THE RAILROAD WEEK IN REVIEW
SEPTEMBER 10, 2004

The long-awaited and much-ballyhooed AAR Fall Peak Season Forum took place Thursday in Kansas City. Papers from the Omaha *World-Herald* to London's *Financial times* picked up the thread of growing shipper concern about the rails' ability to handle the freight. The former quoted UP's Jack Koraleski as saying, "The worst is over," then adding a cautionary "Maybe." FT took a wider view: "The US rail industry warned yesterday that the country's transport infrastructure would have long-term difficulties coping with continued record freight volumes, amid soaring demand for US commodities from Asia and an expanding US economy."

The Dallas *Morning News* reported that "Shippers at the customer forum complained that unpredictable service hasn't gotten much better. They said they're worried that even small disruptions can ripple through the network to worsen congestion." And the Kansas City *Star* picked up STB Chairman Roger Nober's observation that "Railroads must balance the needs of individual shippers with the constraints on the overall system."

WIR readers will find the presentations on the railroads' websites. Highlights: CSX' Clarence Gooden does a great job showing just how fast the carload sector has grown and how CSX is dealing. UP's Jack Koraleski's Slide 8, "Protecting the Network," and Slide 16, "Your Help," are a shortliner's guidelines for successful interchange management. And to my mind BNSF did the best job of summing up challenges faced by shippers, shortlines and class Is – Slide 12, "Preparing for the Peak – Industrial Products," and Slide 14, "Railroad Issues to Watch." We'll *all* be watching to see how well the players follow through on the commitments made during this very instructive Forum.

Rail stocks rocked Wednesday even as the broader averages languished. CNI, CSX and UNP were all up a percent or better. The strongest sign was UP powering through the $57 resistance (WIR 8/6/2004) to close at $58.55 for the day. Support remains at $56 (touched in April, May and June) and a new resistance lies at $60 (touched in April, June). This ought to be particularly encouraging for the merchandise carload sector as these three lead the Big Six in 2Q04 percentage of total revenue from that side of the house. Shortline holding companies like Genesee & Wyoming (GWR) and RailAmerica (RRA) that do business with all three ought to be well served.

The rails then lost some of their gains Thursday as the Forum went on, though by Friday's close UP and CSX had recovered to Wednesday's peak or better. My take is that these two names are about where the others were a year ago: coming out of an operating funk and an economic downturn and rallying as the assets brought on line (in spite of Wall Street warnings about excessive capital spending) took hold. CSX and UNP were behind that curve. But the gains the others saw in 2004 will come to these guys in 2005.

Yellow Roadway (YELL) raised its 3Q04 earnings forecasts on predictions of less price competition and improved operating efficiencies. Stock watchers will want to know that the YELL curve looks much like BNI or NSC – an unrelenting uptrend at or above the 50-day moving average. Among the seven names I track in the sector (ABFS, HUBG, JBHT, KNGT, ODFL, OVNT, YELL) its closest competitors for stock price improvement over six months are Knight and Overnight. YELL gets a "C" rating from Schwab and four stars out of five ("BUY") at S&P.

Reading the trade and popular railroad press for the last month or so evokes several converging themes. Railway Association of Canada *2003 Annual Report:* Three new shortline members, all from the OmniTrax household -- Carlton Trail, Hudson Bay, and Okanagan Valley. *Progressive Railroading*, August 2004, Jeff Stangl's cover story on railroad congestion: Rail congestion will continue to be a problem until networks are simplified and operating irregularities smoothed out.

Railway Age, August 2004, "Making Black Holes Disappear," by RMI's Paul Pascutti: The single biggest contributor to "black holes" – particularly in the small railroad arena – is the delay between the completion of an event and its reporting. *Trains*, October 2004, "BNSF Reborn," by Fred Frailey, quoting CEO Matt Rose: "While there will be a time when a competitor sees our rates [on-line] and uses it (sic) against us, if we simply focus on our customers, our markets, our true franchise, the benefits will outweigh the loss."

Three weeks ago I asked rhetorically if shortline carload gains were masking Class I carload losses (WIR 8/20/2004). A good friend who's been in this business a long time writes, "Many short lines are growing because they have excess capacity, but we are not in a growth industry. Class Is romanced the investment community throughout the 1990s with the concept of 'bottom-line growth' from cost-cutting and unrealistic expectations for merger-related savings.

"In the short run, they are trying to show some top-line growth by raising rates and squeezing short-line connections – at precisely the time when rising trucking costs provide a rare market-share opportunity for the rails.

"The theory that increased equipment velocity will solve the problem is not working because too much infrastructure has been either removed from the system or not modified to suit current operating practices. Short lines now face the reality that their customer successes in building business are being undercut by 'partners' rate and service actions designed to discourage carload traffic. In some cases, shippers that had been induced to invest in rail-loading facilities are being summarily cut off.

"Contrary to accepted practice, several feeder lines are doing well with captive short-haul traffic that is truck-competitive because of outstanding equipment turn-time. Many of us are forced to be clever just to stay alive in the current conflict between the wholesalers and retailers. I'll leave it to you to decide which managements are playing winning hands."

Mom and Pop shortlines are at risk. Them's fightin' words, to be sure. But now that I have your attention, let me tell you exactly why. A "mom and pop" shortline is one with any combination of $1 mm or less in annual revenue, 4,000 carloads or less interchanged with a Class I over 12 months, fewer than 100 carloads per mile per year on FRA class 1 or excepted track, is not part of a larger holding company, and has no leverage other than price to keep the trucks at bay.

These small operations are threatened because over the past five years the Class I railroads' traffic mix has changed (Table 1). Merchandise carload revenue as a percentage of total revenue has drifted south at four out of six Class Is. Carload contributes less than it used to and such carload business as remains is getting more efficient. Note that in the US at least carload revenues were up more than carloads, or, in the case of BNSF, revenues were off less than carloads. In other words, the Big Six are getting better at running their respective carload franchises.

Then there's intermodal. Double-digit increases in revenue and carloads (except for CSX which did not publish intermodal volumes in 1999) and low single-digit increases in mix were the rule. Trailers and containers are mostly a boxcar-type business, though large portions will never have a chance at the carload side – containerized import/export, small-lot supply chains, off-rail O-D pairs, etc. And it's no longer the low-margin, excess-capacity business it used to be. Hook-and haul, point-to-point, high speed, high density lanes can be more profitable than the low-density, low-speed, single-unit business that requires a network of branchlines and yards to make it work.

The carload business is beginning to look more like intermodal as we see more blocking for the distant node, pricing models that can show the cost benefits of bypassing yards, and avoiding light-density branches that can't support even the most modest of capital investment. Moreover, there is the convenience of truck delivery from rail-served distribution centers adjacent the Class I core. The infrastructure is already there, and the existing highway network can be a superior feeder to the core rail network. In short, the mom-an-pops are at the bottom of this food chain.

There is hope, however, and it lies partly with better communication and leadership across the Class I spectrum. At the annual shortline gatherings one can depend on the host railroad for speeches and slide shows showing how important shortlines are. Yet every year in every sandhouse session the same shortline laments about seeming Class I indifference remain.

Just the other day the commercial officer of a sizeable shortline wrote, "My Class I appears to have had a change in marketing philosophy and is attempting to demarket various pieces of business through their pricing policies." He writes that some proposed rate increases exceed the present through rate! He concludes, "a few hundred cars may not be a big deal to them," but it's his livelihood built through years of building customer confidence in rail service. And it's a theme I continue to see and hear throughout the shortline community.

Now to be fair I must add that not all shortlines take the same professional approach to all aspects of running their businesses. A common Class I complaint is that there are still some shortlines, mainly the smaller ones, that are lax in their reporting responsibilities. Rail customers – the guys who pay our salaries – don't want "black holes" in the reporting stream. One TPLP even told me he avoids shortline points precisely because of the black hole at interchange.

We know there are shortlines where a waybilled and released load automatically gets a Class I trip plan to destination, so technology's not the issue. As one seasoned observer has remarked, "The main obstacles are behavioral and political." If that's the case, the price of non-compliance is not high enough. I look to the Class Is, the ASLRRA and the Rail Industry Task Force to raise the ante. And that will at least make being a mom and pop shortline somewhat less risky.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via-mail 50 weeks a year. Individual subscriptions and shortlines with less than $12 mm annual revenues $100. Corporate subscriptions $400 per year. The Quarterly Review, a statistical analysis of the ten largest publicly traded railroad operating companies is $50 per copy to subscribers, $100 per copy to non-subscribers. Both are publications of the Blanchard Company, © 2004. Subscriptions are available at www.rblanchard.com/week_in_review/index.html ***or by writing*** rblanchard@rblanchard.com **.**

Table 1. Big Six Traffic Trends
1999-2003

Periods ending December 31

	BNSF	CN	CP	CSX	NS	UP
Revenue (1)						
Carload Freight*	-2.8%	13.4%	-3.9%	12.6%	21.4%	10.1%
Coal	-9.1%	-35.1%	13.3%	4.5%	13.5%	11.3%
Intermodal	21.4%	35.9%	25.0%	31.1%	45.9%	19.8%
Units (2)						
Carload Freight*	-5.6%	16.8%	-2.1%	0.3%	9.2%	3.1%
Coal	-3.5%	-15.6%	6.8%	-2.7%	6.3%	16.8%
Intermodal units	25.3%	28.4%	24.2%	na	30.1%	8.9%
Total Units	7.2%	15.0%	9.0%	na	15.1%	8.0%
Revenue Mix (3)						
Pct carload	-2.9	0.7	-5.4	-0.2	-0.9	4.0
Pct Intermodal	4.8	3.2	4.4	2.3	3.0	2.6
Pct Coal	-3.0	-3.2	1.0	-1.7	-2.0	1.6
YOY Comps						
2003 Revs ($mm)	$9,413	$5,884	$3,659	$7,439	$6,468	$11,551
Pct. Change	3.4%	12.4%	4.7%	13.0%	23.4%	2.5%
2003 Ops Ratio	82.3	69.8	79.8	91.2	83.5	81.5
Point change	6.9	-2.2	1.6	4.2	-2.8	-2.5

*All but intermodal, coal

(1) Revenue by commodity

(2) Revenue units

(3) Point change in percent total revenue

Source: Individual Railroad 10-Ks and Investor Reports