THE RAILROAD WEEK IN REVIEW
MARCH 4, 2005

Two weeks ago I wrote, "Shortlines handled 14% more carloads for CSX in 2004 than they did in 2003." (WIR 2/18). A number of readers questioned the number so I've done a little digging. As you know, I take some liberties with the Class I carload groupings to get everybody pretty much on the same carload basis, de-emphasizing intermodal and coal ("energy" to UP). Auto is included due to the parts business many shortlines see as well as BNSF's "other consumer," largely perishables in reefers. So part of the error was that my "merchandise carloads" included what CSX did not, i.e., auto, coke and ores.

Backing out those we both show a yoy change of 98,000 "merchandise" carloads and this squares with the 10-K. Of these, shortlines contributed some 46,000 units or about half. System-wide shortlines touched about 17.5% of merchandise loads and in 2004, and the absolute growth of shortline merchandise business was 67,599 units. This latter number, however, includes cars that CSX handled in 2003 but owing to line transfers, went to shortlines in 2004. Remember, this is just "merchandise" and excludes any coal, coke, ore or auto.

At CSX, coal, coke and iron ore play a significant role in the shortline community. Taking these into account CSX system carloads increased by 193,000 units or 4.3% yoy. Shortlines grew overall in these commodities by 83,000 (after backing-out the effects of new line sales/leases) and this number is comprised of the 46,000 units in merch carload gains plus 37,000 in coal, coke and iron ore. Add the 83,000 to the 2003 shortline volume and get 647,000 revenue units, up 14.7% yoy.

Looking back, CSX shortline carloads (and this does not include switching roads) increased at a rate of 3% in 2002, 6% in 2003, and 15% in 2004. It is generally agreed among Class I roads that shortlines can do a better job at the gathering and distribution end of things than they can and it looks to me like CSX's accelerating rate of change puts them off to a very good start.

Meanwhile, Jim Valentine at Morgan Stanley has upgraded CSX to Equal-weight from Underweight as "we believe the worst is behind the company and therefore it should no longer under-perform the more fluid railroads (BNSF, CN and NS) as it has over the past year." Jim continues, "During a recent meeting we held with senior CSX management, we came away with even greater conviction that CSX will sustain strong customer pricing again in 2005."

On the other hand, he feels the ONE Plan has yet to deliver financial benefits, though "it takes time to turn around operations as might be expected for a company that has 33,000 employees spread over 20,000 miles of factory floor." With the stock price hitting successive new 52-week highs this week, and gaining 4% to $43 for the week, the tech signs are all pointing toward continued upward momentum.

Independent analyst Tony Hatch writes, "Increasing revenues faster than expenses may be the most effective way to improve the Operating Ratio. But I like to see expense growth below workload growth – meaning units not rates. Rates are great, the new paradigm, but a truly terrific operator should show expense growth below unit growth, thus showing true leverage."

My Fourth Quarter Review -- http://www.rblanchard.com/week_in_review/current_4.htm -- shows revenue change, unit change, expense change and OR change, but doesn't link units and expenses as Tony suggests. Responding to Tony's challenge we have the Table 1 after the disclaimer. Note the ones with the best ORs are the ones with the best units-to-expense ratio: CN and NS. Thanks. Tony.

Rail stocks generally continued to outpace the DJI this week. The broader average was up 1% while CP led the pack with a 6% gain, followed by CSX and BNSF at 4%, UP 2% with NS and CN matching and lagging the market respectively. GWR jumped 8%, RRA increased 6%, FEC 2% and KCS was unchanged. AAR Rail traffic for the week ending Mar 3 grew 5.3% overall, propelled by a 16% increase in coal loadings and 11% in intermodal. BNSF, CN, KCS and NS all beat the average.

Genesee & Wyoming got some nice ink in *Forbes On Line* this week. Columnist Richard Phalon writes, "It's rare to cast any railroad in growth terms these days, let alone the one-track workhorse [CEO Mort] Fuller's great-grandfather bought more than a century ago. Yet, there's Genesee & Wyoming highballing through Forbes 200 Best Small Companies and closing the books on another big year. Revenue for 2004 was up 24.1% to $303.8 mm, while net climbed 31% to $37.6 mm."

Never mind Phalon gets a bit behind in his railroad history when he mentions "main line hummers like the Erie and the Delaware Lackawanna." Closer to the mark Phalon observes that GWR's biggest customer is a coal-fired generating plant contributing about 5% of revenues and that GWR is the "only rail link to the site. Fuller is protected on price, the traffic is steady and the overhead on short-track maintenance low." After touching on the extent of operations in North America and Australia, the writer comments on GWR's "growth by acquisition" strategy.

The wrap is particularly apt, as I'm sure WIR readers will agree: "There are still some 500 other short lines around that are likely to listen to reason, with only a few well-heeled buyers like G&W in the running. That's comforting news. Fuller's growth-by-acquisition strategy tends to immunize G&W from business cycle swings, the common blight of less sheltered commodity carriers."

Every once in a while something comes across my desk that really rankles. This week it's a newsletter from a Washington law firm taking issue with the line sale/lease program of "a major western railroad." To begin, the writer implies there's something new about the program. If we're both talking about the same railroad, my recollection is they've been using the same process for years and the program has been quite successful.

The letter uses loaded phrases to make its point: "riddled with commercially unreasonable provisions… lessees holding their noses and signing….crams commercially unreasonable terms down the throats," and so on. Hey, it's my property and these are my terms and if you don't want to do business with me on my terms that's fine and we'll part friends.

Class I railroads have been leasing out properties to shortlines for years. I had the good fortune to manage one of the very first Norfolk Southern Thoroughbred shortlines nearly 20 years ago. Without going into the confidential details of the lease, it's safe to say there were provisions for NS to take back the line should certain guidelines not be met. But the fact of the matter is that on this shortline NS revenues today are significant multiples of what they were in the beginning.

At the time the Thoroughbred Lease Program made its debut there were those who derided the NS program as unworkable, unfair and dead in the water. So far, in all these years, I can think of only one failure where NS had to take back the line if only to protect the customers. The property was promptly spun to another shortline operator, I might add.

On the other hand, there have been shortline operators who signed an agreement and five or so years later tried to renegotiate it. That does not sit well and people have long memories. As one senior Class I exec said to me, "I know that when you and I shake hands that's the deal. Others I'm not so sure."

Getting back to the letter on my desk, the writer warns, “Shortline operators need to think through the implications of the more onerous terms.” One should hope a shortline operator think through *all* lease terms, onerous or not. And, if he finds the terms unacceptable, he’s free to say thank you very much and walk out the door. But to clasp hands on the bargain and then try to renegotiate it after the fact is simply not playing the game, as the Brits would have it. Perhaps the “major western railroad” merely wants to be assured the handshake is for real.

The opportunities for improved car supply and accurate pricing continue to pop up. We’ve written before about the link between trips-per-year and “deficit traffic” that doesn’t meet equipment replacement hurdles. Now comes a high-volume shipper of premium manufactured goods facing a serious car shortage. Total elapsed time door-to-door is frequently two weeks or more yet the Class I trip schedules call for five days plus-or-minus. What’s wrong with this picture?

What’s wrong is the switch carrier serving said shipper delays empties in and loads out. Yet when the shipper looks at transit time he only sees dock to dock and naturally blames the Class I. The Class I looks at cycle times and sees deficit traffic due to poor utilization. That comes back to bite the poor customer in the form of rate increases.

Wonder what would happen if the Class I supplying the empties started applying demurrage rules to the switch carrier. Or perhaps took away car hire relief when cars stayed overlong on the switching line. I mean, if the railroad can inflict demurrage charges on a customer for not releasing cars promptly, why not do the same for an intermediate service provider that’s not paying car hire?

I’ve said before that I’m against car hire relief in any form for any outfit that calls itself a railroad. Having to pay car hire is a powerful incentive to get cars off the property promptly. Harrumph.

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Table 1. Percent change in revenue units divided by percent change in ops expense

Metric	BNSF	CN	CP	CSX	NS	UP
Rev Units 2004	9,536	4,654	2,698	7,530	7,464	9,458
YOY Pct. Chg.	10.3%	11.4%	6.3%	3.4%	8.8%	2.4%
Ops exp 2004	$ 9,260	$ 4,380	$ 3,114	$ 6,956	$ 5,610	$ 10,920
YOY Pct. Chg.	19.5%	6.6%	6.2%	6.4%	3.8%	15.9%
Revs chg/Units chg	0.53	**1.72**	1.00	0.53	**2.30**	0.15