The Blanchard Company
www.rblanchard.com
The Railroad Week in Review
February 22, 2003

Morgan Stanley's Jim Valentine sat down recently with Roger Nobler, the new STB head, and came away encouraged. The railroads'continuing challenge in earning their cost of capital is a major concern and it doesn't appear that Nobler's going to do anything to worsen the picture. Open access would seem to be a non-starter and improving service to the level that people actually *want* to ship more by rail is to be encouraged.

Seamless service without the interchange delays that inevitably occur between carriers is essential. If that means more mergers, so be it if that's what it takes to eliminate these nodal dwell-times. Astute shippers and shortline owners will be quick to grasp that single-line service – or least something that looks like it -- is the name of the game. Small railroads offering their customers the same trip plan guarantees as on class 1s will have the edge.

AAR traffic reports for Week Six (ending 2/8) show total volume was up 4.8% for the week and 3.2% YTD. While intermodal volume was up 9.7% for the week and 11.1% YTD, commodity carloads less coal and ag jumped 7.8% for the week and 5.0% YTD. Leading the pack for total weekly volume was BNSF, up 7.0% and CN took top honors for total traffic gains YTD, up 6.1%. On the carload side, including coal, UP led with a 4.4% gain for the week and 1.3% YTD.

Looking ahead, we may soon see that the rails are their own worst enemies when it comes to coal. On-time performance gets better every day. Rail customers – utility customers included have long kept large safety stocks against unpredictable railroad transit times. Take out the randomness and one can make do with smaller safety stocks, ergo coal piles are shrinking. Soon the only safety stocks will be weather-driven. Could this mean smaller, more frequent trains with a better pricing structure? What a concept.

Fuel costs rose on average 1.5% in 4Q02 and could conceivably do worse in 1Q03. The class 1s with aggressive fuel hedges – BNSF, CN, and NS are right around 50% -- fare best. Fuel surcharges remain across the board, however and one estimate says they affect half the revenue base. Moreover, the RCAF may push contract rates up nearly 3% this year. The good news is higher-margin merchandise traffic is growing as a percent of the whole thanks to better service and better yields.

Every now and again CBS' "Market Watch" does some pretty good stuff on the rail scene. This week there's short piece on how the rails are "perking up, doing more of the nation's land-based hauling, thanks to increasingly congested highways. And now, the two industries that once competed fiercely against each other for America's hauling dollars have become great partners."

The article quotes BNSF's VP Corporate Relations Dick Russack, saying that "intermodal transportation the principal growth engine for the railroad industry." As more boxes take to the rails for longer hauls, the truck-rail relationship is bound to become more cozy. Traditional rivalries evaporating between modes enhance the move toward efficient supply chain management as shippers come to care less about the mode than the reliability.

Building on that, some analysts think further rail mergers are dead for the nonce. "Investors don't want to see another deal because they got raked through the coals on the last one. Plus, regulator sentiment is very anti-merger across the board, not to mention that the railroads realize that an end-to-end merger won't help them that much." Russack again: "When the customers see the need to encourage consolidations because of service issues or new requirements, then I think you'll see that occur. It's just not a requirement at this point."

Jack Koraleski is one of my favorite presenters. Jack, in case you are new to Week in Review, is UP's top marketing and sales guru. This is truly a salesman's salesman. He can fill the room with energy and credibility, using his Power Point materials more to elaborate than to carry the message. Besides, everybody has charts; it's Jack's excitement that makes the 'em work.

The reason I mention this is that he's addressing the Prudential Planes, Trains & Automobiles Conference at approximately 2:15 p.m. ET, Thursday, February 27. To dial in, go to the investors page at www.up.com. And if you can't listen real-time, you can listen to a delayed broadcast. The topic is how UP's yield strategy is driving growth and it ought to be a real treat. Points off your score if you're not there.

Florida East Coast Railway's first-glance results for the quarter and year are most encouraging. Revenues were up 7.3% yoy to $44.2 mm including $1.8 mm from drayage operations formerly performed by FEC's trucking subsidiary that were assumed by the Railway in November 2002. Carload revenues grew 3.8% primarily due to a 5.2% increase in aggregates, 20.9% more yoy in orange juice and beverages, and growth in the FEC-NS "Hurricane Train" service. Income from operations was up 4.6% yoy on an operating ratio of 73.3%. For the full year 2002 FEC operating income increased 2% to $42.1 mm Railway operations' EBITDA increased 4% to a record $59.9 mm as freight revenues increased 3% to $162.0 mm over 2001.

Anybody selling UP Feb 60 calls back in Jan would have made a nice profit on Friday. At $320 a contract there was some income *and* a lowered cost basis of any UP long stock position. IMHO as long as we're stuck in a sideways market it seems the only way to make a buck is by selling slightly out-of-the money calls against long stock positions. A word of caution, however. Most traders don't like to be more than 45 days out on buy-writes, though a little uptick in CN could make the April 45's attractive. Attention must be paid.

Regarding Amtrak loco failures (WIR 2/15/2003) a senior marketing manager with a class 1 freight railroad writes, "I tried the Crescent recently. Both directions, the train was 2 or 3 hours late but due to locomotive power problems (controllable by Amtrak). It's not hard to find the root cause: locomotive maintenance costs money -- something Amtrak obviously lacks. Yet simple and basic pre-operations maintenance checks would catch most potential failures before going out on the road. The Army teaches this to all vehicle operators.

"Amtrak riders might want to look at the bright side of things, however. When choosing modes among today's bankrupt or thinly-financed passenger carriers, would you rather be on a train when the engine fails -- or on a jet, 5 miles up?" Point made. As the famous E. M. Frimbo was fond of saying, "We must maintain our best bedside manners with our favorite patient, the passenger train."

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