THE RAILROAD WEEK IN REVIEW
OCTOBER 29, 2004

Earnings Season hit full stride this week as BNSF, CSX, CN, CP, KCS and RRA reported. We also had BNSF's Annual Shortline Meeting in Fort Worth. As is our wont the emphasis is on freight revenues and operating income as that's what really separates one name from another. Everybody has taxes, other income (expense) and interest below the line. The common thread among all was ROIC and seeking revenue levels that support the asset base that's used to generate the revenue stream.

BNSF operating income for 3Q04 was up 31% to $565 mm (before a one-time $465 mm asbestos charge) as freight sales increased 17% to an all-time quarterly record of $2.8 bn on 11% more units handled. Operating expenses were up 13% to $2.2 bn taking another two points off the OR to 79.8, though had fuel prices not increased 12% the OR would have been 78.5 for the quarter. Intermodal continued to lead in revenue gains, up 19%, though Industrial Products, Ag and "other consumer" – perishables – were all up double-digits. Merchandise loads contributed 44% of BNSF's total revenue for the quarter. RPU was up 11% for agriculture and 5.4% for industrial products, besting intermodal's 3.6% on a combination of pure price hikes, fuel surcharges and sheer volume.

Increased system productivity was key. GTMs and unit miles were both up 12% yoy. Train velocity dipped 0.6% to 22.4 MPH however shorter dwell and putting 12% more units on 9% more train starts held cars-on-line to a 4% increase over 2003. I also think this quarter marks a turning point for BNSF as the merchandise network streamlined and improved. Chief Commercial Office John Lanigan said that nine of the industrial products sub-groups were up in the quarter, led by strong demand in the construction products, building products, and petroleum products sectors.

Third quarter per-share earnings were 77 cents before a net of tax charge of $288 million, or $0.76 per share to reflect changes in the way BNSF estimates asbestos and environmental liabilities. Third-quarter 2003 earnings per share were $0.55 representing a 40% yoy increase. The conference call was light on projections for oh-five, though I suspect we'll get our fill at the Kansas City session in two weeks. But for the next quarter we're looking at 13-14% more freight revenue, another point coming out of the OR, and earnings flat at 74 to 77 cents per share.

Having the earnings call on Day Two of the BNSF shortline meeting was instructive. The sessions provided helpful background for the earnings call and set down BNSF's operational and commercial goals for 2005 together with the shortlines' role in achieving them. First is the BNSF focus on a high density, high value system where light density lines and customers are best served by shortlines. Second, there are now 19,000 route-miles of shortlines that connect with the BNSF core and generate a $billion a year in freight sales that BNSF might not otherwise have. Half is in industrial products, 15% agriculture, 15% intermodal (!!) and 5% coal, with a 6% CAGR over the past five years.

YTD shortlines have increased industrial products and consumer goods revenues by 14% to BNSF's organic rate of 8%, shortline ag business is up 21% to BNSF's 11% and total shortline sales across all commodities is up 15% to BNSF's core 9% rate. Moreover, shortlines should expect shortly to participate in BNSF rate increases and fuel charges, easy to do with market-based pricing. There's also a change in the wind regarding grain shuttles as BNSF has committed to treat shortline shuttle points on a par with BNSF-local shuttle stations.

Roughly 9,000 of the 22,000 route miles BNSF owns and operates contribute just 10% of revenues but consume 20% of the maintenance budget. In addition to the usual branch lines there are secondary mains and terminal operations that fall in this bucket. BNSF has three options: sell or lease to shortline, sell or lease to a transit or similar public-private partnership, or abandon and protect any remaining traffic with a main-line transload. The results thus far would seem to say the solid shortline operators with a track record of success with BNSF will be the soonest winners. Innovation, flexibility, and participation are the active words.

Underlining all this CEO Matt Rose did a stand-up, no-notes conversation from the dais at the Monday evening banquet. He opened his remarks to address the three hot buttons from last June's Shortline Caucus: rate competitiveness, rate responsiveness, and car supply. With respect to the first, the environment is conducive to rate increases and the mechanisms are there to let shortlines participate. As to rate responsiveness, Matt said they asked the ASLRRA to forward complaints and so far there have been none. (Why am I not surprised?) As to car supply, the best way to get more cars is to turn what you have faster and BNSF has the tools in place to do that.

Shortlines, said Matt, have helped improve information transparency with customers, have proven their ability to support the BNSF's high-density mainline network, and bring value in their "dogged approach" to building relationships with small-volume carload shippers. The 2005 focus is on better service, increased system velocity, pricing, and cost control. The line rationalization program depends on shortlines to improve ROIC and let BNSF capital zero in on the bottlenecks in the core system. Sounds like a plan to me.

Canadian National increased freight revenues by 21% or $C256 mm while holding operating expense to a 17% gain, $C156 mm. Thus 46 cents of every incremental revenue dollar fell to the bottom line. (Shortlines contemplating acquisitions take note: how much of the new Grand Cache coal business on the Alberta RailNet will show up as operating income, e.g.?) The recent GLT and BC Rail acquisitions played a large part, adding $C148 mm to the top line and $C93 mm to operating expense – an accretive OR of 62.8. CN itself posted a second consecutive quarter with a 65 OR, yet absent the 32% fuel expense increase on 8% more gallons to move 9% more GTMs, the OR would have been down to 64.

On capacity, CN averages 6,600 trailing tons per train and can increase that to 10,000 without breaking a sweat. Tonnage per train is up 8% and train length is up 5% with no new train starts. Passing tracks are all 10,000 feet and Chief Commercial Officer Jim Foote has set a goal of smoothing the merchandise traffic to level out the inevitable weekend peaks that come from customers concentrating all their loading activity Monday-Friday. Shortlines can help, CEO Hunter Harrison told me, by interchanging a consistent number of cars seven days a week. Recall the GCO program is set up to encourage exactly that.

Finally, expect double-digit carload revenue increases in 4Q04. CN is unique in that merchandise carloads generate 73% of total revenue and carload revenue was up 21% to intermodal's 8%, quite the opposite of what we see elsewhere. Chemicals, metals, forest products and coal revenues were all up strong double-digits helped by the iron ore and met coal moving off the former GLT lines to export via Price George plus forest products out of BC. Shareholders earned $C1.19 per ticket for the quarter, up 17% from last year's $C1.02. Nine months' free cash flow after capex and dividends was $C787 mm and CN projects $C900 mm for the full year. Debt to cap is 36.7%, below the "sweet spot" of 40-50%.

RailAmerica reported a $30.6 mm, $0.84 per share, loss from continuing operations in 3Q04 compared to 3Q03 earnings from continuing operations of $7 mm, or $0.21 per share. Disc ops include a $4 mm impairment charge related to the Arizona Eastern sale and the $20.7 mm pre-tax gain on the sale of Freight Australia; with these in, the loss was $33.1 mm, 91 cents a share. Excluding the $39.5 mm pre-tax refinancing expense associated with the bond tender and the amended and restated credit facility, and the $12.6 mm impairment charge for the E&N Railway in British Columbia, earnings from continuing operations were $5.0 million, or $0.14 per share.

Total freight sales for the quarter came to $100 mm, up 11% yoy on 11% more revenue units. Operating expenses were up 22% before the E&N impairment charge. Thus pre-charge operating income slid 21% and the pre-charge OR deteriorated seven points to 82.5 from the 75.2 posted in 3Q03. The prime culprits were a 52% fuel expense increase and a 68% jump in casualty and insurance. RRA paid $1.40 a gallon for fuel in the quarter, up 44% from last years $0.97. Fuel burn was up 5% yoy; had the price per gallon remained the same the OR would have been 79.8.

Casualty costs include $1.4 mm related to a 4Q04 fire and subsequent reconstruction of a tunnel on the Central Oregon & Pacific Railroad plus 9% more derailment expense (derailments down, cost per event up). Double-digit increases for labor, equipment rents, purchased services and materials also took their toll. CFO Mike Howe noted during the Q&A that the recently-passed track maintenance tax credit could be "in the range of" $10-15 mm annually 2005 to 2007. Also during the conference call CEO Charles Swinburn reiterated the "fundamental shift" in RRA's acquisition goal to accretive, strategic buys that complement existing properties. It's good to see this continuing theme and we look forward to fewer one-time items in the financials as the "fundamental shift" takes place.

CSX was next up and it's clearly a work in progress. CEO Mike Ward opened the call citing 3Q04 as the tenth consecutive quarter of revenue growth and continued validation of their value-pricing approach to yield management. He did concede however that operational challenges inhibited CSX' ability to stay ahead of the demand curve. COO Tony Ingram added that though yoy operating metrics may have softened (all six measures on Page 9 of the Quarterly Flash worsened), quarter-to-quarter they are improving. System velocity is as good an indicator as any and Slide 7 (www.csx.com/investors) bears Tony out. Looks like they hit bottom at the end of June and absent the cascading effects of four hurricanes the trend is decidedly northward.

Making the CSX "One Plan" work requires a major cultural shift at CSX, especially at the trainmaster and terminal supervisor levels. The aim is to minimize car miles and handlings, balance critical resources, focus on consistent and executable service delivery, and to deliver faster recovery from disruptions. For it to work everybody has to buy in, and Tony says they're making progress. Still with the PI index still north of two, there's a significant opportunity for improvement. And, IMHO, increased attention to detail on the job and safe practices go together. Improve one and the other can't help but get better.

Railroad quarterly operating revenues were up 6% on no change in volume. RPUs for five of the eight commodity groups in my "merchandise" class (I include auto and coke/ore) were up 8% or more on mix and fuel surcharges. Operating expense increased 5% yoy (ex-restructuring and other charges) and pre-charge operating income was up 12%. Using the incremental income yardstick (see CN, above), just 23 cents over every additional revenue dollar went to operating income. The tools are there and one would look for more revenue at less cost in 4Q04. CSX shareholders earned 50 cents a share including a net gain on the Conrail spin-off vs. 54 cents in 3Q03 excluding charges of $1.02 per share for occupational, arbitration settlements and management restructuring.

Kansas City Southern brought up the markers for the week. CEO Mike Haverty said during Thursday's call that this was the sixth consecutive quarter of revenue growth, that fuel surcharges largely offset the 46% fuel expense increase and that he's expecting the STB to pass on KCS acquiring 51% ownership of the Tex Mex by Nov 29. KCS must buy the remaining 49% by Oct 2005.

Railroad COO Gerald Davis reported $162 mm in sales, up 12% on 7% more volume with all commodities ex-coal up double-digits. Paper & Forest Products led with sales up 23.3%, then intermodal including Norfolk Southern and CSX haulage business, up 14.1%. Agriculture & Minerals, led by strong gains in domestic grain, ores and minerals, and glass, stone and clay, grew 12.9%. Chemicals & Petroleum Products increased 11.7% based on strong growth in gases, plastics, petroleum, and inorganic chemicals business. Coal, the only business segment to experience a quarter-over-quarter decline, experienced a 3.7% decrease in revenues, due primarily to sharply lower deliveries to one plant served by KCS.

Corporate sales came to $163 mm, also up 12%, operating expense was up 10%, and operating income rose 27% yoy. Equity earnings from its Mexican interests netted a $million, about the same as 3Q03. Net income to common shareholders was 14 cents, up from two cents a year ago. Haverty & Company have to be admired for their persistence pursing the Mexican opportunity, though it still appears to realize its potential. The earnings driver continues to be the KCS railroad. The service metrics are improving, price increases are holding, and ex-fuel expense line items are coming down. (A $5 mm derailment derailed the downward trend in the casualty line).

KCS is a solid carload player and when I visit next month I want to ask about opportunities to increase intermodal pricing (KCS' carload equivalent is only 35% of the average carload revenue), how they pushed car hire down 13% on greater volumes, and what accretive values they expect from the Tex Mex. I look forward to reporting the results of that visit.

I went back to look at UP's results to see what drove the high 3Q04 operating ratio of 86.4. Fuel was worth four points: applying the 3Q03 price per gallon to the 3Q04 fuel consumption and leaving the rest of the expense line the same yields an 82.4 OR. From the new total expense take the $58 mm UP ascribed to moving the HQ and catch-up training. This adjusted expense line yields an 80.7 OR, more in line with the other Class Is.

Shortlines and shippers can help ameliorate UP's congestion problems with smarter blocking and better routing. Yards are the main choke points, so making larger than usual blocks for the most distant node may help reduce car handlings. The aggregates business is a case in point. Shortlines can help their customers increase loading capacity and build 50-car trains to be forwarded to UP once a week, say on Friday night or Saturday morning. Ideally, these trains would run non-stop to destination, turn, and come back in a matter of days, with never a change of power sets.

Canadian Pacific's earnings call overlapped the shortline meeting so I didn't get in on the call itself. Suffice to say for now that 3Q04 sales rose 9%, operating expense increased 10% and operating income improved 8%. Net income was also up 8% yoy. Full commentary next week with the wrap from GWR and FLA.

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