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Perhaps the most striking news from Tuesday's BNSF analyst conference was the explanation of and rationale for moving to Activity Based Costing (ABC). Some years ago I tried it with a client shortline and they said it couldn't be done on a railroad. Happily the BNSF team has shown positively that it can. What follows comes from my notes during the conference and from the slides at www.bnsf.com/investors/ . I invite you to follow along. (If you use the PDF format it downloads faster and you can save it for later reference.)

Slides 7-11 lay down the abc's of ABC. Note that 75% of long-term variable costs (LTV) are fuel, crew and equipment and that each has a different driver: geography, train, customer, equipment, and commodity. Some are wholly variable (the train runs or it does not); others are partly fixed (benefits have to be paid regardless of trains). Stripping LTV out of revenue generates contribution per train, car, crew, whatever. From that come the fixed costs and what's left is operating income. Another way, LTV plus fixed cost allocation all divided by revenue is the operating ratio.

There is no reason the same discipline can't be applied in the class 2 and 3 railroad arena. Many of the shortlines that went into creating the benchmark spreadsheet (www.rblanchard.com) have ORs in the 90s and up. We see high loco maintenance and fuel expense due to poor train handling practices. We see high clerical costs thanks to labor-intensive data management techniques. Track maintenance is minimal pushing down operating speeds and increasing derailment exposure. Yet if operating practices and revenues were universally managed in terms of contribution rather than absolute dollars the non-class 1 community would be a lot better off. End of rant.

Tuesday's presentation on revenues takes us into some very interesting growth possibilities. Intermodal revenue is expected to grow at about 5% a year and carload at 3% through 2010. Coal is seen at about 1.3% a year. Starting with the Morgan Stanley 2002 estimates for these three franchises one can see (Chart 1) that intermodal and carload revenues will be grow closer through 2010. Now before the carload advocates set up a howl about how intermodal is stealing from boxcars a couple of points are in order. See Table 1.

First, carload -- what Morgan Stanley calls "economically sensitive" traffic -- typically grows at the same rate as the general economy. In his presentation Industrial Products Group VP Dave Garin said that "same store" repeat business represents 60% of his market; new customers replacing old ones in the same lanes with the same commodities represent 40% of the business. Best of all, while same store revenues are expected to grow at 2% a year, new business is expected to grow at twice that, yielding a blend of 3% per year. Can you say "contribution"?

Second, this means there is an opportunity to grow the carload business by more than a $billion over the next eight years. Here's how. As a general rule businesses churn about 10% of their customers annually. Typically in the railroad business new customers come from other railroads and from the highway, with the latter offering the larger opportunity. And to win over the truck user the railroad must act more like a truck.

For this reason Garin says "fundamental changes in the carload business" mandate a focus on "sustainable, profitable" products that can be quickly and consistently priced. Yet the shift to market-based public pricing is IMHO neither fully appreciated nor comprehended by many used to the "everything is negotiable" mode. The speed of change to public pricing from pricing authorities (slide 48) is laudable. It's a very strong story with benefits that need to be clearly conveyed during the BNSF shortline meeting two weeks hence.

The key to growing the carload business is what might be called the "Contribution Dollar Network" (slide 14). Step back for a moment and think Fed Ex. It works because it's a hub-and-spoke network. The carload network as presently constituted is anything but – Garin says he has 30,000 potential O-D pairs. Now if the carload network (spokes) could be simplified to feed the Contribution Network (hub) while preserving most of the revenue several benefits would accrue.

First the sheer number of BNSF-direct station pairs gets smaller. Second, direct LTV and fixed costs incurred running trains and track to non-network stations are eliminated. Third, the asset base would be concentrated where the contribution lies. Thus the previous announcement to transfer ownership of some 3,000 miles to local operators makes perfect sense.

The shortline community ought to be dancing in the aisles. There's a potential $billion in new carload revenue out there. At the moment shortlines touch some 15% of BNSF revenue; expanding the shortline network 10% (BNSF runs more than 30,000 miles) increases the shortline share. Add to that the shortline strength of being closest to the customer, throw in scheduled service and trip plan integration, and the numbers begin to look rather attractive. With one caveat: Matt Rose told the shortlines assembled at the annual ASLRRA meeting last spring that to do business with BNSF shortlines will have to be e-compatible. To which I would add they will have to be financially sound and have a good grip on their ABCs.

Last week a question was raised about the relationship between intermodal volumes and stock price. An analyst friend writes that "good revenue should lead to good earnings and thus stock price performance." Taking the other side a railroad marketing manager writes, "On the issue of what is more profitable, containers and trailers tend to move higher value, finished goods which are more time-sensitive. The higher value commodity can absorb terminal and dray costs." To which I have to take exception. Seems to me all boxes move FAK. The relationship between beneficial owner and transport vendor is with the TPLs, not RR pricing depts.

GAAP forces won another round this week as the National Investor Relations Institute put out new guidelines on so-called pro forma results. They suggest that financial reports put GAAP results first with any pro forma or "as if" results elsewhere in the text. The most frequent use of the non-GAAP numbers appears to be in news releases and annual reports. SEC reports like the 10-Q and 10-K have been pretty straightforward.

Taking it a step further NIRI wants to see explanations as to why pro forma and GAAP reports differ and to see that a complete income statement and balance sheet accompany such releases. The goal is to show at a glance how a company makes its money and whether it can meet its obligations. Of course, WIR readers already know this. Railroad operating income tells the story about the core business. Everything "below the line" is coloration.

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.

Chart 1. Growth rates from BNSF; projections are mine.

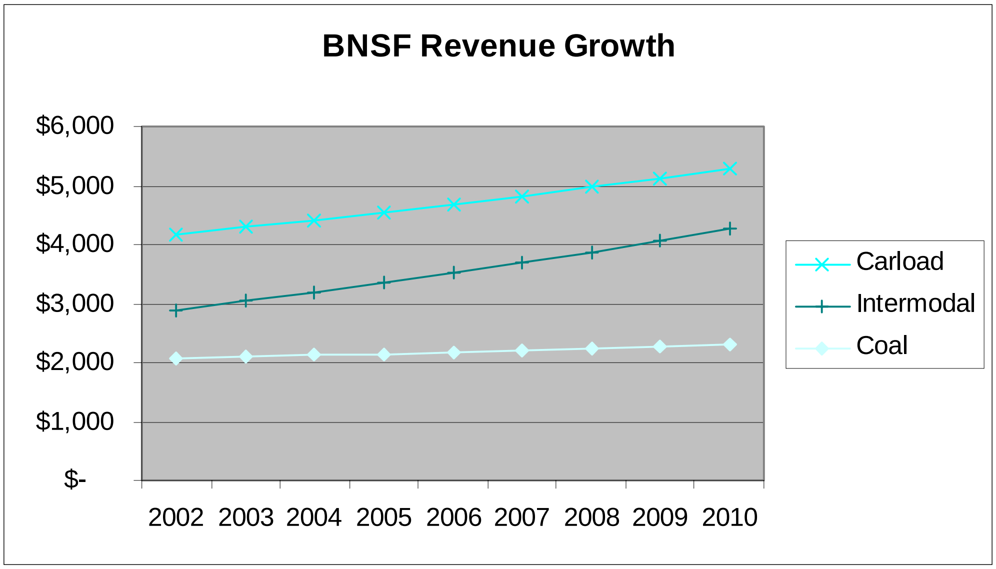

Table 1.

Year*	CL Rev	IM Rev	Coal Rev	Total	Pct CL	Pct IM	Pct Coal
2002	$ 4,043	$ 2,755	$ 2,039	$ 8,837	47%	31%	23%
2003	$ 4,164	$ 2,893	$ 2,066	$ 9,123	47%	32%	23%
2004	$ 4,289	$ 3,037	$ 2,092	$ 9,419	47%	32%	22%
2005	$ 4,418	$ 3,189	$ 2,120	$ 9,727	47%	33%	22%
2006	$ 4,550	$ 3,349	$ 2,147	$ 10,046	47%	33%	21%
2007	$ 4,687	$ 3,516	$ 2,175	$ 10,378	47%	34%	21%
2008	$ 4,828	$ 3,692	$ 2,203	$ 10,723	46%	34%	21%
2009	$ 4,972	$ 3,877	$ 2,232	$ 11,081	46%	35%	20%
2010	$ 5,122	$ 4,070	$ 2,261	$ 11,453	46%	36%	20%

*2002 ests from Morgan Stanley 10/9 report; does not add to 100 due to rounding

bnsf_revs.xls