THE RAILROAD WEEK IN REVIEW
APRIL 29, 2005

Four Class I rails reported this week and my comments are based s much on my *Quarterly Review* observations as they are on what was said in press releases or on the conference calls. RailAmerica reported this week as well, but let me save that report for next week to go with the GWR and KSU reports on Mon and Tues.

Overall the results were encouraging, with the outperformers continuing to outperform. One caveat before you rush out to buy any rail stocks: the tech signs are decidedly down, with *Market Edge* saying the only worthwhile market activity this week was shorting. Wednesday's report that consumer discretionary goods were at a new low did not help.

The week's technical downtrend in rail stocks pushed CN and RRA into short territory with NS and FEC right behind them. Warnings have been posted on CSX, GWR and KCS due to an increasing number of bearish indicators. And even though quarterly results have been encouraging, don't forget the trend is your friend. Repeated bounces off resistance are a good sign and we ought to be getting there soon. What follows may hasten that event.

At CSX the story is one of improving operating cost control and traffic mix. Revenues went up 10% and ops expense was held to 2%, leveraging a 72% improvement in ops income. Granted, the Conrail transaction took out $67 mm of expense since 1Q2004 and I pushed last year's restructuring charge below the line so we could see how the railroad is actually doing. The OR before the restructuring charge came in at a respectable 83.3, down 8.8 points yoy.

Operationally, CSX is still a Work in Progress. The Service Measurements (see www.csx.com for the PDF) show some degradation in yard dwells, cars-on-line, and re-crews. OT departures were down 5% but OT arrivals were off 20%, indicating trains aren't getting over the road in good shape. That squares with the 7% drop in system velocity to 19.5 MPH. We know that slower speeds increase the number of assets required to move a given volume of freight so these results have a cost.

Aggressive price increases in food and consumer, metals and forest products drove double-digit RPU increases on modest volumes. Across the board revenue gains were led by strength in the coal and merchandise markets, producing 20% and 8% yoy revenue gains, respectively. CEO Mike Ward said in the presentation that the outlook is favorable in most commodity groups with only auto off.

Below the line CSX booked a $425 mm cash credit for the International Terminals business, pushing eps growth into the stratosphere at $2.56 vs. $0.30; strip that out and it's $0.68 vs. $0.13, a nice change in anybody's book. We've seen some reports pushing CSX' 2005 and earnings estimates up 15% and 11% respectively with share price targets around $40. CSX closed Friday at $40.13, up 20 cents, and above resistance at $39.50.

BNSF rang up record first-quarter earnings of $0.83 per diluted share, a 60% increase over 1Q04 earnings of $0.52 per diluted share. In fact, over a period of only two years, BNSF has *doubled* its pre-accounting charge first-quarter earnings per share. Freight revenues for 1Q05 increased 18% yoy to an all-time first-quarter record of $2.9 bn. For the month of March 2005, BNSF's monthly revenues exceeded $1 billion for the first time ever.

All four commodity groups posted double-digit revenue increases giving BNSF the highest percentage yoy revenue gain of the Big Six. (Table 1). Double-digit revenue increases were recorded in all four business groups compared to the first quarter of 2004. Though BNSF includes automotive and “other consumer” in the same group as intermodal, I combine them with industrial products and ag to create a merchandise carload set of comps. It’s instructive to note that BNSF merch carload revenue is a lower percentage of the whole than anybody else yet has the highest RPU in $US *and* the greatest yoy change of the lot. Ag revenues were up 20% on strong export moves to Pacific Rim countries while Industrial Products revenues rose 15% on volume growth in the building products, petroleum and construction products sectors with both groups posting double-digit RPU gains.

Q1 operating expenses were up 13% on a 9% GTM increase and 31% higher fuel prices after hedge benefit. Once again, the positive spread between revenue gain and expense increase drove a 55% yoy gain in operating income, again Best of Show. The OR came down by five more points to a respectable 78.7 based on total revenues (The press release uses carload revenues only but I use total above-the-line operating revenue to keep the comps even.)

Elsewhere, the BNSF shortline program continues with the April 23 lease of some 22 route miles in and around St. Cloud MN to Northern Lines Railway, an Anacostia & Pacific property. Specifically, the leased lines include five miles from just west of BNSF’s St. Cloud yard to end-of-track in St. Joseph and a 17-mile spur from Rice Junction in St. Cloud to end-of-track west of Cold Spring. Dan Rickel, who has 25 years of rail experience, has been appointed president of NLR and is based at the railway's headquarters in St. Cloud.

It appears BNSF is moving more aggressively than its peers to involve shortline operators in the gathering and distribution aspects of its carload business. No doubt the operating income gains BNSF generates by keeping operating cost increase below revenue increases and exiting the low-margin local business helps. The way I see it both CSX and UP have too much railroad under their corporate umbrellas and would do well to step up the pace of branch line leases. They have the highest ORs in the land and this may be a contributing factor.

David Goode, Norfolk Southern CEO, opened the earnings call saying first quarter revenue and operating income set new records. Revenues and operating expense were both up 16%, holding the ops income gain to 16%. The OR came down two-tenths of a point to 79.4. However, the Graniteville SC derailment added $35 mm in casualties and claims; absent this the OR would have been 77.7, a better measure of actual RR performance. Moreover, operating income would have been up 27% as the ops expense increase would have been held to 13% -- see what a two-point spread can do?

Diluted eps grew 18% to $0.47 from $0.40; back out the accident hit and NS would have earned $0.52 a share, up 30% yoy. Reading between the lines of the accident reports, one may conclude that a momentary lapse of attention to best operating practices can have significant financial consequences. The good news is that NS has a top-notch safety record going back – how many? – consecutive Harriman Awards, and that the lapse was indeed momentary and eminently correctable.

Merch carload revenues increased double-digits everywhere but auto where a 6% gain in RPU offset a 5% decline in volume and generated a 1% yoy revenue gain for the group. Coal and intermodal posted 17% and 24% revenue gains respectively on 4% and 12% volume increases respectively. Overall traffic volume was up 6% on 3% more train starts, though the expense increase including Graniteville was triple the volume increase where we would have liked to see it go the other way.

In his remarks closing the conference call NS President Wick Moorman said NS has ordered 50 more locos (to be delivered in Q4), has ordered loco overhaul and car repair programs, and has continued the faster pace of T&E hiring. Finally, NS will be rolling out the Thoroughbred Operating Plan (TOP) to cover the intermodal network as well. That’ll cover about 75% of the revenue stream.

CP repeated the hat-trick of increasing revenues double-digits, increasing expenses at a lower rate, and posting a healthy ops income gain. Freight revenues increased 15% on just 8% more ops expense, generating a 54% ops income jump and taking 4.5 points out of the OR to 82.4 with fuel the biggest single increase, up 35% yoy. The healthy ops income gain fell mostly to the bottom line thanks to small changes in below-the-line items as eps more than tripled to C$0.50 from C$0.15 yoy.

Merch carload revs were up 13% led by double-digit gains in grain, industrial products and forest products. The sulfur and fertilizer group was up 7% in revenues on a 10% gain in carloads while RPU dropped 2%, indicating an unfavorable mix situation. On the other hand, coal revenues jumped 44% on a 10% volume decrease, pushing RPU up 60% -- more money, less work works every time. The recent retroactive rate agreement with Elk Valley Coal added $C17 mm so we have to expect a slower rate of change going forward.

CP also announced a C$160 mm track capacity enhancement program between the Prairies and the Vancouver Port. The work is scheduled for completion in Q4 and will allow CP to increase grain volumes alone by 400 cars a day, call it four trains each way. That's about C$800,000 a day in revenue. Add in merch, coal and intermodal capacity benefits and one can see why CP figures the added capacity could be worth C$025 to C$0.40 a share for FY 2006.

The D&H remains an enigma. CP has pretty much gotten out of anything east of Montreal and for good reason. The traditional strength of the D&H was as a bridge carrier between Eastern Canada and the NYC, Lackawanna, Lehigh Valley and CNJ. These flags have all fallen, replaced by the much larger CSX and NS systems, each with its own excellent routes to Canada. So what's a bridge carrier to do with nothing to bridge to? Haulage and trackage rights mostly, though with little organic revenue the future is bleak. No wonder the capacity expansion money goes west.

Comes a disturbing note from the Stratfor intelligence newsletter. The topic is railroad hazmat security and the argument is that every graffiti tag on a tank car is a security breach. If one can get to a car with a can of spray paint, then surely one can get to the same car with something more dangerous. And since railroad yards are not typically situated in the most posh or best-policed parts of town, it's pretty much Open Access.

Railroads participate in the chemical industry's Responsible Care program and protection of the goods in transit is a critical part of the process. Leaving cars sitting for a week at a time in a residential neighborhood with a lot of drug traffic, to cite one example, would not seem to be taking the tenets of Responsible Care seriously enough. To be continued. Feedback, anybody?

Commodity News: Arch Coal (NYSE: ACI) reported Q1 revenue up 49% to $600 mm with PRB volumes up 43%. The outlook for increased PRB production as rail service has improved and more utilities add greater amounts of PRB coal to their mix. Even though PRB is less polluting than Appalachian coal, it also has about a third of the heat content, meaning more carloads per mm BTU.

Table 1

Big Six Class I Commodity Carload Comps

Quarter ending 3/31/2005

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 2,982	$ 1,706	$ 1,014	$ 2,108	$ 1,961	$ 3,152
YOY Pct. Change	19.8%	18.6%	14.4%	9.8%	15.8%	8.9%
Carload revs (2)	$ 1,345	$ 1,277	$ 555	$ 1,270	$ 1,086	$ 1,812
Pct carload	45.1%	74.9%	54.7%	60.2%	55.4%	57.5%
Pct Intermodal	32.1%	16.8%	26.5%	15.6%	20.8%	16.6%
Pct Coal	20.1%	4.7%	16.9%	22.9%	23.8%	21.2%
Mdse Carloads (000)	685	789	286	879	716	994
Rev/CL x coal, IM	$ 1,900	$ 1,619	$ 1,939	$ 1,445	$ 1,517	$ 1,822
YOY Pct. Change	13.3%	-9.0%	8.6%	7.0%	10.2%	10.8%
Rev/IM CL equiv	$ 1,418	$ 1,660	$ 1,602	$ 1,059	$ 955	$ 1,217
IMCLE/avg CL rev (3)	75%	103%	83%	73%	63%	67%
RR Operating Income	$ 634	$ 526	$ 179	$ 351	$ 403	$ 313
YOY Pct. Change	54.6%	33.2%	54.3%	72.1%	16.5%	-0.3%
RR Operating Ratio	78.7%	69.2%	82.4%	83.3%	79.4%	90.1%
YOY Point change	(4.80)	(3.36)	(4.56)	(6.03)	(0.11)	0.93
GTM/gallon diesel fuel	748	812	796	742	709	751
Fuel/gallon (US$)	$ 1.13	$ 1.22	$ 1.40	$ 1.14	$ 1.13	$ 1.45
YOY Pct. Change	30.7%	24.3%	32.3%	17.3%	35.2%	42.2%

(1) CN, CP in $Canadian

(2) Excludes coal, intermodal

(3) Intermodal carload equivalent revenue as percentage of avg carload RPU

Table 2

Metric	**BNSF**	**CN**	**CP**	**CSX**	**NS**	**UP**
Rev Units 1Q05	2,408	1,187	648	1844	1,863	2,300
YOY Pct. Chg.	9.2%	21.5%	-1.4%	1.1%	6.0%	0.5%
Ops exp 1Q05	$ 2,348	$ 1,180	$ 835	$ 1,757	$ 1,558	$ 2,839
YOY Pct. Chg.	12.9%	13.1%	8.4%	2.4%	15.7%	10.1%
Ops Efficiency*	0.71	1.64	(0.17)	0.46	0.39	0.05

*Point change in revenue units per point change in ops expense

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