The Railroad Week in Review
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Earnings Week for once brought the entire Big Six crowd together in one week. There were few surprises. International intermodal continues to steal the show, though that's to be expected as more and more of what we consume at home is produced offshore. Domestic intermodal loadings appear to be turning around to the good, and it's not all containers. There are glimmerings of gains in processed and fresh food, building products and grain. The auto sector is pretty much on hold as dealers work through zero-percent financing inventories.

The outlook for chemicals in general and plastics in particular is not what it once was thanks to the double-whammy of slowed auto production and high natural gas feed stock prices. The outlook for domestic steam coal is better than it was and met coal – well, there's the auto industry again. Consequently the class 1s are looking for all the revenue they can get, and they're getting less fussy about where it comes from. Truck conversions are up, and that takes service and price. Ergo carload shippers and shortlines would be well served by insisting on and providing reliable, truck-like service. I see STCCs 01, 20, and 24 as being particularly attractive.

BNSF posted 6% improved eps to 54 cents a share on net income of $200 mm, up 3%, thanks in part to a 10% reduction in the number of diluted shares outstanding. Total revenue increased 3.7% to $2.3 bn; operating income drifted down 2% to $412 mm for an OR of 81.8, up 101 BP yoy. Diesel fuel increased 16 cents a gallon after hedge, representing 58% of the total expense increase. The $80 mm freight revenue increase included $24 mm in fuel surcharges; without it the revenue increase would have been 2.6%. EVP John Lanigan said on the conference call that fuel surcharges cover 80% of all accounts, a 25% increase yoy.

The Intermodal/Consumer Products group continues to lead the revenue stream at 37% of total revenues and up 9% yoy. The truckload segment was up 12% with JBH and Schneider in the lead. Coal was up only 3%, ag a point-plus, and industrial products off less than a point. Auto got hammered to the tune of 7% down yoy. High natural gas prices may help the utility coal burn, but they also take down chemicals, ferts, and everything else where NG is a feed stock.

On the operating side, COO Carl Ice showed how improved reliability reduces costs and capital needs. Ton-miles per employee have increased at a 5% CAGR over the last three years thanks largely to efficiency. Best Practices now include "condition-based maintenance," or "fix it before it breaks." As a result mean days between loco failure and car bad order rates, to name two measures, are greatly improved.

Canadian National posted net income of C$1.26 a share on C$244 mm net income vs. C$1.39 a share on C$280 mm net in 2Q02. Revenues were down 6% to C$1.5 bn with ops exp down 3% to $1.0 bn. The stronger Canadian dollar reduced revenues, operating income, and net income by approximately $90 million, $25 million, and $11 million (six cents per diluted share), respectively. Excluding the currency exchange impact revenues would have increased slightly, and four of the company's seven business units would have posted revenue gains.

Adding back $90 mm to the $1.463 bn shown (www.cn.ca) actually shows revenues slightly ahead of 2Q02, said Chief Commercial Office Jim Foote during the Call. Q3 ought to be better as

normal moisture levels have returned to the grain fields, though high natural gas prices could dampen some industrial production. Re BC Rail, CEO Hunter Harrison said, yes, they are interested, but even if CN does not prevail, provincial law requires the routes to be open to all.

Intermodal was the star performer, up 11% without any adjustments. The newly-introduced IMX service provided "balanced, consistent service in all CN's eastern corridors from Halifax to Chicago." CN will start rolling it out in the West on Aug 11. Foote said IMX contributions in the east could be up 25%. Harrison, asked about future intermodal asset purchases, said there are already too many assets in the IM pipeline.

Looking ahead, Foote feels confident about growth in the merchandise and consumer lanes, sees improvement in the coming grain crop, and expects further pricing initiatives to improve yields. CFO Claude Mange foresees an earnings rebound in 2H03, especially if the Canadian dollar stays in the US$0.71 range.

Canadian Pacific quarterly revenues dipped less than 1% to C$914 mm and operating income fell 13% as costs for fuel, depreciation, and materials each rose by double digits. Equipment rents declined 10% mainly as a result of US dollar exchange rates. Reported income fell 83% yoy after the D&H restructuring and currency exchange effects. Absent these charges eps was C0.55 vs. C$0.70 a year ago, down 21%.

Slide seven (www.cpr.ca) shows that the C$0.17 per share revenue increase was eaten up by fuel and the stronger Canadian dollar. Chief Marketing Officer Fred Green shows how revenue gains by commodity were affected by the exchange rate, pushing some gains into losses (slide 8). The take-away here is that carloads and revenues in constant dollars are on the mend. As previously noted, CP's goal of a 1% increase in same-lane pricing remains intact, though changes in traffic mix offset revenue gains from price and fuel surcharges.

For the second half (assuming C$1.00 =US$0.71) prospects for continuing intermodal growth are strongest of all, followed by grain, ferts, sulfur and coal. Industrial and forest products will lag while auto takes the biggest hit. The operating ratio came in at 79.1, second only to CN. Miles per car day rose 5% and cars on line decreased 6%. Productivity continued to improve as both GTMs and train-miles per employee increased. For 2H02 CP expects the Canadian dollar to stabilize around 74 cents US and improved results in coal and grain, with total revenue growth overcoming the continuing challenges from fuel and the exchange rate.

CSX combined rail and intermodal revenues increased 3% yoy to $1.9 bn from $1.8 bn yoy. Operating income fell 11% to $259 mm on double-digit increased for fuel, Conrail-related expense, and inland transportation – what CSX pays its drayers for their contribution to the highly successful CSXI dock-to-dock marketing program. The operating ratio worsened 2.3 points to 86.3.

Revenue per unit improved slightly as the 3% revenue increase was posted on 2% more units. Domestic intermodal was the clear winner with 14% more revenue on 10% better volume. The merchandise carload group increased sales 4%. In terms of dollar volumes Chemicals led at $244 mm, off a point, Forest and Industrial was next at $207 mm, up 5%, followed by Ag and Food, $165 mm, up 4%. These three represent 2/3 of CSX merchandise carload revenues. The coal group got 6% more money on 2% more carloads, another positive mix sign.

Of the dozen or so railroad operating companies I follow, CSX is probably the most transparent when it comes to service measurement. By "transparent" I mean the data is the easiest to find and

interpret. Serious students of the industry would be rewarded by downloading the "Service Measurements" PDF from www.csx.com and applying the metrics either to the railroads they run or the railroads they use.

This quarter CSX slipped in a number of measures, all of them linked to whether or not one is running to plan. CSX management takes these measures very much to heart and it would not be surprising to see some personnel changes in the field as a result of this quarter's performance in comparison with what they did a year ago. IMHO there is no reason CSX, even with its far-flung and complicated network from Hudson East to the Alabama Coast, shouldn't have an OR in the low 80s. The quarterly charts in the Measurements document show where the fixes need to be made and my money is on seeing a reversal of these trends next time around.

Norfolk Southern freight sales rose 2.5% to 1.63 bn from $1.59 bn yoy however operating income was off 7.5% to $298 mm from $322 mm yoy as operating expenses rose 5% to 1.33 bn chiefly on 8% higher compensation costs plus 11% more in diesel fuel. Equipment rents were down a $million and fuel consumption was down 3.3 mm gallons, a neat trick while pushing revenues up. My only quibble is that $24 mm "other income" vs. $2 mm in 2Q02 is what kept the yoy change in net income positive. The OR came in at 81.8.

Merchandise revenue per was up 2% yoy. Ag revenues were the best ever, up 12%, forest products revenues rose 5%, offsetting losses in met/construction and automotive. Chemical revs were flat yoy thanks to lowered demand and higher inventories of plastics. Asphalt shipments also declined due to wet weather. Chemical plant production levels dropped to 74.3% during the quarter due primarily to feedstock cost factors.

Looking forward, merchandise traffic growth is projected to be flat due to the condition of the housing and automotive markets coupled with the severe impact of increased natural gas costs for chemical production. Imported chemicals are projected to increase by 5% this year after a 9% spike in 2002 as feedstock costs continues to drive some production offshore. Norfolk's growing business at import/export terminals reflects this trend.

Intermodal produced record results for the quarter. International loadings were up 8% yoy offsetting declines in Premium and Triple Crown volume. Highway-to-rail conversions drove a 7.5% volume increase in domestic truckload business, which offset declines in the domestic IMC business. Coal carloadings increased significantly, as there was a push to replenish stockpiles. Traffic levels were up throughout the quarter and increased nearly 27,000 carloads or 7%.

Union Pacific Railroad racked up sales $2.9 bn in the quarter, up 2.6% yoy on essentially unchanged volume. Corporate net income fell 5.8% to $288 from $304 mm on a $30 mm yoy difference in "other income." Surprisingly, intermodal was *not* the star performer, with revenue unchanged on 2% fewer units. Coal and ag revenues both rose 6% followed by industrial products, up 5%. Operating income was unchanged at $584 mm as double-digit increases in diesel fuel, depreciation, materials & supplies, and purchased services added 3% yoy to the cost line. The OR remained at a respectable 79.8, up just 50 BP.

Railroad President Ike Evans showed (slide 18, www.up.com) that so far this year RPU is rising, now +2.9% since Jan. Lumber, steel, stone and paperboard are all up yoy while chems continue to drift lower on continued high NG prices, volatile inventory levels, and on the remaining economic uncertainty. Nonetheless, UP showed ARC up across all commodities for the quarter.

UP's proprietary Customer Satisfaction measure again reached another quarterly high, another positive sign that the carload business is alive and well at UP.

Vermont Railway's Eric Moffett and I have been having a delightful exchange on the truck trailer-intermodal business and I think his latest is a gem. He writes, "The trailer market is going down every year due to the domestic intermodal shift to the 48- of 53-foot container from the 45-foot trailer. Yet even as the domestic container replaces the trailer, the loss of trailer movements over the past four years zeroes out the domestic container gains.

"The railroads have of late invested millions of dollars in intermodal equipment and terminal expansions however the bottom line is an even more-bewildering mix of container products, an overcrowding of the intermodal terminals, and a new headache of chassis management. So, yes, the AAR numbers show an increase in container traffic every year, even in the domestic market. Except that domestic container growth is only equipment replacement growth and not a gain as a result of Over-the-Road business converting to intermodal. And, even though there is a decline in the trailer market.

"Peel the onion back and see that the sheer numbers of trailers are declining to be sure, but it's mainly the 45-foot segment. Some of the loss is offset by gains in the 48- and 53-foot segments because this is what the OTR truckers need to ship intermodal. And that's why the Vermont Railway went into the 53-foot trailer market."

Barron's, always an amusing source of inspiration, quotes the Dow Theory Forecast newsletter regarding company size and credibility. And though the thread is more toward software, the shoe fits shortlines as well. The argument is that success requires not just clever ideas but also the marketing savvy, financing, and just plain luck.

Just plain luck sometimes means being in the right place at the right time. Like being a WIR subscriber when a $million opportunity lands in your e-mail box. So far the number of serious shortline inquiries can be counted on the fingers of one hand. And every one of the inquires has been from a shortlines that are known for their marketing savvy, their financial strength, and strong business models.

As further proof of the added value railroads can bring to the grocery products business UP tripled its order for 64-foot reefers to 1500 from 500. These "next generation" units from Trinity (TRN) increase ladings by 40% above conventional refrigerated railcars. Shortlines play an increasingly important role, serving more than half the Express Lane origins.

They could play an even bigger role if they reached out to the many truck farms and independent packers not rail-served and consolidated their wares at a central rail-served gathering point. There is also a growing need for east-coast shortlines to do the same thing, only on the receiving end. If you're interested in specific opportunities, drop me a line.

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Table 1: Year-over-Year changes, three months ending June 30

Big Six Class I Comps
Revenue and income in $millions
Quarter ending 6/30/2003

Metric	BNSF	CN (1)	CP (1,3)	CSX	NS	UP
Revenues (4)						
2Q02	$ 2,207	$ 1,551	$ 922	$ 1,834	$ 1,593	$ 2,822
2Q03	$ 2,294	$ 1,463	$ 914	$ 1,887	$ 1,633	$ 2,894
YOY Change	3.9%	-5.7%	-0.9%	2.9%	2.5%	2.6%
Operating Income						
2Q02	$ 421	$ 490	$ 219	$ 293	$ 322	$ 583
2Q03	$ 422	$ 437	$ 191	$ 259	$ 298	$ 584
YOY Change	0.2%	-10.8%	-12.8%	-11.6%	-7.5%	0.2%
Operating Ratio	81.6%	70.1%	79.1%	86.3%	81.8%	79.8%
Net Income (2)						
2Q02	$ 194	$ 280	$ 169	$ 135	$ 119	$ 304
2Q03	$ 200	$ 244	$ 29	$ 127	$ 137	$ 288
YOY Change	3.1%	-12.9%	-82.8%	-5.9%	15.1%	-5.3%

(1) CN, CP in $Canadian

(2) Corporate

(3) CP 2003 ops income before $229
mm asset impairment charge
(4) CSX, UP revenues and ops income railroad only