THE RAILROAD WEEK IN REVIEW
NOVEMBER 12, 2004

Transportation stocks were in the news this week. Monday's WSJ led off its Money & Investing section blaring, "Transports Become Unlikely Stars." A chart with the Transport Index components' gains since the end of 2002 showed the rails did well. NS led the group, up 74.2%, then BNSF up 68.8%, CSX up 30.6% and UP gained 8.5%. By way of comparison non-DJTA members CN and CP gained 82% and 38% respectively. GWR stock price doubled, RRA and FEC each gained 50% and KSC turned in a 15% increase.

Among all DJTA members the Best of Show went to J B Hunt, up 185.1% with Ryder in second place, up 132.8%. Other notable results include Fed Ex (+69.6%), Northwest Airlines (+38.4%), and Delta (negative 49.2%, and the only loser of the lot). The paper goes on to ask how can this be with oil prices in the $50 per barrel range and the relative hit on consumer spending.

The answer lies partly in the leading transports' ability to pass on fuel price increases through surcharges and market-based rate hikes. Another reason is the transports' high fixed cost base that allows incremental revenue to fall quickly to operating income (WIR 11/5). Finally the transports typically sport smaller market caps than the DJIA leaders and their ilk. Thus smaller amounts of new money can push bigger stock price increases.

A companion piece in Reuters noted that rising transport stock prices are a good leading indicator for the market as a whole. The article went on to quote my good friend Jason Seidl of Avondale Partners who opines, "We also have fairly tight capacity across the distribution supply chain so pricing power is in favor of transport providers. I see the rally [in transport stocks] continuing in the near term."

Gerald Davies, EVP and Chief Operating Officer at KCS will retire at the end of this year, though he plans to stick around as a consultant to help the TFM acquisition process along. His transportation career began in 1970 with the United States Department of Transportation. From there he went on to hold various marketing, operating and finance positions within the railroad industry, including vice president of marketing at CSXT, senior vice president of marketing at Burlington Northern, and senior vice president marketing of Canadian National. He joined KCS in 1999.

We had a chance to chat during my visit to KCS this week. Given his marketing background, I asked Gerald to comment on KCS' leadership in the merchandise carload business. In a nutshell, he said the new Management Control System (MCS) gives KCS a car-management toolbox such as they've never had before. And the key to its success is the ability of everybody who touches a car, from sales rep to trainman, to tap MCS data to insure trip plan compliance. Best of all, the MCS is set to roll out to the Tex Mex and ultimately through the entire TFM and the resultant 6000+ mile KCS system.

Readers will recall my remarks on trip plan compliance tools at BNSF, NS and UP. I had the good fortune to spend an hour or so with KCS' Scott Arvidson, VP and Chief Information Officer, for an overview of the MCS. Working from a live screen it was immediately evident how KCS uses a wide network of AEI readers linked to each other and the MCS mother ship to improve car velocity, fleet utilization, and train operations. For example, one can tell what train is passing a given AEI reader because the MCS matches the consist to the train symbol. In short, MCS does everything the others do and more.

This is a powerful failure analysis tool. If Train XYZ is on-time at destination only 50% of the time, the system can tell when and where the failures occurred and can identify delay patterns. Benefits include 10% fewer hour-of-service outlaws, reduced crew overtime, and taking out initial terminal delays. Moreover, the AEI link cuts customer billing errors and can help shorten car dwell times at customers. All of which goes to show why KCS has increased revenue and volumes from existing customers pushing up Q3 carload revenues up 17% on 9% more units and improving RPU 7%.

BNSF held its annual Investors' Conference in Kansas City this week. CEO Matt Rose set the tone for the session in his opening remarks: "There has been a marked shift in customer focus from driving down the absolute dollar cost of transportation to insuring the rail option is available to meet specific supply chain needs." Readers will recall we got the same feedback after our NEARS panel last month. The shipper representatives present said they now understood why the railroads have become better supply chain partners and that reasonable price increases to insure continued service would be acceptable.

Perhaps EVP and Chief Marketing Officer John Lanigan said it best. "Railroading at BNSF is a team sport." As if to drive that home, the commodity group presentations were set up as panels with remarks from the Group VP followed by various combinations of Service Design (Rollin Bredenberg), Transportation (Dave Dealy), and Operations Support (Steve Bobb). The common thread among all the commodity presentations was franchise description, 2004 update, and outlook. But the differences came out in the discussions of operations and support. It is here that BNSF differentiates itself from the competition.

Shortline readers will be encouraged to know that Industrial Products (chems and POL, const and building prods) service design goals include minimizing car handlings, optimizing gateways, and cutting the time from waybill and release to departure from the first serving yard to 24 hours or less. Intermediate terminals are eliminated where possible by making solid single-destination trains. The process, dubbed Operation Pentagon, seeks to reduce to five the major originating and terminating yards -- Pasco, Barstow, Tulsa, Galesburg and Argentine (KC), where each makes and receives trains for and from the other four. Which is why BNSF encourages shortlines to operate directly into these yards where possible.

The Pentagon Plan also increases the revenue-generating capacity of the individual freight car. The good news is YTD 2004 vs. 2003 combined transportation time and customer time is down 13.5%. The bad news is off-line time is up 11.5%. Goes to what we heard CN say recently about reduced net equipment rents: car hire from cars stuck off-line offsets foreign car hire payables. But that doesn't help empty car supply for shippers (see Matt Rose, above). BNSF is also reducing the number of car types in the fleet to five, all 286: plate F boxcars; 5161 cf covered hoppers; 73-ft CB and 62-ft bulkhead flats; 66-ft, 100-ton mill gons; aluminum rapids and gons for coal. All others are being cascaded down or out.

Service design for the ag group remains centered on unit trains and the shuttle network. Back in 1997 there was no shuttle network and the typical covered hopper made 1.2 revenue trips per month. Now, with 90 trains in place, cars are making money at the rate of three trips a month with the greatest 2002-2004 growth in northern MN, western MT and ID, and Seattle-Spokane. In the same period the grain fleet has held at about 27,000 units yet the shuttle fleet has increased to 31% of the total from 17% and fleet capacity has grown by roughly 18%.

Here's a factoid from Coal Group VP Tom Kraemer: the spot market price for PRB coal runs $5.53 to $6.63 per ton depending on heat content vs. $60.50 for Central App. "PRB 8800" is 38 cents per mm

BTU vs. $2.42 for Central App. Including transportation to the east PRB 8800 is still less than a buck per mm BTU, so its no wonder Tom's PRB Test Burn map shows sites from Illinois to New Hampshire to Florida. As in IP and ag, velocity is a big productivity driver. Just by taking 24 hours out of the trip time BNSF can take 20 car sets out of the lane and move almost 12 mm more tons.

Finally, intermodal. I generally stay away from this area because it's not a hot topic with shortlines or carload shippers. However, as goes intermodal on BNSF so goes carload. The Pentagon Plan is making intermodal-like point-to-point trains out of merchandise carload moves. Coal and grain shuttles are also single-lane moves a la intermodal, where simplicity drives density, frequency and efficiency.

Simplicity also drives profitability and in 2004 for the first time intermodal revenue is growing faster than volume. It stands to reason as BNSF serves all seven major West Coast ports from LA to Seattle and tosses in Vancouver for dessert. What's more, there are but two eastward intermodal gateways – Chicago and Dallas. Service design runs to maximizing revenue per platform and running point-to-point with no intermediate set-outs. Container trains now average 211 boxes vs. 114 boxes for trailer trains and each 1% increase in slots used is worth about 800 more platforms a day. Proof of this particular pudding is that BNSF averages more than $1,300 per platform, 78% of its merchandise carload RPU and more than any other US Class I.

And since intermodal is the fastest growing revenue group it follows that the rest of the network has to run to stay out of the way of these hotshots. The best way to do this is by confining the gathering and distribution to branch lines and terminals, leaving the core routes free for intermodal, the Pentagon Plan merch trains, shuttles and coal units. Even aggregates, perhaps the most revenue-challenged of all commodities, has a fit, and shortline can help. BNSF wants its aggies to be single-destination trains that can turn in 24 hours or less. Shortlines that want to break up trains among several customers can play by building an extra train-set for BNSF to turn while the shortline does its thing.

Railinc and RailAmerica have placed the former's "RailSync Command" transportation management and event-reporting system on the latter's North Carolina & Virginia. This 54-mile property runs about 3000 carloads a year of ag and steel products and is a great place to start rolling out the new Railinc product. A primary role for the system is eliminating "black holes" where cars vanish from the customer's view upon being interchanged to a shortline. RailAmerica COO Joe Conklin says the RailSync suite of tools "offers a strategic and cost-effective solution to car reporting for our 46 shortlines." Based on what I've seen the partnership ought to be a solid one.

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