# THE RAILROAD WEEK IN REVIEW
## MERRY CHRISTMAS 2004

**Union Pacific** (NYSE: UNP) gapped up $2 at the open Tuesday and closed up $3.55, 5.6%, for the day. Before the open UNP upped its Q4 guidance to 82 to 84 cents citing “stronger than anticipated commodity revenue growth.” That’s not hard to believe. As far back as the August 2004 shortline meeting we were hearing about car shortages and the need to shorten turn times. On the intermodal side, I’m told boxes heading out the gate as loads are back a day later as loads going out again. That’s just one reason why the railroads are full.

The down side is that the smaller the space between trains the bigger the impact of slow orders, missed windows, and delays at interchange. Late arrivals can affect dwell dimes and on-time originations, and the capacity constraints show up across the board. For both Q4 to date and the most recent four-week trend dwell times are up, train speeds are down, and cars on line are up.

Shippers can help by loading and unloading equipment immediately on placement. Shortlines can help by turning cars as soon as released by the customer, and, where possible, running right into the serving yards. But let me add a cautionary note: shortlines must steer clear of the temptation to ask for significant allowance increases or take over the class 1’s local work between the shortline interchange and the serving yard. Show the economic benefit first and the results will follow.

Still, the class 1s themselves must do more. Take balancing power and crews. Many mergers ago the Penn and the Central had very different operating environments and each dealt with local operating conditions in the way that generated the right results. Southern and the N&W were different; the B&O and the ACL took two entirely different operating philosophies. Ditto the MOP and the Espee.

Granted, operating practices were more dictated by not spending money than getting trains over the road in a manner that best suited the customer. There was no trip plan compliance and Wall Street wasn’t gauging performance on STB Performance Measurements (flawed as they are). Everybody had their work-arounds and could fight the battle with the resources at hand. Fast forward to 2004 and every place I see power and crew imbalances part of the root cause is failure to play the hand that was dealt. Maybe it’s time to dust off some of the Fallen Flag play-books.

**Burlington Northern Santa Fe** (NYSE: BNI) made *Barron’s On Line* Dec 17 with a blurb entitled, “Burlington Northern’s on the Right Track.” The article cited an upgrade from A. G. Edwards to *Buy/Conservative* with a $56 price target. The writer thinks BNSF can “steal market share from UNP” at a faster rate and good service will yield “pricing power and shareholder wealth.”

It’s interesting to note that BNI’s accelerated capital program gets rave reviews whereas it wasn’t that long ago the analysts were kvetching about the rails’ spending *too much* on capex. But the proof of that particular pudding is the stellar service levels and revenue growth by those who bit the capex bullet back then, most particularly BNI and Norfolk Southern (NYSE: NSC).

**Norfolk Southern** led the rails in shrinking its shorts. For the month ending Dec 15 NSC short interest declined 26%. By way of review, short sellers generally expect to see prices decline and the bet is being able to repay the short sales at a lower price. Fewer shares short equals more upside optimism. On the other hand BNI short sales increased 15% and CSX short shares were up 12%, a sign that some players think these stocks may be peaking out. Others were neutral as the month-to-month positions did not change or the number of shares short was less than 1.4 mm.

**Providence & Worcester** (amex: PWX) takes a unique approach to property sales, placing them above the line to be counted as part of operating revenue rather than below the line as "other income." As reported, PWX had total Q3 revenues of $8.2 mm vs. $6.9 mm in 3Q03. Railroad operating revenues came to $7.0 mm vs. $6.7 mm yoy, a totally different picture. Without the property sales PWX net income would have been $349K, $0.08 a share vs $694K, $0.15 a share last year. All in, the net was $1.2 mm vs. $694K (no property sales in '03), up 87%, ditto EPS.

The OR, as usual, remains in the high 80s, with comp & benefits eating up 52% of revs vs. an industry average closer to a third. They handled nearly 20,000 intermodal containers at $42 each, or about 11,000 carload equivalents at $72 each. The railroad did 9,900 conventional carloads averaging $559 each. Love to know the revenue/cost ratios of each. And, speaking of EBITDA, take out capex and there's nothing left. What ever happened to the concept of Free Cash Flow? To be continued.

**My Quarterly Review calls** "carload" everything that isn't coal or intermodal. However, grain and automotive (parts and finished vehicles) tend to move in trainload lots in dedicated lanes where possible. They look more like coal or intermodal when it comes to O-D pairs and the route miles to connect them. For example, BNSF uses a series of commodity maps in their financial presentations. Auto, ag, coal and intermodal use pretty much the same route structure in varying degrees. The Industrial Products map is more complicated and that's where the shortline opportunities lie.

Table 1 compares the Big Six North American Railroads' single-car commodity revenues two ways: as a percentage of operating revenues for 3Q04 and the yoy change in percents. Note the two best-performing US rails both decreased single-carload percent of total revenue by about the same amount. At the same time CN showed a sizeable increase due largely to their IMX-like carload program, highly-structured scheduled operations, and their GCO process that makes the carload network move faster. UP and CSX remain very branchline-dependent for their single-carload business, though CSX is aggressively seeking other operators for its low-density lines.

Where's it going from here? CN's Jim Foote got it right when he told a group of Wall Streeters about a year ago that he was taking a page from the carload book to segment intermodal according to priorities. The IMX program was one result. And now he's coming full circle to apply the IMX lessons learned to the carload business. You've read about the BNSF's "Pentagon Plan" (WIR 11/12/2004) to streamline the classification, gathering and distribution of single carload business. At NS intermodal is replacing coal as the main shaper of the railroad network.

One should expect the single-car business as a percentage of the whole not to grow much in 2005, contributing less to ROIC, and for the breadth of commodities handled to shrink. Look also for increased reliance on shortline operators to handle gathering and distribution, allowing the class 1s to invest capital where it serves the maximum number of over-lapping lanes.

**Larry Kaufman writes,** "Your discussion of performance metrics is much like my criticism in a column in *Rail Business* some months ago. I went a bit further than you on dwell time, considering that it's only a snapshot of a piece of a carrier's business these days. Throw in unit grain trains among those that spend no time in yards, and at BNSF you are down to under 30% of its total operations being handled in yards [for proof, see Table 1 – rhb]. You are right that it is a good proxy for carload operations, and perhaps AAR should rename it. I agree that train speed is a silly or meaningless metric, besides, various carriers use different criteria when doing the calculations. Cars on line is a pretty decent internal metric, but I'm not sure that it provides much meaningful information to customers.

"My argument is that if the carriers really want to let customers know how they are doing, they would provide an index of compliance to trip plan. This is a metric that they all have, and that they all guard jealously. I do know that some years ago Paul Tellier told me what the CN adherence was. If I recall correctly, it was something in the low 90% range plus or minus a two-hour window, and moved up to the mid- to high-90% range if you widened the window to four hours. When I put this argument into my column, I received some interesting comments from shipper readers. One guy accused the carriers he dealt with of changing criteria often enough as to make comparisons invalid."

But there's more. You say "average speed 20 MPH" to a truck shipper who thinks of his loads moving at 80-per on I-80 and it's a pretty meaningless metric. TPC is not, and properly framed can be an excellent sales tool. But we also need to gang it with a tracing-reporting system that follows the car regardless of whose railroad it's on. Then we'll be on to something.

**Continuing last week's merch carload thread, CSX Shortline Maven Len Kellermann writes** that shortlines feeding his railroad have done themselves proud in 2004. Through Nov carload volumes on a "same store" sales basis are up 14% versus the same period in 2003. Len writes, "If you include business involving lines that CSX sold in 2004, our volumes with shortlines are up almost 19%. CSX will exceed 630,000 loads and $800 mm in revenues attributable to shortline originations or terminations in 2004.

"Metals, Coal, Aggregates, and Waste/C&D debris are all double digit percentage gainers year-over-year, reflecting the strength in the economy, but also reflecting the fact that shortlines do an exceptional job of cultivating new business and successfully collaborating with CSX." Please note that CSX will kick off the 2005 Shortline Meeting season with its annual workshop Feb 13-15 in Jax.

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**Table 1.**

**Big Six Class I Single-carload Commodity**
**Comps ex IM, coal, ag, auto**

**Quarter ending 9/30/2004**

**Revenue in $millions**

| Metric | BNSF | CN | CP | CSX | NS | UP |
|---|---|---|---|---|---|---|
| Railroad revs (1) | $ 2,793 | $ 1,709 | $ 990 | $ 1,938 | $ 1,857 | $ 3,076 |
| Carload revs | $ 719 | $ 904 | $ 309 | $ 869 | $ 617 | $ 1,055 |
| Pct carload 3Q04 | 25.7% | 52.9% | 31.2% | 44.8% | 33.2% | 34.3% |
| Pct carload 3Q03 | 26.3% | 50.0% | 31.0% | 44.7% | 33.7% | 32.9% |
| YOY change in pts | (0.56) | 2.86 | 0.24 | 0.13 | (0.50) | 1.42 |

(1) Includes "other" -- demurrage, etc. CP, CN in $Canadian