THE RAILROAD WEEK IN REVIEW
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This week's NS Shortline meeting was direct, to the point and with a single theme: Times they are a-changing and here's how NS is managing change. VP Strategic Planning Dave Brown summed it up best. The rail industry is in the midst of a "shifting paradigm" going from shrinking the asset base to controlled growth, putting the assets where they will generate maximum return.

In other words, NS sees significant double-digit growth in many lanes – 40% Chattanooga-Memphis, 25% around Danville, KY, and between 10% and 13% on others. What we're seeing, says Brown, is a confluence of forces that favor rail: a strong economy and increasing freight volumes, highway and port congestion, driver shortages in trucking, record high fuel costs, and increased costs for capital equipment. NS has invested more than $136 mm in capacity improvements – chiefly in the former Conrail service area – since 2000 and has announced $20 mm for seven major projects in 2005.

NS some years ago divided its railroad into core, strategic and tactical lines. Using a nine-box matrix, line segments were classified by track condition and traffic yield as good, marginal and poor. By now the marginal and poor combos are pretty much gone. I don't see NS doing any significant line sales or other property transfers because, as Brown said, NS needs to preserve corridor access and capacity.

Shortlines benefit, too. This year, for the first time I can recall, there were virtually no operational complaints from the caucus group and annual survey. Last year's hot button – the Interline Service Agreement (ISA) – came off the table as NS introduced the ISA performance measurement tool. It's available through Access NS at www.nscorp.com and provides a chart showing actual compliance with the ISA agreement. This is a first for the industry and makes good the NS promise at last year's meeting to come up with such a tool.

Rate-making is another matter. I don't mean to single out NS but I'm increasingly of the mind that Class I pricing uses historical system averages where it ought to be lane specific. The data is there. Dave Brown said "a reliable network includes adequate infrastructure without choke points." Finding and fixing choke points infers knowing the relative costs of ways to get around them. That's what determines network capacity, reliability and speed and at the end of the day the relative costs of and pricing options for each lane.

Tom Peters' 1988 classic, *Thriving on Chaos*, makes the point that "sustainable profitability comes primarily through customers' perceived product quality vis-à-vis competitors." Thus one can charge more for a quality product because the customer sees it as worth more. Just as operations split up the railroad into core, strategic and tactical lines marketing needs to do likewise. Then tell the shortline owners what products to pitch and which to pull and pay them accordingly.

Paying the shortlines an FAK allowance makes all commodity O-D pairs equal in the eyes of the shortline operator. He's looking to generate carloads irrespective of what's in 'em as long as he perceives a customer need. No wonder he's miffed when he takes this opportunity to his connecting Class I and is rebuffed. But if he knows a short-haul box of rocks won't work because his Class I counterpart says so, and is paid accordingly, he'll look elsewhere.

That's the beauty of pricing to the market. But the Class Is have to extend certain commodity lanes' ability to generate premium rates to their shortline partners with the opportunity to earn higher per-car allowances. Higher rates do not equate to "non-competitive pricing" (a common shortline complaint) if the traffic still moves. But if a rate high enough to cover the cost of the move does not move the traffic, that's deficit traffic and harvesting is a very real option.

Bottom line, we've all got to get away from cost-plus pricing. Part of the paradigm shift is to market pricing and that means knowing whether one can produce a profitable competitive to play in the given market. And that's the direction that NS is embarked on. The 230+ shortlines doing business with NS handle about 2.2 mm revenue units a year, excluding the big switching (BRC e.g.) and steel (EJ&E e.g.) roads. Of these, fewer than 100 roads handle 90% of the 2.2 mm figure. These are they guys NS needs to tell what they want and hear what each shortline can provide in support.

Confirmed: tax credit program for track rehab (WIR 6/3/2005) is not well understood in the shortline community. At the NS meeting I spoke with a number of representatives from the smaller roads and the consensus appears to be "no income, no tax, no credit." When I got into the "Eligible Taxpayer" concept you could see the light bulbs going on.

We uncovered an opportunity for a transload customer to earn credits rehabbing the city-owned shortline where he is the major customer. There's a county-owned shortline with a developer who needs better track than he's got. Ditto for some privately-owned properties. Moreover, what the third parties contribute counts toward matching state rail preservation funding. In any event, shortlines considering the tax credit program will want to check with their tax advisors first.

The tone of the mail and personal contacts is the shortline allowance model is in fact broken (WIR 5/27/2005) though how to fix it has taken an interesting twist. It appears there may be accounting rules that prohibit paying shortlines as an operating expense. If such is the case, another way to fix the model is to give market managers extra credit for including shortlines.

If the goal is to preserve corridor access and capacity, and it's generally agreed shortlines have capacity where the Class Is are challenged, then having a shortline in the route ought to be a plus, not a minus. Recall the BNSF model is to turn gathering and distribution over to shortlines in part to free up expensive assets. I know where Class Is will entertain gathering rates for grain trains if they can assemble trains and the Class I cannot. And NS said just this week TOP-2 seeks to deal with record volumes by minimizing unscheduled and extra trains.

Shortlines, particularly those with significant feeder capacity, are uniquely suited to support these models. I would also submit that where shortlines use a light-density Class I lane to connect the dots and feed the Class I core, then the trackage rights fees earned should go to the enabling market manager, not into some amorphous "joint facilities" bucket. That said, the usual 31 cents a vehicle-mile won't do. Fees have to reflect incremental GTMs and the related incremental capex and maintenance costs plus mark-up. A buck-thirty a car seems to be the working number in many cases.

Determining incremental capex can be difficult unless you can capture GTMs and shortlines are not generally in the business of counting anything but carloads. In the past one could approximate with loaded and empty weights plus loco weights times miles, but it was always a guess at best. Now, however, both Railinc and RMI have products that can help. Be sure to check their websites or call your sales rep for assistance.

Peabody Coal (NYSE:BTU) took off like a shot Friday, opening at $50.40 after closing at $50.04 Thursday and running up to $52.91 in the first hour of trading before settling down to $52.20 by mid-afternoon. The company predicted in mid-April that it would earn from $2.50-$3.10 per share this year and now First Call shows the *average* estimate at $3 even. This is a company that has consistently exceeded forecasts and 3Q05, CY05 and CY06 estimates have risen accordingly over the past 90 days. Not coincidentally, MarketEdge ® upgraded both BTU and competitor Arch Coal (NYSE: ACI) to BUY ratings this week.

By way of review, BTU owns and operates 32 mines in the PRB, Appalachia, and the Colorado basin, with 300 mm tons of reserves in the PRB alone. BNSF and UP are expected to be the primary PRB beneficiaries with GWR's Utah RR having a hand in Utah. Western coal volumes were up 2.5% yoy through Week 22 (June 4) but the short week and a pair of derailments in the PRB took their toll. In the east, CSX and NS yoy coal traffic increased 8.1% and 4.2% respectively.

Rail freight volumes for Week 22 were up an anemic 1.3% overall. Primary forest products and grain mill products increased 16.2% and 14.8% respectively and intermodal inched up 2.8%. YTD volume increased 2.5% yoy with coke, ores and aggregates up 9.2%, 5.4% and 8.1% respectively and intermodal up 5% yoy. KCS took top honors for Week 22 with total loadings up 6.5% followed by NS at 4.4%. KCS also captured the brass rung for commodity carloads, up 8.2% followed by Canadian National at 4.2%.

BNSF volumes YTD were up 7.6% followed by KCS with a 6.6% increase in revenue units. On the commodity side of the house, it was KCS again, up 10.9% with nobody else even close – second slot went to BNSF at 2.9%. Meager, perhaps, but it's better than being a trucker. Jim Valentine reports that "we see the best prospects for select railroad stocks followed by FDX, whereas we are cautious about owning the trucks."

Similarly, Ken Hoexter of Merrill Lynch says truck stock prices are "in a rut because of rising driver pay and because of the addition of capacity." One factor is the need for some carriers to increase driver pay by 50% to attract more drivers. But the hard fact is that hours of service laws will mean more drivers to do the same work.

Which gets us back to lane-specific service design and pricing. My sense is that shortline operators who live in the same communities with their customers will know sooner what works and at what price than their Class I counterparts. The truckers' travails have only just begun and the shortline with a sharp customer focus on the customer's supply chain requirements will do quite well.

Rail stock prices languished along with the DJIA this week. The US Big Four plus KCS were down two to four percent to the Dow's no change; CN slipped 2% and CP was off 6% by week's end. RRA was unchanged while GWR and FEC both shed 2%.

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