

# THE RAILROAD WEEK IN REVIEW

## FEBRUARY 11, 2005

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**Political pressure and The New York Times** have prompted the FRA to get tough on the nation's railroads. The agency will leave the local inspectors less discretion as to whom, when and where to inspect and focus efforts on the most egregious violators. This could be either boon or bane to the shortlines, depending on compliance and injury records. With national Class I reportable injury rates falling through the twos, the shortline operator in the fives will find itself encouraged by the FRA to change its ways.

The pair of recent events on NS and some high-profile mishaps in the west have muted the fact that, overall, railroad safety has improved steadily over time and 8% in the last three years. But a cloud of chlorine over a sleepy southern village out-ranks a dozen trash truck crashes killing one or two at a time on the Pennsylvania Turnpike when it comes to the 11 o'clock news.

So, shortlines, clean up your act. If you're running your main line as FRA class 1 or worse, fix it now. You may have all CLEs on the point, but are they equally skilled at using the train and engine brakes? I remember one guy who at a standing start with 50 loads would shove the controller into run eight with his foot and sit back. Needless to say, his train handling skills were lacking and he was shortly given the opportunity to seek other employment.

Class Is are watching, too. They know who's been naughty or nice when it comes to track maintenance. They've learned that selling a line to the highest bidder isn't always best if it means track money is spent on the bank loan. Same goes for handling fees. Some shortlines have been adept at getting increases yet continue to let the track deteriorate. It's tough to get on anybody's bid list once you join the Derailment of the Week Club. And with the changes in Washington it's a better than even bet the FRA man will become a frequent visitor.

**Kansas City Southern hit a new 52-week high** of \$19 Thursday and after a dip at the opening kept right on going Friday to close at \$19.12. The technical tea leaves indicate more of the same and marketinsight.com has it listed as a buy. The stock started its run at \$11 in May of 2003, leveling off in the \$17 neighborhood last December. Then came the Jan 31 earnings announcement (WIR 2/4/2005) and a second upswing began. Up two bucks in ten days is a 12% increase, nice enough, though I think this run still has legs.

**Union Pacific may have finally bottomed** out. The stock has been stuck in the \$55-65 range for going on three years while its peers have doubled (NS, BNSF) or even tripled (CN). On Friday it broke through resistance at \$59 and that ought to be worth a few points at least. Last time this was early Sep when buyers at \$58 got to \$60 before topping out in early Nov. This week's chart looks a lot like last Aug when UP started its recovery from the \$54 low.

After writing the above Friday morning an AP item came across my trading screen about 1300 to advise that UP is raising freight rates significantly in Phoenix, adding that the yards there are among the most congested. Specifically cited are rates for industrial materials and construction goods, with some rates up "as much as 100% for some items" starting for March 1. According to the *Arizona Republic*, "The railroad is trying to encourage shippers of certain goods to look at other transportation methods and to consider unloading goods at freight yards outside the Phoenix area. The goods would then be brought into Phoenix by truck."

FWIW, RailAmerica's Arizona & California and BNSF also serve Phoenix, coming in from the north. Perhaps shippers can use these other carriers if they have capacity and can price it right. Of course, to

get to BNSF a UP shipper has to go across the very yards that are causing the problem. But if the alternative routings were for inbound only then at least UP would not have a car supply problem (assuming private cars or non-UP origins). And a transload is a transload, whether on UP or AZCR.

**Regional railroad operator Genesee & Wyoming** North American traffic for Jan increased 9% vs. Jan 2004 to a record 54,000 units aided by double-digit jumps in forest products (STCC 24 and 26), farm & food (STCC 01, 20) and chemicals (28). Excluding more than 2,000 revenue units handled by the new (11/1/2004) Tazewell & Peoria Railroad (ex-PPU), North American traffic was up 4% driven mainly by 1,800 more forest products loads in Canada and the PNW.

**RailAmerica handled** 105,000 revenue units in Jan 2005, up 8% yoy, posting double-digit gains in chemicals, minerals, ag (STCC 01), food (STCC 01 or 20, depending), lumber (24) and paper (26). Backing out the sale of the AZER and the Fort Wayne and Columbus additions business was up just 2.1%, about the same as the AAR total for YTD through Week 4 (see Table 1).

This tells us something about volumes in the acquisitions. AZER by my reckoning was doing about 16,000 cars a year or 1,300 a month. RRA's press release says they backed out 5,600 carloads to get at their same-railroad total. Do the math and you get nearly 52,000 revenue units on the buys. Back in October the RRA press release on the Cincy-Columbus line estimated 19,000 loads a year. The April release on the Ft Wayne line suggested 42,000 loads annually, total for the two: 61,000.

As an aside, permit me to repeat a quibble I first voiced a year ago. Neither GWR nor RRA classifies commodities the same way, making comps difficult and perhaps even misleading unless you have the STCCs at hand. Moreover, neither list fits with the AAR groups, making comps with the Class Is meaningless. Wouldn't it be lovely if GWR, RRA and the AAR all used the same commodity groups? Then one might be able to say something like, "I see RRA is up 22% in chems while its largest connection, UP, is down three-tenths of a point." Does this mean RRA's gains might be masking some of UP's losses?"

**The continuing decline in manufacturers' inventory-to-sales ratios** does not bode well for the carload sector. For more than 20 years the trend has been to tie up less working capital in inventory and to go for quality over quantity. It's an exercise in queuing theory, essentially the study of arrival interval, wait time, and serve-time, each with its own cost. The longer the wait the more the opportunity cost of having whatever's waiting to do something else. Whether it's beans waiting to be ground into meal or your e-mail to me waiting for server time there's a cost.

Queuing theory tries to minimize wait time by having the arrival time of the item to be processed equal the time it takes the preceding item to be processed. If it takes an hour to grind a ton of beans into meal then the arrival interval at the grinder ought to be a ton an hour. But if the grinder breaks or if the arrival time is extended by external forces, new costs incur. Ergo, as a grinder of beans, you keep your grinder in top shape and hope your transport provider can deliver a ton an hour – just in time, in other words.

And so it is companies are using everything from satellite tracking to RFID to get the arrival time as close as possible to the service time. The closer the time the less inventory, and if the rail customer's process is 20 tons a day why bring in 100 tons and store 20 tons for week? Back in the day you'd order ten cars' worth because train time could be any time. But today you can order a truck's worth for arrival tomorrow at 1430 and send the railroad packing. Unless they can be that precise.

The lesson for the carload service provider is to match the carload product to the carload volume user and make sure that carload arrives just in time. Take the corn sweetener user who uses a car a day and can store two cars' worth. Get him three cars every three days. Work off Car One on Day One and

transfer the other two cars' worth into the tanks. Release the three cars for pull on Day Two, helping car cycle time for the vendor. On Day Four the next three cars arrive and start the process all over again. Trip plan compliance is what makes it possible, and it's why shortlines need to be part of the trip plan if they don't want to be left out.

(BTW, shortlines' event reporting software must have the capability to retrieve customer carloads by commodity and O-D pairs to be of any real use. Counting cars to and from interchange isn't enough any more. Yet time and again I'll ask a shortline to tell me how many widgets went to a customer and what were the origins and they can't. Who has the tool to fix this? Anybody? I'll print your response here if you have such a product.)

Railroad sales reps have get into the supply chain headspace of their customers and think out months, not just to the next carload. Look for inventory-to-sales ratios to decline still further as inventory management tools get even better. And if the rails can work it right, faster inventory turns will improve car cycle time, giving car owners incentives to use more rail, not less. On the other hand...

**A friend writes**, "I've learned over the years how to cope with the railroad's irregular transit times. I've been able to hit JIT needs by adjusting inventory resupply intervals to the point that increased inventory costs don't offset the rail freight contract-rate savings over truck. But now that the rails are going to public pricing my contracts have been cancelled and the inventory costs plus the higher rates make truck more attractive."

Here is a guy who has worked hard to keep his business on rail, both from plant to customer and even inter-plant. But the service-price-inventory cost ratios have gotten so out of whack that there were more inter-plant truck moves in 2004 than there had been in the previous four years combined. He continues, "Higher transportation and inventory expense drive up my cost of goods sold even as they shrink my competitive advantage and market share. Often labor takes the hit, and where I had budgeted staff increases I wind up going the other way."

Boy, I sure wouldn't want to be the one telling an employee he will be let go because the railroad did not perform as promised. Worse yet, my correspondent is in the relatively high-value manufactured goods business, the very stuff the rails say they want more of. The wrap? This national brand and good corporate citizen moves to truck, uses more off-shore raw materials, and lays off workers thanks largely to the rails letting him down. Don' make no sense.

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*Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies discussed here. A listing of such holdings is available on request.*

Table 1. GWR, RRA January 2005 yoy comps.

Commodity	GWR			RRA		
	2005	2004	Change	2005	2004	Change
Overhead				16,981	17,138	-0.9%
Coal				11,729	11,157	5.1%
Coal, coke, ores	15,038	14,820	1.5%			
Met, non-met ores				5,011	5,680	-11.8%
Pulp & Paper	8,631	7,812	10.5%			
Paper Prods				9,091	8,273	9.9%
Lumber & FP	6,256	5,413	15.6%	10,465	9,457	10.7%
Metals	5,722	5,648	1.3%	7,206	7,902	-8.8%
Farm & Food	4,297	3,110	38.2%			
Ag & Farm				10,369	8,621	20.3%
Food Prods				7,723	6,103	26.5%
Mins & Stone	4,092	3,927	4.2%			
Minerals				4,394	3,847	14.2%
Chems	3,153	2,347	34.3%	9,804	8,005	22.5%
Petroleum Prods	2,731	2,797	-2.4%	4,811	4,069	18.2%
Automotive	1,326	1,356	-2.2%	2,196	2,352	-6.6%
Intermodal	356	490	-27.3%	2,800	2,743	2.1%
Other	1,103	742	48.7%	2,928	2,474	18.4%
Total	52,705	48,462	8.8%	105,508	97,821	7.9%

AAR thru Wk 4			
Commodity			-1.1%
Intermodal			7.2%
All-in			2.1%