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The Railroad Week in Review 5/12/2001

This week I drove to Norfolk to spend a couple of days with NS management. Two threads emerged: First is capitalizing on the revenue-generating strengths of the NS franchise. Second is an emphasis on pricing services according to the value provided to the customer.

With respect to the first, NS is taking a close look at its network with respect to what piece generates what revenue at what long-term cost. That leads to the second thread, pricing. Better consistency and reliability helped drive the OR down 470 basis points YOY partly because it meant better revenues at lower cost. We ought to see more of the same going forward.

As you know, Q1 NS carload volumes were off in all the merchandise commodities and only chemicals saw a positive change in revenues. Even at that, the revenue dips were less severe than the dips in units, indicating that price increases are sticking and they are sticking because shippers perceive better value in the improved service levels.

That means the revenue-producing assets will be redirected toward those commodity lanes that generate the best ROA. Increasingly, NS will look to shortlines to be the "hunters and gatherers" who know the customers and can convert opportunities into results for both. In sum, I came away with the sense that NS is determined to zero in on real, not fancied, customer needs and then create a service and price that meets that need.

It is, as Chairman and CEO David Goode noted at the recent analysts' conference, "We're now beginning to see fair pricing for our service, which is clearly improving. It's a value pricing proposition." That sounds like good business to me.

BNSF has brought Value Pricing to the coal business with a vengeance. On May 25 the railroad opens its coal transportation options (CTO) program. By way of review, buying an option in the stock market gives you the option to buy shares at a fixed price on or before a certain date. Buying a BNSF coal transportation contract gives the buyer the right to move a trainload of coal via BNSF from one of three groups of PRB mines to any one of 11 rail-water transfer terminals.

It's important to note that option holders may elect to use private or carrier-supplied 286.000 lb. GW aluminum (and only aluminum) equipment. Since the program is based on tons per train, specifying equipment is the only real way to control delivered weight. Like a stock option, price is preset and time intervals range from three months to 18 months from the date of the auction. See www.bnsf.com/business/coal/options/ for more details.

Chris Leshock at MSDW explains it thus: Eastern coal delivered at current spot market rates runs about $55 a ton for coal and transportation. If you work through equivalent BTUs, sulfur content, etc., the PRB equivalent is $15 a ton and up to $20 a ton for transportation (more tons of coal for the same BTUs). If the current base rate for transportation is $14, then an eastern utility would be in a position to bid up to $6 a ton for the option.

Here's where it gets interesting. Just as stock options are in lots of 100 shares, the BNSF contracts are in trainloads, and at 13,000 tons up per train, we're now talking $85,000 a contract.

And, like stock options, they are negotiable after the initial sale, creating added liquidity in the rail transportation market. Says BNSF, “We hope this product will be of interest to a broad cross-section of industry participants, not only the traditional power generators but also marketers, end-users and traders.” Doubtless it will.

Wisconsin Central + Canadian National will be a “Minor Transaction” for regulatory review purposes. according to the STB. The order establishes a schedule anticipating a final agency decision in the merger proceeding by Sept. 7, 2001. CN and WC filed a common control application with the STB April 9. Written comments from interested parties are due June 8.

Investors took this as a positive as WC gapped up two bits at the open Wed to $16.60, just 40 cents shy of the merger price, and held it through the close Friday. CN was up a buck and a half on the week to nearly $40, posting most of the gain on Wed as well. Recall the merger will secure CN ownership and control of a link in its NAFTA network between Superior, Wis., and Chicago.

In addition, the parties say it will generate service efficiency gains for shippers and enhance transportation competition. CN will maintain existing rail gateways affected by the transaction, and its service assurance plan will assure that service on the combined CN/WC network is as good as, or better than, today's service. And that’s the kind of stuff the STB likes to know.

EPIK Communications, the telecommunications subsidiary of FEC Railway parent Florida East Coast Industries has completed its second major dark fiber transaction in 2001 to expand its national fiber network. This dark fiber swap, completed with a nationwide broadband networks provider, will add over 1,400 fiber route miles to EPIK's national footprint and provides a fiber route from Atlanta to New York City. In exchange for this long-haul fiber, EPIK is providing fiber on the southern portion of its Florida Footprint. The transaction also includes an option for EPIK to obtain additional dark fiber in the future.

Gulf & Ohio Railways of Knoxville, Tenn., is a shortline railroad holding company with eight railroads and 65 employees. Its twice-a-year glossy six-page *Crossties* has been named “Best Newsletter Other than Class 1” by the Association for Railway Communicators, and has provided much grist for my publishing mill over the years. In the most recent issue, Lindy Claussen, wife of President and CEO Pete C., provides this bit of wisdom on railroading, being in a service business, and leadership.

“Railroads are a complicated business. If you are going to serve your customers well then you need to understand what they do. So in addition to learning about the shortline [railroad] business you also need to learn about chicken feed, wood chips, insulation, asphalt, light bulbs, and any number of other products we haul. You have to understand and follow FRA regulations. You have to keep up with your class 1 carriers. You have to keep safety and employee morale your top priorities. And you have to do all of this with one eye on the bottom line.”

Have a great week.

Roy Blanchard

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