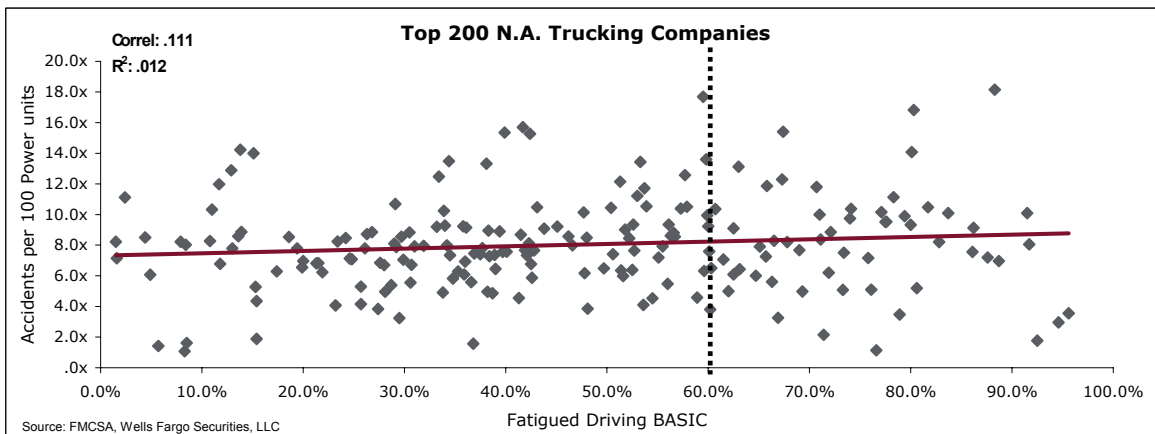
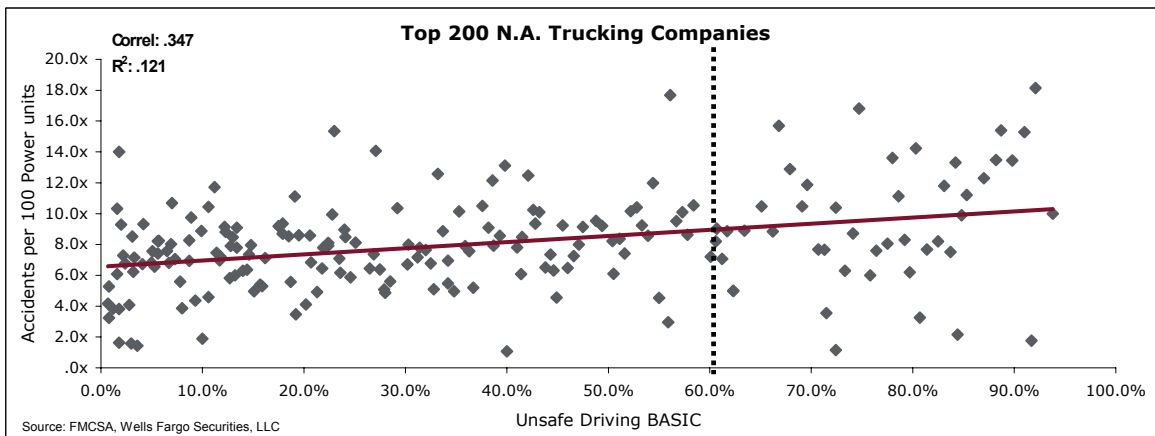
Examining a broader group of carriers yielded even less statistical significance. We found a very low correlation between Unsafe Driver scores and actual accident incidence.



Similarly, Fatigued Driver scores did not show significance to accident rates.

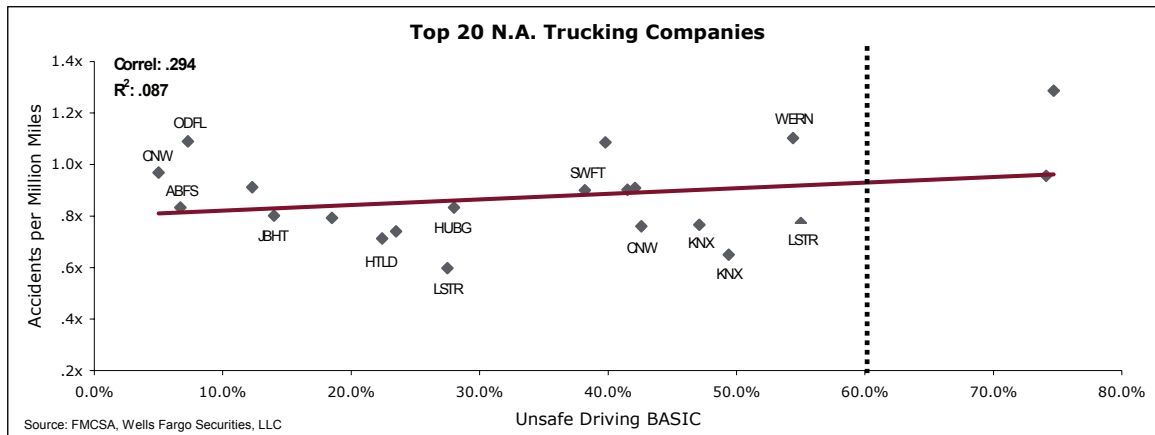


A similar analysis based on power units vs. Unsafe/Fatigued Driver yields very similar results. Quite simply, we found very little relationship (i.e., not statistically significant) between Unsafe Driver or Fatigued Driver scores and actual Accidents per Power Unit.

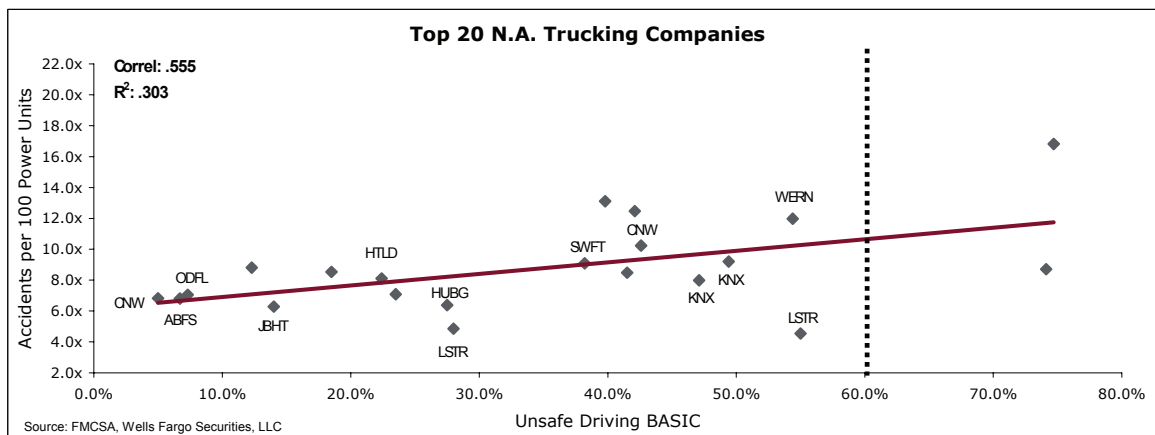


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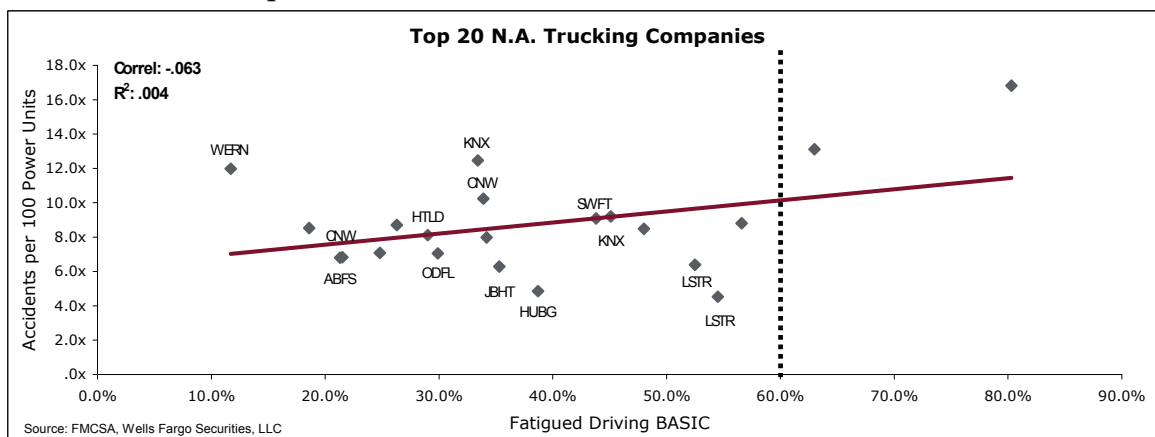
Here we use a smaller sample size to make a few observations more clear. First, we note Knight, Knight Refrigerated and LSTR-Inway were above several peers in the Unsafe Driver score but had accident rates below peers who scored better under the CSA methodology. In the second chart we note LSTR with a low accident incident rates and above-peer Fatigued Driver scores.



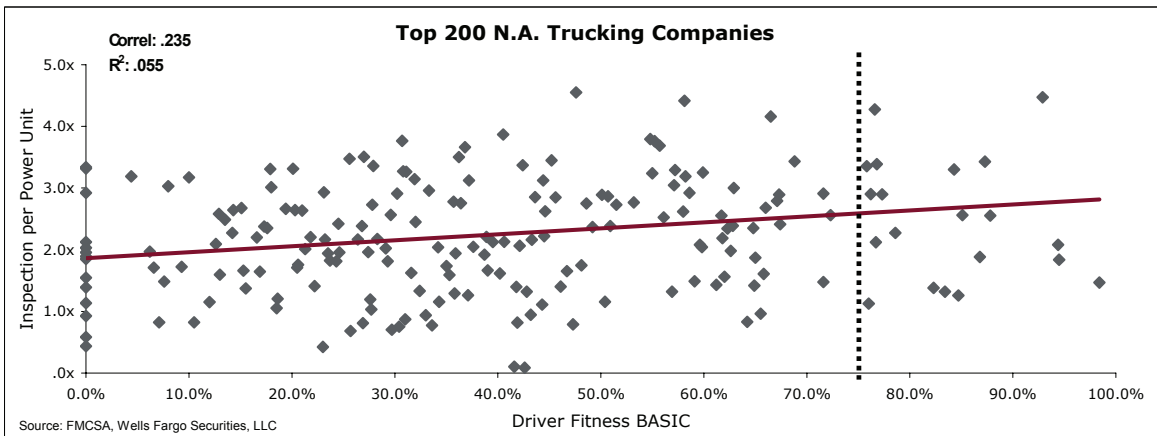
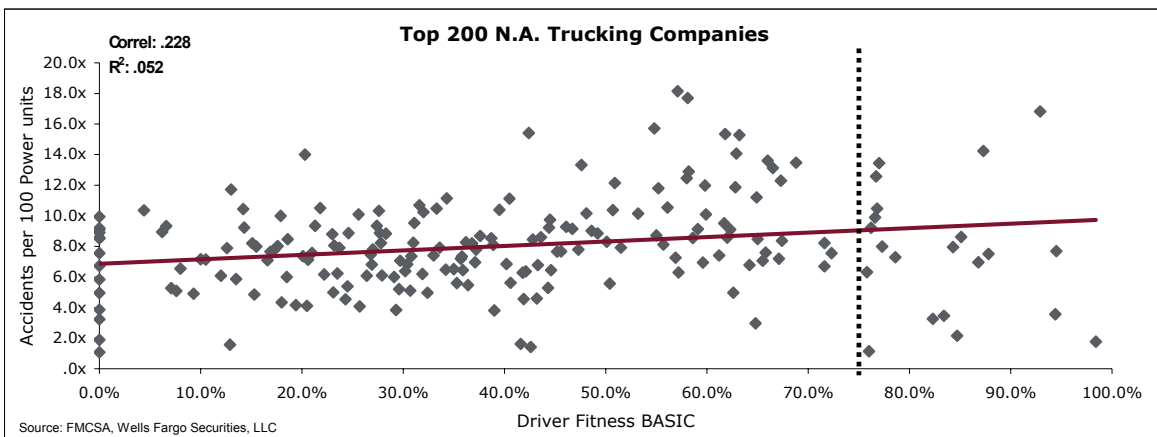
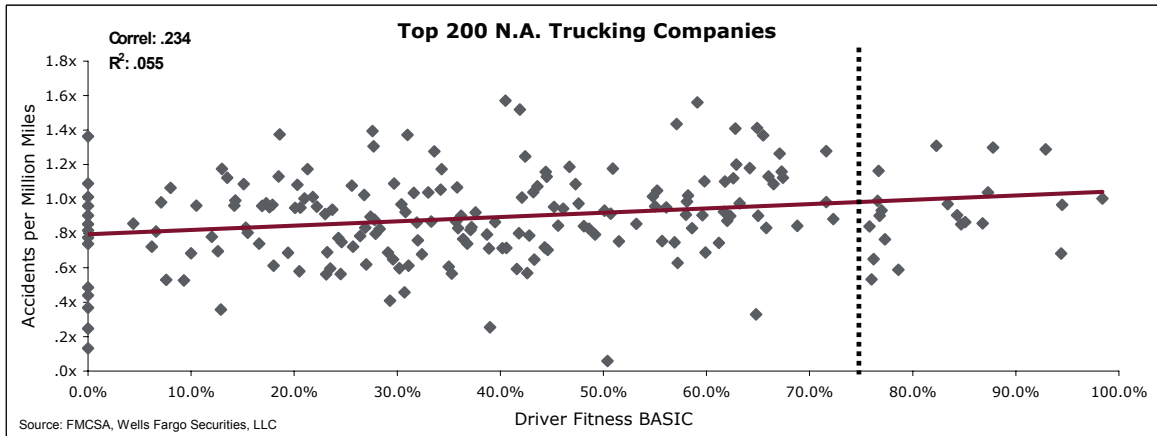
Using a smaller sample size we did find some relationship between Unsafe Driving scores and Accidents per Power Unit. However, an r-squared of .303 is still relatively weak.



Even with a smaller sample size there was no meaningful relationship between Fatigued Driver scores and Accidents per Power Unit.



Driver Fitness scores do not show a relationship to accident rates, in our assessment.



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Appendix

Unsafe Driving BASIC:

Severity Weights and Violation Description

Section	Violation Description Shown on Driver/ Vehicle Examination Report Given to DMV Driver after Roadside Inspection	Violation Group Description	Violation Severity Weight	Violation in the DSMS (Y/N)
177.800(d)	Unnecessary delay in HM transportation to destination	HM Related	1	Y
390.17D1	Operating a DMV while texting	Texting	10	Y
390.20	Failing to properly secure parked vehicle	Other Driver Violations	1	Y
392.2C	Failure to obey traffic control device	Dangerous Driving	5	Y
392.2DH	Headlamps - Failing to dim when required	Misc Violations	3	Y
392.2FC	Following too close	Dangerous Driving	5	Y
392.2LC	Improper lane change	Dangerous Driving	5	Y
392.2LV	Lane Restriction violation	Misc Violations	3	Y
392.2P	Improper passing	Dangerous Driving	5	Y
392.2PK	Unlawfully parking and/ or leaving vehicle in the roadway	Other Driver Violations	1	Y
392.2R	Reckless driving	Reckless Driving	10	Y
392.2RR	Railroad Grade Crossing violation	Dangerous Driving	5	Y
392.2S	Speeding	Speeding Related	5	Y
392.2-SLS1	State/ Local Laws - Speeding 1-5 miles per hour over the speed limit	Speeding 1	1	Y
392.2-SLS2	State/ Local Laws - Speeding 6-10 miles per hour over the speed limit	Speeding 2	4	Y
392.2-SLS3	State/ Local Laws - Speeding 11-14 miles per hour over the speed limit	Speeding 3	7	Y
392.2-SLS4	State/ Local Laws - Speeding 15 or more miles per hour over the speed limit	Speeding 4	10	Y
392.2-SLSWZ	State/ Local Laws - Speeding work/ construction zone	Speeding 4	10	Y
392.2-SLT	State/ Local Laws - Operating a DMV while texting	Texting	10	Y
392.2T	Improper turns	Dangerous Driving	5	Y
392.2Y	Failure to yield right of way	Dangerous Driving	5	Y
392.6	Scheduling run to necessitate speeding	Speeding Related	5	N
392.10(a)(1)	Failing to stop at railroad crossing—bus	Dangerous Driving	5	Y
392.10(a)(2)	Failing to stop at railroad crossing—chlorine	Dangerous Driving	5	Y
392.10(a)(3)	Failing to stop at railroad crossing—placard	Dangerous Driving	5	Y
392.10(a)(4)	Failing to stop at railroad crossing—HM cargo	Dangerous Driving	5	Y
392.14	Failed to use caution for hazardous condition	Dangerous Driving	5	Y
392.16	Failing to use seat belt while operating DMV	Seat Belt	7	Y
392.22(a)	Failing to use hazard warning flashers	Other Driver Violations	1	Y
392.60(a)	Unauthorized passenger on board DMV	Other Driver Violations	1	Y
392.62	Unsafe bus operations	Other Driver Violations	1	Y
392.62(a)	Bus—Standeers forward of the standee line	Other Driver Violations	1	Y
392.71(a)	Using or equipping a DMV with radar detector	Speeding Related	5	Y
397.3	State/ local laws ordinances regulations	HM Related	1	Y
397.13	Smoking within 25 feet of HM vehicle	HM Related	1	Y
398.4	Driving of vehicle—migrant workers	Other Driver Violations	1	Y

Source: FMCSA

Fatigued Driving BASIC:

Severity Weights and Violation Description

Section	Violation Description Shown on Driver/ Vehicle Examination Report Given to CMV Driver after Roadside Inspection	Violation Group Description	Violation Severity Weight[2]	Violation in the DSMS (Y/N)
392.2H	State/ Local Hours of Service (HOS)	Hours	7	Y
392.3	Operating a CMV while ill/ fatigued	Jumping OOS/ Driving Fatigued	10	Y
395.1(h)(1)	15, 20, 70/ 80 HOSviolations (Alaska-Property)	Hours	7	Y
395.1(h)(2)	15, 20, 70/ 80 HOSviolations (Alaska-Passenger)	Hours	7	Y
395.1(h)(3)	Adverse driving conditions violations (Alaska)	Hours	7	Y
395.1(o)	16 hour rule violation (Property)	Hours	7	Y
395.3(a)(1)	Requiring or permitting driver to drive more than 11 hours	Hours	7	Y
395.3A1R	11 hour rule violation (Property)	Hours	7	Y
395.3(a)(2)	Requiring or permitting driver to drive after 14 hours on duty	Hours	7	Y
395.3A2R	14 hour rule violation (Property)	Hours	7	Y
395.3(b)	60/ 70- hour rule violation	Hours	7	Y
395.3BR	60/ 70 hour rule violation (Property)	Hours	7	Y
395.3(c)	34- hour restart violation (Property)	Hours	7	Y
395.5(a)(1)	10- hour rule violation (Passenger)	Hours	7	Y
395.5(a)(2)	15- hour rule violation (Passenger)	Hours	7	Y
395.5(b)	60/ 70- hour rule violation (Passenger)	Hours	7	Y
395.8	Log violation (general/ form and manner)	Other Log/ Form & Manner	2	Y
395.8(a)	No drivers record of duty status	Incomplete/ Wrong Log	5	Y
395.8(e)	False report of drivers record of duty status	False Log	7	Y
395.8(f)(1)	Drivers record of duty status not current	Incomplete/ Wrong Log	5	Y
395.8(k)(2)	Driver failing to retain previous 7 days' logs	Incomplete/ Wrong Log	5	Y
395.13(d)	Driving after being declared out-of-service	Jumping OOS/ Driving Fatigued	10	Y
395.15(b)	Onboard recording device information requirements not met	EOBR Related	1	Y
395.15(c)	Onboard recording device improper form and manner	EOBR Related	1	Y
395.15(f)	Onboard recording device failure and driver failure to reconstruct duty status	EOBR Related	1	Y
395.15(g)	On-board recording device information not available	EOBR Related	1	Y
395.15(i)(5)	Onboard recording device does not display required information.	EOBR Related	1	N
398.6	Violation of hours of service regulations—migrant workers	Hours	7	Y

Source: FMCSA

Transportation

Driver Fitness BASIC:

Severity Weights and Violation Description

Section	Violation Description Shown on Driver/ Vehicle Examination Report Given to QMV Driver after Roadside Inspection	Violation Group Description	Violation Severity Weight[2]	Violation in the DSMS (Y/N)
177.816	Driver training requirements	General Driver Qualification	4	N
383.21	Operating a QMV with more than one driver's license	License-related	8	Y
383.21(a)	Operating a QMV with more than one driver's license†	License-related	8	Y
383.23(a)(2)	Operating a QMV without a CDL	License-related	8	Y
383.23(c)	Operating on learner's permit without CDL holder	License-related	8	Y
383.23(c)(1)	Operating on learner's permit without CDL holder	License-related	8	Y
383.23(c)(2)	Operating on learner's permit without valid driver's license	License-related	8	Y
383.51(a)	Driving a QMV (CDL) while disqualified	License-related	8	Y
383.91(a)	Operating a QMV with improper CDL group	License-related	8	Y
383.93(b)(1)	No double/triple trailer endorsement on CDL	License-related	8	Y
383.93(b)(2)	No passenger vehicle endorsement on CDL	License-related	8	Y
383.93(b)(3)	No tank vehicle endorsement on CDL	License-related	8	Y
383.93(b)(4)	No hazardous materials endorsement on CDL	License-related	8	Y
383.93(b)(5)	No school bus endorsement on CDL	License-related	8	Y
383.93B5L CDL	License (CDL) - Operating a school bus without a school bus endorsement as described in 383.93(b)(5)	License-related	8	Y
383.95(a)	Violating airbrake restriction	License-related	8	Y
386.72(b)	Failing to comply with Imminent Hazard OOS Order	Fitness/ Jumping OOS	10	Y
391.11	Unqualified driver	License-related	8	Y
391.11(b)(1)	Interstate driver under 21 years of age	General Driver Qualification	4	Y
391.11(b)(2)	Non-English speaking driver	General Driver Qualification	4	Y
391.11B2S	Driver must be able to understand highway traffic signs and signals in the English language	General Driver Qualification	4	Y
391.11(b)(4)	Driver lacking physical qualification(s)	Physical	2	Y
391.11(b)(5)	Driver lacking valid license for type vehicle being operated	License-related	8	Y
391.11(b)(7)	Driver disqualified from operating QMV	License-related	8	Y
391.15(a)	Driving a QMV while disqualified	License-related	8	Y
391.41(a)	Driver not in possession of medical certificate	Medical Certificate	1	Y
391.43(h)	Improper medical examiners certificate form	Medical Certificate	1	Y
391.45(b)	Expired medical examiner's certificate	Medical Certificate	1	Y
391.49(j)	No valid medical waiver in driver's possession	Medical Certificate	1	Y
398.3(b)	Driver not physically qualified	Physical	2	Y
398.3(b)(8)	No doctor's certificate in possession	Medical Certificate	1	Y

Source: FMCSA

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Transportation

ABFS: Our estimates are premised on a recovery in pricing in 2011. Absent an improvement in pricing our estimates will not likely be achieved. ABFS has a higher cost structure than union and non-union peers, which could keep the company at a competitive disadvantage.

CNW: Our estimates are premised on a recovery in pricing in H2 2011 and 2012. If pricing does not improve as we expect, our earnings estimates would not likely be achieved. CNW appears to be at the early stages of a turnaround but further productivity improvements are needed to achieve our estimates.

HTLD: Our estimates are premised on a recovery in pricing in 2011 and 2012. HTLD's customer concentration may create hurdles to achieve pricing gains. If pricing does not improve as we expect, our earnings estimates would not likely be achieved.

HUBG: Our estimates are premised on a recovery in pricing in 2011. If pricing does not improve as we expect, our earnings estimates would likely not be achieved. HUBG's truck brokerage margins tend to be adversely affected during periods of tightening capacity, which the industry appears to be now facing. HUBG's recent brokerage acquisition entails various integration risks.

JBHT: Our estimates are premised on a pricing recovery in 2011. If pricing does not improve as expected, our estimates and valuation range would not likely be achieved. Our estimates are also reliant on operational progress and intermodal margins stabilizing, which may not occur.

KNX: Our estimates are premised on continued price recovery in 2012. If pricing recovery does not continue, our earnings estimates would not likely be achieved. KNX has been making strategic investments in related business which may or may not achieve desired results.

LSTR: LSTR's relatively high exposure to the industrial sector can present a risk or an opportunity depending upon the rate of recovery. LSTR must continue to recruit and retain high-production agents in order to achieve our revenue and earnings growth forecasts.

ODFL: Our estimates are premised on continued pricing gains in 2012. If pricing does not improve as we expect, our earnings estimates would not likely be achieved, placing downward pressure on the shares. ODFL faces encroachment in its core market by a variety of competitors who often use price as a means to capture market share.

R: Despite the contractual nature of the business, Ryder is still subject to cyclical swings in customer volumes. As such, Ryder would not likely achieve our estimates if customer volumes turn down. Ryder must renew 16-20% of its lease fleet annually, which is subject to cyclical market conditions.

SWFT: Our estimates are dependent on improved pricing in 2011 and 2012. If industry capacity constraints ease or if shipment demand were to contract our estimates would not likely be achieved. SWFT maintains above-peer financial leverage, which may place limitations on expansion opportunities.

WERN: Our estimates are premised on a recovery in pricing in 2011. Further, recent cost-cutting efforts appear to have reduced cyclical exposure. If these cost-cutting efforts turn out to be unsustainable, our estimates would not likely be achieved.

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2=Market Perform: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD

3=Underperform: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING

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M=Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

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