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The Railroad Week in Review 7/27/2002

Earnings week had a couple of common threads. Everybody showed improved operating income and a degree of optimism for a return to better days in the second half. And almost everybody (UP was the sole exception) talked about how The Scheduled Railroad is driving costs down and is improving reliability. I think Mike Ward of CSX says it best: "Better is cheaper."

As for UP, the metric there is "customer satisfaction" as noted in WIR 7/19/2002. To be sure, it's an indicator of what *some* customers think of UP but it doesn't tell you how the railroad operates for *all* customers. On-time performance measures not only tell how well the railroad is running to plan but also how well it's keeping costs down and maximizing yield opportunities.

BNSF and CN will tell you that performing to plan means consistent dock-to-dock on time performance according to the trip plan made when the car is waybilled. NS and CSX talk about on-time performance however that's largely a *train* measurement between major yards. Local service is still being attacked, at NS as part of the Thoroughbred Operating Plan (TOP) and at CSXT under the "Industrial Service Excellence" and "local origins" measures.

What follows are some remarks concerning each railroad's results. In a couple of weeks WIR will publish its first ever *Quarterly Review and Outlook* geared specifically to the merchandise carload business. It will be especially valuable to shortline operators wanting to zero in on the traffic lanes most attractive to their largest customers, the class 1s.

BNSF 2Q02 net income remained unchanged yoy though the share buy-back program added a penny to eps, 51 cents. Revenues were off 4% for the quarter and 7% for the half with coal, automotive and agricultural each down more than a percent. Intermodal saved the day somewhat, up 5%. Operating expenses came down 2% including fuel down 16% -- 13% on lower cost per gallon and 3% lower fuel consumption in gallons per car/intermodal unit. The operating ratio went up anyway, 50 basis points for the quarter and 87 BP for six months. Note too that carload freight accounts for less than half BNSF total freight revenues unlike the others where it is more than half the total.

CEO Matt Rose in his introductory remarks said that the line rationalization program will continue as a "slow and deliberate" process. The carload network system BNSF envisions is one based on feeding the core system, essentially an overlay of the coal, intermodal and ag unit train routes. There are about 1,000 miles on the block for 2002 and another couple thousand in the wings. The view from here is that BNSF dearly desires to increase the carload business and a better fit to the best-run networks is an excellent way to achieve that worthy end.

Canadian National's strengths are its carload franchise (up 14%) and its low operating ratio (68.4). This in spite of a 7% revenue hit to the grains and fertilizers group as all other commodity groups were up double-digits. Coal revenue was off 8%, but when you're a 75% carload railroad *without* coal it's not the big deal as at some other properties. Total 2Q02 railroad revenues increased 11% yoy to $C1.5 bn while expenses (absent a special workforce-reduction charge) went up 12% so operating income was up only (!) 10%.

The operating ratio remains the lowest in the biz, 68.4%, even though up 30 basis points. CN does not provide carload information in their investor package, so we can't see what's happening to yield and mix. However, we are told that trip plan compliance is at the 93% mark through June and that the outlook is for more new business initiatives and away from Chief Commercial Officer Jim Foote calls "the commoditization of transportation." Given that CN has the lowest operating ratio and the highest percent of merchandise carload business in the land, the strategy has to be working.

Canadian Pacific CEO Rob Ritchie said over a sandwich following his Wednesday presentation that improved traffic densities on the former D&H may well provide some competitive advantages over the Buffalo route traditionally used. The Northern Ontario network is undergoing a $C20 mm enhancement program which will extend passing tracks, allow longer trains, and increase system velocity.

Out west the grain belt drought cost CP 15% in 2Q02 grain revenues yoy and 18% YTD. Industrials were off 5% and 6% as well so the 11% auto gains in the quarter and half netted out to 4% and 5% less carload revenue for the quarter and half. Carloads were off 3% and 6% respectively indicating some revenue gains are sticking. Ritchie says he's still hoping for 3-5% more revs for 2002, though he does concede the lower end of that range is probable.

As an aside, it is instructive to note how CP approaches the scheduled railroad paradigm. We all know about the short-frequent train argument – always a connection, keep things moving. However, the CP school of thought argues for less frequent, bigger trains with the rationale being that the fewer scheduled trains there are the less the odds of missing a scheduled connection. Sure, it may stretch out transit times but it removes random events, i.e. missed connections that could wreak even more trip plan havoc. Note that CP now enjoys the second lowest OR in the group. QED.

CSX came to town with a lot of energy and a great story. What I like especially about their presentation is the detail they give the carload business – eight commodity groups plus automotive. For example, CSX breaks out agricultural fertilizers from industrial chemicals so one can see the effect of mix changes more readily. The surge of phosphate exports out of Florida's Bone Valley generated a lot of short-haul, low revenue traffic that, if combined with the broader chemicals group, could have been misleading for the broader picture.

The *Quarterly Flash* booklet highlighting the quarter's results has been expanded to include details on merchandise carload changes. It's a helpful read and may be downloaded from the Investors' page at www.csx.com. The real story is one of increasing efficiency. Railroad revenues were up 3% on 2% more loads while taking 3% off the expense line thus increasing operating income by 21% and taking 2.7 points out of the OR in the bargain. Still, CSX has the highest OR and lowest net margin of the Big Six class 1s so there's ample upside room.

Kansas City Southern railroad revenues declined 3% after hits of 63% and 24% in auto and coal after major contract losses. Saving the day were revenue increases in the other commodity groups helped immensely by significant price increases on ho-hum carload gains. YTD revenues were off a percent along the same lines. Operating expense fell 5% for 2Q02 and 6% YTD leading to 10% more operating income for Q2 and a whopping 45% gain for the half. Fuel expense dropped 21% while casualties and insurance expense was down 36%. The 2Q operating ratio came in at 86.6, nearly two points better yoy; YTD the OR shed 4.2 points to 86.9.

Performance-wise, KCS Railway train speeds are up 9% on average, terminal dwell time is down 10%, cars on line went down 3%, unit coal train cycle time is off 11% and they're doing all this with 5% fewer crew starts. Against this background the new "Management Control System" or MCS was cut in July 14 to combine scheduled operations and improved data warehousing. The goal is to "match performance to commitment with real-time feedback," says COO Gerald Davies. TexMex gets cut in this Oct and TFM mid-2003.

Norfolk Southern commodity carloads less coal and intermodal gained 2% and produced a 3% revenue increase yoy. Coal revenues remain depressed, off 11% for the quarter and 10% YTD. Intermodal sales were up 7% yoy so all-in 2Q02 revenues were unchanged yoy at $1.6 bn. Expenses were another story, off 3%, contributing to a 14% gain in operating income and pushing the OR down 2.5 points to 75.8 yoy.

Chief Operating Officer Steve Tobias offered up some impressive proof that the TOP is generating significant improvement in on-time performance. The revenue network is now roughly 43% merchandise carload (i.e., not automotive, not intermodal, not coal). On-time general merchandise train performance yoy jumped to 82% from 62% in 2Q01. Not yet included in the TOP are the local trains that actually touch the customers, however that's due later in 2002. Can a 75 OR be far behind?

Roy Blanchard

Roy Blanchard provides railroad financial and operating performance measurements for shortlines and shippers. Disclosure: Blanchard may from time to time hold long, short, or debt positions in the companies mentioned here. A list of such holdings is available on request.

Commodity Carload Comps
Quarter ending 6/30/2002

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 2,207	$ 1,551	$ 873	$ 1,834	$ 136	$ 1,593	$ 2,822
Carload revs (2)	$ 1,002	$ 1,157	$ 536	$ 1,124	$ 93	$ 948	$ 1,615
Pct carload	45.4%	74.6%	61.3%	61.3%	68.4%	59.5%	57.2%
Mdse Carloads (000)	631	NOTE	275	865	118	723	1,036
Rev/CL	$ 1,588	NOTE	$ 1,948	1,299	$ 791	1,310	$ 1,559
Operating Income (3)	$ 405	$ 490	$ 219	$ 321	$ 15	$ 322	$ 583
Other Income (3)	$ 10	$ 23	$ 63	$ 4	$ -	$ 2	$ 35
Net Income (3)	$ 194	$ 280	$ 169	$ 135	$ 15	$ 119	$ 304
RR Operating Ratio	81.6%	68.4%	76.3%	84.0%	86.6%	79.8%	79.3%
Net Margin (3)	8.8%	18.1%	19.3%	7.4%	10.6%	7.5%	10.8%

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
(3) Corporate
NOTE: Carload information not provided