# THE RAILROAD WEEK IN REVIEW
## MAY 6, 2005

**RailAmerica at first glance** had a great quarter, earnings-wise. Earnings per share quadrupled to 17 cents vs. four cents yoy as interest expense dropped 46% to $4.4 mm and the provision for income taxes came down 58% to $1.2 mm (tax rate dropped to 17% from 38% thanks to the track maintenance tax credit program). Income from continuing operations increased 27% to $6 mm; quarterly net income after sales and income from discontinued operations was $6.2 mm vs. $1.3 mm or $0.17 a diluted share vs. $0.04 a year ago.

That's the good news. The bad news is that operating income before the gains on asset sales (I've never understood why they take this as a credit against ops exp) dropped 25% yoy to $11.6 mm from $15.5 mm. Operating revenue increased 15% to $110 mm however 11% of that is "other" such as leases and demurrage. Ops expense grew by 22% on $3 mm more for comp and benefits (to 36% of revs from 33%), 39% higher equipment rents and a 64% jump in casualty expense. The OR before asset sales was 89.5 vs. 83.9 a year ago.

Fuel expense went up 46% or $4 mm on a 12% decrease in burn and a 65% increase in price per gallon. Since shortlines don't generally score GTMs because (a) they're low and (b) hard to capture, it's instructive to look at gallons per revenue carload. I use 13 gallons per car as a benchmark based on a national survey I did a year ago and it's held pretty steady in my shortline consulting work. So when I see RRA at 24 gallons/revenue unit it raises questions.

Two big contributors to poor fuel use are bad track and old power that has not been kept up to peak performance. There are still a lot of shortlines using first generation GP-7s and 9s, but I don't know of many getting peak power out of them – I can think of only two. FRA class 1 or excepted track keeps speeds to 10 mph, meaning it takes twice as long to do the work as it would if the track met the 49 CFR Part 213 specs for class 2. The track tax credit program will help RRA here.

Freight revenues increased 15% to $99 mm on a 10% increase in revenue units handled and that's not bad. Put in the context of the 22% ops expense increase it's another story. Merchandise RPU ex-intermodal, coal and overhead traffic increased only 5% on a combination of mix and fuel surcharges. On a "same railroad" basis (last year's revenue reduced by lines sold since) Q1 revenue increased $8.7 mm, meaning acquisitions contributed 66% of the $13 mm revenue increase, and that's good.

Looking ahead, CFO Mike Howe says 60% of fuel use is protected by hedges and surcharges in equal parts and net debt-to-cap is a reasonable 47.4% so interest will take less of a bite. Using the track tax credit will hold down that below-the-line item even as it gets track speeds up and fuel consumption down. As we've said before, RRA is very much a Work in Progress. Writes Jon Langenfeld at Baird Equity Research, "RRA appears to be building momentum as it moves through 2005. Our concerns coming out of a disappointing 4Q04 centered on stagnant growth and a higher cost structure. We believe RRA is making operational progress as demonstrated by positive trends coming out of the first quarter."

**Genesee & Wyoming grew Q1 earnings** by 18% to $0.34 a share on a 24% North American operating income increase offset by a 39% (US$1.4 mm) decrease in ARG equity earnings. NA freight revenues were up 16% to $82 mm on 9% more revenue units. Switching revenues from the Rail Link division were up 19% along with double-digit revenue increases in paper, lumber, metals, chemicals, and coal, coke and ores. But across-the-board merchandise RPU was up only 4%.

Operating expenses were held to a 15% increase. Fuel was the big gainer, up 40% on a 38% jump in price per gallon and 2% more burn. Most other items decreased. See Table 1 for a comparison of RRA and GWR yoy expense line changes. I think there are two reasons for the spreads. First, GWR runs five regions of contiguous shortlines plus a stand-alone switching division whereas RRA has four dozen railroads with little or no connectivity outside of the Midwest. Second, GWR's been at it longer as RRA is just now evolving from the "any railroad any place" model to one of greater contiguity (watch this space for further proof of that pudding).

Back at GWR, same-railroad revenue increased by $8.7 mm, up 11%, with particular strength in paper, coal and lumber including manufactured wood products like plywood and OSB. Same-railroad volume increased by 4.8%, a good sign that the yield on the old business is getting better thanks to a combination of rate increases, fuel surcharges and mix.

Also this week GWR tapped Jim Benz COO and Billy Eason got the nod for Benz' old slot as President of the Rail Link division. Other Rail Link changes include Dave Rohan to VP Atlantic Shortlines with responsibility for seven railroads, and Charlie McBride to VP Gulf Central Shortlines with five roads under his belt. Both are new positions created specifically to manage Rail Link's growing portfolio of smaller properties not contiguous to the other GWR regional rails.

Says GWR Chairman Mort Filler, "Rail Link has experienced significant growth over the past several years primarily due to its success in the award of competitively bid business in industrial switching and Class I branch line spin-offs. This new business is in addition to acquisitions made by GWR and managed by Rail Link. We've been fortunate to have been able to attract and retain a team of experienced, high quality managers at Rail Link, which really has made this growth possible."

**Kansas City Southern breaks out** its railroad revenues by KCS on the one hand and KSC plus Mexrail and Tex-Mex on the other, calling them in the press release "US Domestic Operations." First quarter sales for these three properties came to $197 mm, up 34%, while ops expense increased 33% for a nice 43% ops income gain. The OR for the combined Mexrail and Tex-Mex was 107.9, improved from 1Q04's 113.

The press release includes carload data for KCSR only, and that's what we'll follow here. All six commodity groups posted double-digit quarterly revenue increases compared with the 2004 period. Volume increases were not quite as robust and so every commodity but auto (not surprisingly) saw double-digit RPU gains. The merch carload group generates more than two thirds of KCS' revenue and for the quarter delivered 23% more revenue on 9% more volume than a year go.

Operating expense increased 21% yoy and the spread produced a 27% ops income gain. Fuel, oddly enough, was the *second* biggest expense increase, behind casualty and insurance which doubled to $10 mm from $5 mm even after a favorable settlement of $2.4 mm.

Below the line, KCS lost $1.0 mm in Grupo TFM's equity and $1.8 mm in Panama. The TFM losses were partly the result of higher fuel expense and lower income tax benefit, though revenues increased 11% on 9% more volume. Panama Rail's loss was mainly due to the redemption of the International Finance Corporation preferred shares resulting in a $1.4 mm charge to KCS Equity. This swing in equity earnings, higher interest expense and a near-tripling of the income tax provision whittled down the nice ops income gain to a mere $6 mm net income, split 64.8 mm ways to $0.09 a share. Still, that's four-and-a-half times what is was in 1Q04.

**The hazmat security thread** (WIR 4/29) generated a lot of very helpful comments. One regular contributor writes, "Of course the industry should be doing more. It not only good public policy to do so, it's good business policy.  I doubt that any railroad wants to be in the same position as the major airlines found themselves after 9/11.  Had the airlines been taking security seriously, they and we might not have suffered the 9/11 terrorist attacks.  I'm sure airline executives trying to stay out of bankruptcy with their companies wish they had taken security more seriously.”

A rail safety professional writes, “Your note about tank car security is accurate enough; anyone can walk up to any stationary railroad car and lay their hands on it, especially when that car is not in a busy yard.  A spray paint can, bolt cutters, pry bar, or plastic explosive—there’s nothing to stop someone from doing something that we don’t want them to do.

“Apart from changes in the practice that allows loaded tank cars to be stored in unsecured locations while awaiting customer requests for delivery to their plants, which should be looked at carefully, some sort of technological monitoring seems like the most cost effective answer. But who is going to pay to develop, test, implement, and monitor this new technology?  Is it just going to be applied to the rail industry?  Are trucks and pipelines also vulnerable?  What about those thousands of containers that come in to our ports from abroad each week?

“In addition to the risk of an actual incident that causes harm to people and the environment, I worry about the effect that this new found concern about tank car security will have on the industry’s competitive position. This calls for sophisticated risk analysis to put the components of the problem into perspective and make some reasonable decisions.”

A shortline operator with considerable Class I experience sent this: “I concur with your bit about the graffiti-covered tank cars.  Securing our rights-of-way presents a seemingly insurmountable hurdle, but perhaps we can take steps to secure locations where cars are stored or trains are regularly stopped in populated areas.

As a car owner, I have to say that graffiti on our equipment drives me crazy - even when it's not tank cars of hazardous materials.  I suspect that it hurts our service image in the eyes of our customers as well.  I remember well the words of a former customer ‘Your car is the package for my product." That said, I support your idea about paint-outs and re-stencils being included in the AAR billing regime.  On another property we made a point about painting out graffiti on our boxcars when they returned to our line - we considered a graffiti-covered car to be a bad order.  Of course, we then were asked why we had some cars that are only half-painted.” But it’s a start.

**Truckload capacity growth is outstripping demand.** “New capacity coming into the industry is causing the gap between 2005 and 2004 to widen. In fact, adjusting for seasonality, our TL index is at its lowest levels since December 2003. This further suggests to us that new industry capacity continues to outstrip demand growth and we'll likely see weaker TL pricing going forward, which is consistent with our current forecasts.” – Chad Bruso, Morgan Stanley, in a research note.

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Table 1. Operating Expense Line Item
1Q05 vs 1Q04 change in basis points

| Exp Line | RRA | GWR |
|---|---|---|
| Comp & Benefits | 330 | (211) |
| Equip Rents | 377 | (12) |
| Purch Svcs | 137 | 19 |
| Diesel Fuel | 398 | 164 |
| Cas & Ins | 243 | (80) |
| Materials | 62 | (12) |
| Joint Facilities | 40 | na |
| Other Exp | 138 | 86 |
| Depreciation | 77 | (60) |
| **Total Ops Exp** | 1,801 | (106) |

Table 2.

**Small Class I and Shortline Holding Company Commodity Carload Comps**

**Quarter ending 3/31/2005**

**Revenue and income in $millions**

**North American Rail Operations Only**

| Metric | FEC | KCS* | GNWR | RRA |
|---|---|---|---|---|
| Railroad revs | $55.8 | $179.3 | $84.1 | $110.1 |
| YOY Pct. Change | 19.2% | 22.1% | 16.2% | 14.7% |
| Carload revs | $0.0 | $123.1 | $50.4 | $83.3 |
| Operating Income | $15.7 | $24.8 | $14.2 | $11.6 |
| YOY Pct. Change | 15.9% | 27.0% | 14.7% | -25.2% |
| RR Operating Ratio | 71.9% | 83.4% | 83.1% | 89.5% |
| Price/gallon of fuel | $ - | $1.35 | $1.60 | $1.62 |

* Does not include Mexrail or Tex-mex