THE RAILROAD WEEK IN REVIEW
JANUARY 14, 2005

Watco Companies begin their CSX shortline relationship with the lease of a 158-mile former B&O line segment between Grafton and Cowen, WV. This will be the second foray to the east for the Pittsburg, KS-based company. We've written often about Watco because it has one of the best shortline and railroad support models going. In addition to its ten shortlines in 11 states the company also provides contract switching services in another 24 locations.

By way of background, privately-held Watco has forged a particularly strong relationship with BNSF. That in turn will benefit the company as BNSF – and now CSX -- continue to focus on core routes and look to third parties for the gathering and distribution aspects of the carload business. Thus it's instructive to note that Wall Street continues to rate BNSF (BNI) as a "buy" or "outperform" even though the industrial products or merchandise carload trade makes up a smaller percentage of the revenue pie than at other class 1 roads.

BNSF has about the sharpest yield focus around and the shortlines that best support that thesis will be the winners in Fort Worth. With this transaction one would expect we'll see more of the same in Jacksonville.

Union Pacific is literally up to its neck in mud in some parts of So Cal. WIR reader and *Trains* contributor Tom Murray sent me UP photos across three divisions and hundreds of miles of track and the devastation is considerable. There are mudslides caused by whole mountainsides succumbing to gravity. There are washouts on the order of what CSX faced on its Gulf Coast lines after the series of hurricanes. Whole bridges have completely vanished or been so undermined they will have to be rebuilt from scratch.

A note from Bear Stearns analyst Tom Wadwitz adds, "Given the significant weather hits, UNP has embargoed substantially all freight coming into and out of the LA basin (roughly 20% of UNP's total freight) at the present time. Tom thinks it could last "several days," though given the extent of the damage I would not be surprised if some lines were out for longer.

UP's Chief Commercial Officer Jack Koraleski puts it this way in his Jan 11 Letter to Customers: "The series of storms that hit California this week is having significant impact on our operations to and from the Los Angeles Basin, through the Sierra Nevada, and the rest of California. Washed out tracks, mud and rockslides over the tracks, and flooding have closed five of our main routes in that area. There is also signal damage along some of these routes.

"Recovery will be slow and will depend on weather as crews work in very difficult conditions. Snowfall of over 14 feet in some passes has slowed mountain operations as we fight to remove record amounts of snow. Our employees in this region take great pride in their ability to keep our tracks open, but they have been sorely tested by these repeated challenges." Be sure to read the entire letter at http://www.uprr.com/customers/updates/2005/011105.shtml .
Late Thursday a note from Morgan Stanley's Jim Valentine suggests that "problems in southern California could develop into something much larger. There is a risk that UNP's problems in California could spread into other regions of its network, given its already fragile state. One needs to look no further than UNP's '97-'98 service crisis for evidence as to how a localized problem quickly began to impact other regions of a rail network."

My take is that the present mudslides and snow storms, combined with the tunnel fires not so long ago, have only served to exacerbate the system slowdown. That in turn cascades down to crew and loco assets being out of place, making merchandise dragouts and holdouts that much more likely. Revenue suffers, crew, fuel and car hire expense goes up and operating income goes down. Yet Koraleski says they're still handling record volumes. What shippers want to know is the effect on trip plan compliance and whether they ought to make other arrangements.

Shortlines appear to have had a good year based on what RailAmerica (RRA) and Genesee & Wyoming (GWR) report. The former's carloads (in this context carloads equal freight cars plus intermodal units) for December 2004 increased 2.9% yoy for the month and 8.7% for the full year. The annual increase was almost 100,000 units of which the Central Michigan, the Midland Sub (Cincy-Columbus) and the Ft Wayne & Eastern added about 6%. System-wide same-store carloads for the full year were up 3%. Canadian volume was down 5% for the month and 4% for the year; in the US it was up 6% for the month and 10% for the year. US traffic volumes run about triple the Canadian base yet Canada represents only a sixth of the total route miles operated.

Over at GWR December North American carloads were up 19.6% excluding volumes acquired from the GP roads and the former PPU which accounted for about two-thirds of the increase. GWR, unlike RRA and the rest of the railroads, gives only quarterly comps, so we can't tell where they are for the full year. But for the quarter ending Dec 31 volumes were up 21.6% including the acquisitions.

As I said shortlines did well in oh-four if one uses GWR and RRA results as a proxy for the group. The AAR reports that total volumes including intermodal were up 5.6% for the year; 2.7% excluding intermodal. For the month, commodity (non-IM) traffic was up 2.9%, about the same as RRA where IM accounts for less than 4% of total units vs. AAR's 12%. It's possible also that RRA's results could be hurt by UP's poor showing: commodity (all ex-IM) up 1% for the year. Recall UP is RRA's biggest interchange partner, accounting for 28% of volume according to the 10-K for 2003.

Time may be running out for CN. The federal government in Canada has asked the Canada Industrial Relations Board (CIRB) to make a determination as to whether specific rail services should be maintained in Canada in the event of strikes or lockouts involving three of the railroad's unions. Recall that the UTU, Teamsters (ex-BLE) and the IBEW are involved and these august groups tell some 5,000 workers how much they'll get paid and under what conditions they will work.

During the CIRB determination process, CN will continue to bargain in Canada with the unions and any right to strike is suspended until the CIRB renders its decision. After the board's determination, at least 72 hours' strike or lockout notice would be required prior to any work action.

The latest Fallen Flag is none other than EMD. On Wednesday GM announced it had reached and agreement in principal to sell EMD to an investor group led by Greenbrier Equity of Rye NY and Boston's Berkshire Partners. The company's direct antecedent was the Electromotive Corporation founded in 1922 and its first product was a six-cylinder Winton-powered flop. After some modest successes in building self-propelled railcars the firm was acquired by GM in 1930 and it was renamed the Electromotive Division.

At that point Matthias Baldwin's company had been in the steam loco business for 100 years. Fifty years later the western world had been largely dieselized and Baldwin closed its doors in 1954. Now, another fifty years later, GM itself has had enough. Yet many Baldwin look-alikes are still at work in China and there are even one or two China-builts in the US. Hmmm.

Lunch with Ike Roberts is always a treat. We first met many moons ago when he was in processed food marketing for Conrail and I was just starting my shortline consulting business. Today Ike and his partner Mike Behe, also a graduate of the Conrail STCC 20 marketing group, have crafted a dandy tool that makes using the railroads' merchandise carload services a lot easier.

The tool is USRail.desktop ("***.dt***") and though it may look at first like just another rate-negotiating tool there's a lot more to it. The welcome page at http://www.usraildesktop.com advises that ***.dt*** allows one to "negotiate lower rail rates and rail mileages, and develop win-win negotiating strategies." Better yet, the tool allows one to compare railroad revenue/cost ratios on the railroads' proposed rates with those of one's alternative routings.

Case in point: a raw material vendor on a shortline wants to sell to a point served by the connecting class 1. The class 1 says the customer currently gets his material from a source local to the class 1. Using ***.dt*** the shortline customer can determine the relative costs of rail service in each lane and determine the margin in the existing lane. Then he can try to beat the rate with the same dollar margin or better for the class 1.

One can then use the class 1's transit schedules-- http://www.bnsf.com/bnsf.was5/goaltp/cntrl/QRY for example **--** to determine cycle times. The shorter the time, the better the equipment use, another rate-making lever. What's more, we've actually seen places where the class 1 market manager's pricing tool could not price in a shortline as a bridge carrier to shorten an otherwise round-about route. The shortline could have used ***.dt*** to make the case and win the business.

Finally, ***.dt*** works particularly well in the "market-based" pricing environment. Any vendor can get his competitor's rate from the railroad website and set out to beat the price while improving on the class 1 margin and transit time. This is a particularly fascinating application because it goes directly to what the class 1s are telling Wall Street. What a great way to be sure commitments are kept.

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