The Railroad Week in Review
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Response to my suggestion that WIR increase emphasis on operating earnings has been most encouraging. Writes one particularly articulate reader, "Concentrating on carload business is of most value. Doing so allows you to be more critical than you can afford to be on the general financials, and also to employ your own knowledge and judgment to better effect." On the other hand, one of my Wall Street friends opines that some mention of net earnings and what drives yoy changes helps frame the larger picture.

Norfolk Southern's 3Q03 report provides an object lesson of why focus on operating results. NS reported 35 cents a share ($137 mm) vs. 32 cents ($126 mm) a year ago on absolutely zero change in either revenue or expense. The change in the net came from other income and interest expense, neither of which has much to do with how the RR's running. On the other hand, drilling down into revenues by commodity group and expense by line item reveals more.

The theme of "taking work out of the process" recurs as NS offered yet another early retirement program to select non-agreement employees though the number of T&E personnel continues to grow. And whereas some roads were caught behind the curve on hiring, NS actually led the pack, bringing on more operating staff ahead of anticipated volume increases, but pushing up comp and benefits 9% yoy in the bargain. The diesel fuel bill increased 6% yoy on as price at the pump rose 8% to 77 cents however MGTM per gallon was up 2% by running better locos smarter. The Local Operating Performance Adherence (LOPA) program has now been fully rolled out, allowing managers to zero in on dock-to-dock carload performance.

Revenue mix remains at merchandise 57%, coal 23%, intermodal 20%. Within that, agriculture and forest products increased 7% and 5% respectively offsetting the 11% decrease in automotive and 1% in metals/construction. Merchandise RPU went up in metals/construction, forest and chems, and I think there's room for further price increases as NS moves toward market-based pricing. It's pretty clear that not all carloads are created equal at NS, and that blocks of cars are better than singles. Message to shortlines: use your skills in aggregating single carload customers into blocks for NS to forward from interchange. Less cost, higher revenues, more money for you.

Kansas City Southern did itself proud in its core US railroad business; it was the Mexican Standoff that tanked the earnings. As in the case of NS, the rail operaiting story is in the above-the-line numbers. Sales for 3Q03 were up 5.3% to $146 mm largely on ag and minerals (up 16%) and forest products (up 8%). Carloads for ag/minerals were also up 16% while forest products cars increased only 4% with particular strength in paper and lumber.

Operating income more than doubled to $15 mm from $6 mm as expenses decreased $3.1 mm (2%) yoy primarily due to lower car hire ($2.8 mm) and compensation ($2.2 mm) expenses. Casualty and insurance costs increased $2.3 mm and fuel costs increased by $2.2 mm thanks to a 19% increase in the average price per gallon. The 3Q03 operating ratio was 87.5% compared with 94.3% for the comparable 2002 period. Below the line it gets complicated. KCS equity income from its share of Grupo TFM dropped to $1.7 mm from $9.8 mm a year ago with the chief culprits being adverse exchange rates ($4 mm) and legal fees ($14 mm more), wiping out the $6 mm tax benefit and then some.

The end result was a whopping 88% eps drop to 2 cents from 17 cents yoy. It's really a meaningless number, and we're going to ignore it. Looking ahead, KCS is determined to stay the course. It is expected that the tax and TMM arbitration matters will progress according to plan. Recall that the Mex government's remaining 20% ownership of TFM is worth about $469 mm. TFM revenue gains ought to continue at moderate levels. Revenue gains on the core railroad ought to hold in 4Q03 for some yoy operating income gains as expenses are held in check.

Canadian Pacific's 3Q03 was, like CN's, somewhat distorted by exchange rates between the US and Canadian dollar. CEO Rob Ritchie opened the call saying, "We didn't shoot the lights out but it was still a good quarter, and without the FX effects it would have been even better." Freight revenues dipped 0.7% (ex-FX up 4%) on 5.2% more ton-miles, aided by double-digit percentage gains in grain and ferts. Total units were up half that, however each of the seven commodity groups suffered some RPU degradation after foreign exchange and mix factors.

Operationally, RTMs were up 5% on only 1.6% more train-miles. Train weights and lengths rose 3% and 5% respectively, making good on COO Ed Dodge's previous pledge to run bigger trains smarter. They've brought on 200 more T&E employees and added 76 new AC units to the fleet. Dodge says the AC units work better than anything else in a variety of assignments – intermodal, mid-train, bad weather, intermodal or merchandise. As a result it took 600 fewer train-starts to produce the ton-mile increase.

Pre-foreign exchange, and using reported numbers, the operating ratio increased 130 BP to 76.9, proving once again that revenue drives the OR. Even as CP took operating expense down $15 mm to $208 mm, the $13 mm revenue hit to $904 mm from $917 mm did the damage. Adding back $57 mm revenue and $36 mm expense drops to OR to 76.5, still up a point yoy but giving us a better picture of the railroad.

RailAmerica's big surprise is the planned exodus from Australia. Saying they can get more bang for the buck on home shores, CEO Gary Marino wants to exit Australia on what is hoped to be the cusp or a resurgence of the grain business, decimated by the on-growing drought and causing much woe down in Boca. Thus Freight Australia is carried as "discontinued operations" on the income statement, meaning the "consolidated income" line is largely North American freight revenue. RRA hopes to be out of Ferronor by year's end, adding still greater transparency.

Q3 consolidated revenue from *continuing operations* (emphasis added) increased 7.5% to $91 mm while operating income increased 20% to $21 mm indicating an operating ratio of 76.9, down 3 points yoy. North American same railroad sales increased 2% and the OR inched up 90 BP to 75.4 oh higher fuel and health insurance costs. Revenue increased 2% on a "same railroad" basis. Net income was $4.2 mm, or $0.13 per diluted share, compared to $5.9 mm, or $0.18 per diluted share, in 2002. The Australian drought negatively impacted earnings by $0.06 per share. Carload commodity and revenue information was not included in the press release, though once it's in hand you'll have it.

Genesee & Wyoming rang up a 7.7% increase in North American same railroad sales even with a $mm fall-off in metals and automotive on the B&P. All-in 3Q North American revenue increased 16% to $61.5 mm or $8.5 mm. Of this, $3.4 mm was from the acquisition of Utah Railway and $1.0 mm was from the start-up of a new rail line in Oregon. On the expense side GWR lowered the all-important North American comp and benefits line by two points to 34.3% of revenue, partially offset by a 1% change in fuel costs.

North American operating income increased 25.7% to $9.2 mm including a $0.7 mm non-cash charge for a legal settlement. The 3Q03 operating ratio was 83.8 before the charge, worth 1.2 points. A year ago the OR was 84.1 before the effect of Hurricane Isadore, worth 2.1 points. Net income was $7.6 million vs. $7.0 million in 3Q92, up 8.6% after below-the-line impacts of a US court ruling (negative) and a tax change in Australia (positive).

North American commodity revenues were up 15% on a 13% increase in volume. Because we're dealing with relatively small numbers, percentage changes yoy can be misleading. But dollar values aren't. Coal, coke & ores led the way, up $1.6 mm. Next came paper and lumber, $1.2 mm each. The only negatives were farm & food (STCC 01 and 20, I guess), auto and other, total $1.0 mm, so perhaps the B&P's metals shortfall was made up elsewhere. This is what I like about the GWR model: a handful of tightly knit, contiguous railroads in key sectors where managerial spans of control are not diluted by long-distance commutes.

BNSF held its annual shortline meeting in Fort Worth this week. To my mind the theme was "Growth and Fit," or how shortlines and BNSF can grow together by fitting the small railroads' gathering and distribution skills to the BNSF strength in high speed, high density core network operations. As if to underline this theme, one conference attendee writes, "There are interesting contrasts between Class I marketing philosophies. One may go after all the merchandise carload business they can get; another may be skeptical about the true profitability of much of this business and consequently is more selective in seeking additional traffic."

Moreover, the Fall issue of the BNSF employee magazine, *Railway*, carries a four-page article on the company's Reshaping the Carload Network initiative ("Accelerating Change," pp 20-23). And to eliminate any thoughts that small customers are beyond BNSF's radar screen "The Growth Game" in the same issue (pp 26-28) shows how the Emerging Growth Sales Team (EGST), a baker's dozen of reps, is blanketing the country looking for new business. Shortlines are specifically named as key resources.

Here are some brief take-aways, with a commitment to dwell more on each in future weeks. (1) Carload network redesign was the Number One concern in the recent shortline survey. (2) Shortlines touch $14% of the BNSF traffic base, generating $1 bn of revenue YTD through Sep. (3) Shortlines are the "supply chain of choice" for fitting with the BNSF long-haul model. (4) ISAs performance measured by shortlines can enhance BNSF service design. (5) Shortlines can play a major role in the "Four Corners" paradigm. (6) The top 20 Industrial Products customers generate 20% of the revenue; the rest is so dispersed 80/20 does not fit. Shortlines do.

And that, friends, was the week that was. Thanks for bearing with me through all this. Carload comparison charts follow next week.