**The Railroad Week in Review**
**August 27, 2004**
**www.rblanchard.com**
**(215) 985-1110**

**Union Pacific** gets top billing this week for yet another successful shortline meeting. Attended by representatives from more than 80 shortlines and holding companies, it was once again a tightly-scheduled one-day affair with mealtime presentations by the senior management team and myriad one-on-one meetings with UP commodity and support services personnel. The best part was the train ride from Denver to Omaha, for me at least. Riding the theater car with a set of track charts is the *only* way to see how the railroad really works.

UP, alone among Class Is, features an office car trip every year, alternating between overnight trips and one-day out-and-backs. This was a long trip year but owing to the sleepers' commitments elsewhere the all-day ride had to suffice. We had breakfast in Colorado, lunch in Wyoming and dinner in Nebraska. With 140 trains a day over the Central Corridor we saw plenty of action, allowing us to put in context what we saw and heard on Monday.

On the train it also became quite evident that a river divides the shortline community. There are those who Get It and those that don't. The Top 20 (see below) are increasingly the forces to be reckoned with as they understand railroad economics best. Consequently they get the most face-time with their Class I counterparts on *any* railroad, not just the UP. But on the train ride and during the sessions the loudest complainers were the ones who had the least to offer in terms of economic benefit to the host railroad. This river runs deep and does not affect only UP.

The successful shortline operator spends more time with customers than running trains and since the connecting Class Is are the biggest customers that's where the energy must be directed. For example, car velocity and the shortline interchange process were two Hot Topics. Yet the number of shortlines with adequate EDI is woefully small. A car waybilled and released on a shortline must trigger a Trip Plan the same as it would if released on a class I branch. But it doesn't.

Inefficiencies at interchange slow down system average velocities and drive down operating cash flow. Railroad President Jim Young said a one-MPH change in system velocity is worth 5,000 freight cars available for loading. UP's running at 22 MPH, three MPH behind target. How many of those 15,000 cars are languishing on shortlines? Jim also told me ROIC is about 6%, three points below the reinvestment threshold. (BNSF's Matt Rose confirms 9% as the investment threshold in his STB response re fall peak planning). Returns are a function of operating income and the less there is of that relative to revenue the lower the ROIC.

A key step in making UP run better is increasing velocity by controlling volume. The STB response from UP (see www.up.com) goes directly to this point. Koraleski's letter says UP is doing exactly that by consolidating commodities in trains, re-establishing single-system service design parameters, and dropping single-commodity services where possible. Capping incremental train-starts will help, and shortlines can assist by moving interchanges into serving yards and by getting serious about more robust event recording.

This year's UP shortline session underscored three important opportunities for shortlines: improving volume predictions by base, seasonal and spot moves, sharpening interchange practices, and sharing in fuel surcharges. Those that Got It will do well. Those that did not may not be around for next year's Session.

**Watco** announced on Wednesday that EVP Terry Towner will succeed Rick Webb as President and Chief Operating Officer of Watco Companies effective immediately. This is a great move and there's every confidence in this quarter that Terry's got the chops for the job. Rick retains the CEO role thus giving himself more time to focus on the corporate vision and related expectations.

Towner has a solid background in financial affairs, railroad operations, business development, marketing, and sales that will form an excellent foundation for him to lead the day-to-day operations of the firm. Key to Watco's success has been its consistent and unwavering ability to providing the right service, at the right time, at the right price and in the safest manner possible. Rounding out the Top Team, Gary Lundy and Ed McKechnie will continue in their respective roles of Executive Vice President of Support Services and EVP/Chief Commercial Officer.

By way of review, Watco owns nine US short line railroads across the United States and ranks seventh among US shortline holding companies (single-line regional companies excluded) in annual revenue carloads. The company also runs 25 switching and terminal operations. Together Watco's shortlines and switch services may be found in 23 states. You can see them all at www.watcocompanies.com and perhaps in the bargain get some good ideas for revamping your own shortline website. Congratulations, Terry. Well done.

**Short** sales for railroads increased across the board in the WSJ's monthly listing. For the period ending August 13, NSC short sales went up 48%, UNP's shorts were up 29% and BNI increased 24%. Surprisingly CSX made the "Largest % Decrease" list in the WSJ, down 42%. Short interest is the number of shares that are yet to be repaid and is an indication of a bearish outlook for the equity in question.

**My Top 20** shortline list undergoes yet another revision this week (Table 1), including the three largest "independent" shortline operators with only one railroad name – Indiana Railroad, Paducah & Louisville, Wheeling & Lake Erie. Who cares, you may ask. Investors care, and here's why. We see more CSX lines in play, the BNSF program heating up, and the possibility of ownership transfers between and among shortlines. And the winners will be the ones with the best institutional investor story.

Of the 500+ shortlines out there 60% are mom-and-pops with marginal properties and minimal resources. They're not in the game. At the other end of the spectrum are a dozen or so properties owned by steel mills and the like, and they're not in the market for additions. That leaves the Top 20 Shortlines in terms of annual carloads. Carloads are a pretty reliable proxy for revenue and the more revenue per mile the better the free cash flow. A sure investor draw.

**Book Review.** Dave Dealy, VP Transportation at BNSF, has recently published a very insightful read for anybody who works for anybody else or who has people who work for them. My review of his *Defining the Really Great Boss* follows WIR. The book is available at www.amazon.com .

**Table 1.**

**Top 20 Shortline Operating Companies by Annual Carloads**

**Ranked by Revenue Carloads per Route Mile per Year**

| Owner | Lines | miles | Annual Carloads | CPMPY |
|---|---|---|---|---|
| Transtar | 4 | 367 | 500,000 | 1362 |
| Indiana Railroad | 1 | 155 | 130,000 | 839 |
| Paducah & Louisville | 1 | 309 | 181,000 | 586 |
| Rail Management Co. | 13 | 735 | 302,000 | 411 |
| Washington Group | 2 | 723 | 285,000 | 394 |
| Anacostia & Pacific | 3 | 416 | 97,000 | 233 |
| Genesee & Wyoming | 23 | 2,778 | 600,000 | 216 |
| Pinsley | 6 | 200 | 43,000 | 215 |
| Gulf & Ohio Group | 9 | 276 | 46,000 | 167 |
| Ohio Central | 7 | 516 | 71,000 | 138 |
| North Shore | 8 | 266 | 35,000 | 132 |
| RailAmerica | 46 | 8,745 | 1,140,000 | 130 |
| Rio Grande Pacific | 3 | 484 | 57,000 | 118 |
| Wheeling & Lake Erie | 1 | 769 | 87,000 | 113 |
| NA Rail Net | 4 | 1,165 | 125,000 | 107 |
| DME | 2 | 2,300 | 227,000 | 99 |
| RJCorman | 7 | 222 | 20,000 | 90 |
| Pioneer | 7 | 331 | 25,000 | 76 |
| Omnitrax | 11 | 1,500 | 107,000 | 71 |
| Watco | 9 | 2,834 | 200,000 | 71 |
| **Totals** | **167** | **25,091** | **4,278,000** | **170** |

Omitted: Lines owned by class Is, steel and ore companies, municipalities and govt entities.

*Defining the Really Great Boss,* by M. David Dealy, VP Transportation, BNSF

There's a reason the early railroads followed a military management style. The Military Model is particularly well-suited to running an organization with lots of moving parts spread across a wide geographic area. The platoon leader out on patrol with nothing to connect him with HQ but a cell phone is much like a section gang leader or even a train conductor.

Both organizations have to entrust lots of very expensive equipment to a cadre of officers and men operating independently but within a strict set of rules and regulations covering everything from latrines to nuclear weapons, from spike mauls to high speed, high density mainline trains. Think, if you will, of a factory 10 to 1000 miles long and rarely more than 100 feet wide with little more than ties and rails on a lot of it.

The common thread is one of leadership and managing change. In a combat environment the quality of leadership can directly affect whether one lives or dies. In railroad operations it's not quite so dire, though failure to follow the leadership's safety directives can get one killed. And therein lies the strength of being an effective leader, or "boss" if you will.

The Random House *Unabridged Dictionary of the English Language* defines "boss" as one who "one who employs or superintends workmen" and a leader as "one who leads, a guiding or directing head." Clearly it is implicit on one who leads to guide and direct those in his employ, ergo boss implies leader, one upon whom the lives of people -- or organizations -- may depend.

A manager on the other hand, says Random House, is one "who manipulates or controls resources and expenditures," from the verb manage, "to direct, govern or control in action or use." It's a fine line, to be sure, but one of critical importance in a new management book, *Defining the Really Great Boss,* by Dave Dealy, BNSF Vice President of Transportation.

At the very outset Dealy warns that "great bosses are NOT (his emphasis) great managers. And the reason is? "Managers assure that the programs and the objectives of the organization are implemented. Being a great boss has to do with casting vision."

That is not to say bosses (or leaders) don't or can't manage. The Dealy Difference is that the mere manager uses authority from above and his own clout to get things done; the great boss relies on his own reputation and ability to facilitate and encourage change in the organization.

Dealy writes, "Managers deal away their credibility because they manage according to the numbers at all cost, even when it is obvious that the decision is detrimental to the greater good." On the other hand, "great bosses look for the circumstances they want and when they cannot find them they make them." And "People perform according to what's expected of them." The boss who expects little from himself can't complain if his direct reports are underachieving. No vision, no expectation, no performance.

Rich Timmons, President of the American Shortline and Regional Railroad Association, is a retired Army three-star general and we've touched on the differences between leadership and management a time or two. Says Rich, an organization either changes from within because someone or something forces the issue or some outsider comes in and bangs heads until they get it right.

Timmons' point goes directly to vision, or mission in the military sense. The importance of vision cannot be overemphasized. If there is no vision, there can be no core business objective. In my consulting practice vision is the first thing I look for in client companies. If I ask the owner to explain his business in 25 words or less and he can't we're in trouble. If the leader doesn't know what to expect of himself, how will his people know what's expected of them?

Dave Dealy's core message is the link between The Vision and Leadership. He writes, "The five skills that define the truly great boss receive their direction and mandate from the vision of the organization." At its core the vision of an organization is what dictates

- Doing the right things for the right reasons;
- Where to set your expectations;
- What kind of risks to take and mistakes to avoid;
- What kind of action plans and solutions you should take to your boss;
- How to follow up.

As an example of what *not* to do in terms of vision, Dealy cites the Enron website slogan, "It's really hard to explain what Enron does." No wonder the company imploded. If "vision is the covenant between the organization and its stakeholders" then logically there must be a shared vision of what makes the organization excellent.

Throughout the book, a well-written tome of a little more than 100 pages, Dealy takes us on a fascinating journey that is both a delightful read and an object lesson in drilling down and finding teaching opportunities in a myriad of situations. The recurring theme is one of building on mistakes (never make the same one twice), following up, and managing change.

After all, it was Darwin who said it's not the strongest who survive but the ones most responsive to change.