The Railroad Week in Review
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Debbie Butler's keynote address at the **Norfolk Southern** shortline meeting in Roanoke this week hit all the right notes. As VP Operations for Customer Service, she's in an excellent spot to see how actions of NS and its shortline partners drive customer relationships. At the previous evening's reception Debbie told me she's never seen the railroad running better and she truly believes the best is yet to come.

And so it was that her remarks went to the theme of "The Next Big Thing," an allusion to companies' ability to become trend-setters rather than also-rans. In transportation, "The explosive growth of the shortline industry was one of the Big Things of the 1980s." Moreover, shortlines "are a critical part of dock-to-dock service and our revenue stream." And the combination of global events plus new hours-of-service rules for trucks positions the rails well for "significant, long-term growth."

The convergence of positive and negative forces from a strengthening economy to high fuel prices has led to record rail traffic levels and NS, thanks in no small measure to the Thoroughbred Operating Plan (TOP), has the additional capacity to handle the increase right now. Cars-on-line has remained stable even with record volumes because average train speed and terminal dwells are also stable, and stability in operations drives consistency and reliability.

She concludes, "My hope is that the next big thing in rail will be the business growth and profitability that comes out of our response to the unprecedented opportunity that lies before us. We must work together as an industry to provide our customers with a seamless view of rail shipments. If we do, rail becomes not only the smart choice, but the preferred choice of transportation." Music to mine ears.

During the formal presentations it was refreshing to see how much emphasis the shortline partnership received. SVP Marketing Don Seale gave what was essentially an analysts' meeting presentation yet so couched in shortline terms it was hard to miss the message: that all carloads are *not* created equal. Success of the merchandise carload business lies in volume niche markets, precisely the area where shortlines can do best. Rob Martinez, VP for Industrial Development, further amplified the theme with many examples of ID successes with shortlines.

How important are shortlines to NS? See Table 1. NS says the reported commodity revenue figures are net after shortline allowances. I arbitrarily assigned shortline allowances to the NS commodity groups from the 2003 annual report. The 20% shortline allowance is based on what's usual and customary in the industry, though I marked down coal and auto because so much of that moves in dedicated trains. Intermodal gets a zero for all the obvious reasons. Net net, it looks like the shortlines are worth nearly a $billion a year to NS, 13% of the total cash coming in. Anybody with a sharper pencil is invited to contribute.

The shortline panel was a first for any class I shortline meeting. Ohio Central's Bill Strawn moderated a series of discussions on shortline finances (CAGY's Roger Bell), marketing (GWRR's Ron Klein), pricing (RMC's Garland Horton) and operations (NSHR's Gary Shields). The remarks were addressed to NS counterparts and the common thread was, "We're here to grow the business with NS – tell us what you need."

It was an appropriate message. Throughout the session both from the dais and informally I heard of many instances where new shortline business potentials were brought to NS and dismissed without any explanation. NS market managers can do better examining their costing models in the context of market-based pricing. Shortlines operators need to know more about revenue/cost ratios, how equipment decisions are made, why pricing for the same commodity in different lanes can differ, and what they need to do to make a proposed move more attractive to NS.

Strategic Planning's Dan Mazur gave a most fitting wrap to the session. He described the "bright line" dividing the responsibilities of Shortline Marketing and his department: rates and service to AVP Shortlines John Kraemer, route structure to Mazur et al. With respect to the latter, NS still has its marginal lines and their disposition can range from abandonment to sale to a third party. The message is that cost-benefit ratios drive decisions and the surest winners are the ones who do their homework. But keep in mind that NS has no set goal of Miles to Divest as at BNSF.

Dan said shortlines work best when there is access to capital, where a third party operator charges less than it does costs NS to do the work, and where the market can support both. Most critical, and this gets to the BNSF's insistence that commodity groups cover capital costs, NS will avoid cross-commodity subsidies. Strong words, to be sure, but they needed to be said. And they were a fitting wrap to the session because NS works best in the absolute, avoiding the series of internal contradictions one finds all too often in this industry.

Union Pacific this week warned that 2Q04 eps will be in the 65-cent range vs. the consensus 95-cent range and 2Q03's diluted $1.05 per share. UP expects freight revenues to be up 5% to record levels yet loss of network efficiency, hiring and training costs, T&E compensation, fuel and equipment expense will drag down earnings. In fact, UP expects to average about $1.15 a gallon, up 30% yoy and the quarter's OR could be as high as 88. As an aside, it's instructive to note that both BNSF and NS in their 1Q04 presentations quoted hedged fuel costs for full-year 2004 in the 80-cent range.

The STB numbers indicate a slower railroad. Average network velocity for April and May was 21.2 mph, roughly 11% below the 2Q03 and 3% percent below 1Q04. For the first week of June, system train speed increased to 21.8 mph. Terminal dwell time for April and May was 35.4 hours, approximately 18% unfavorable compared to 2Q03 and 2% worse than 1Q04. System dwell time for the first week of June improved to 33.8 hours. So some progress has been made.

In a note to clients Bear Stearns' Tom Wadewitz writes, "UP ramped up their efforts to address their network fluidity issues towards the end of 1Q04 so that the on-going costs of the added leased locomotives and added rail crews are having a greater effect in 2Q04. In addition, we believe that a lag in their fuel surcharge mechanism combined with the sharp rise in fuel prices has hurt UNP in 2Q."

I have to agree with Tom that the cost pressures will drag on into the second half of 2004 and even into 2005. My indicator is the UP-shortline interface where anecdotal evidence shows no improvement in interchange consistency or taking out interchange-related costs. In some places, simply moving the interchange to a more sensible location gives back crews and locomotives and reduces labor expense from overtime and outlawing. One would like to think they would move smartly to the easy pickin's and at least get *something* back.

Have a safe week.

Table 1. NS Shortline Carload Revenue Analysis

Commodity Grp	Full Year 2003 ($mm)	Shortline Allowance Pct Revs	Revs before SL Allow	Shortline Allowance ($mm)
Ag/Consumer/Govt	$ 688	20%	$ 860	$ 172
Metals/Const	$ 699	20%	$ 874	$ 175
Paper/clay/Forest	$ 634	20%	$ 793	$ 159
Chemicals	$ 772	20%	$ 965	$ 193
Automotive	$ 936	10%	$ 1,040	$ 104
Coal	$ 1,500	10%	$ 1,667	$ 167
Intermodal	$ 1,239	0%	$ 1,239	$ -
Totals	$ 6,468		$ 7,437	$ 969