THE RAILROAD WEEK IN REVIEW
OCTOBER 21, 2005

Shortline operators in the ASLRRA's Eastern Region gathered in Pittsburgh for their annual meeting and all seem to agree it was one of the best. The presentations dealt with real issues from eminent domain (Kelo fallout) to shipper satisfaction (Todd Hunter's panel did not give the class Is exactly rave reviews). Several themes emerged. First, even as State DOTs are committing $millions to shortline infrastructure to support the single-carload business, Class Is' actions show a distinct movement away from small-lot customers. Worse, what'll happen to all those singe-car shipments when they hit a network already clogged with intermodal coal, grain and automotive unit trains?

Second, the Class Is have a huge opportunity to decide what they want to be. My shortline contacts tell me the big roads ought not to say on the one hand they are looking more to multi-car movements of high-rated commodities and then hang on like grim death to shippers of low-rated commodities in lanes where the shortline would be the more rational provider. Either-or; A is A.

Third, I came away impressed that many shortline operators know more about Class I costs by lane than they get credit for. Said one shipper, "The shortline understands our business model and we feel that their knowledge plus the trunk line advantages of the Class can together create a more useful transportation product than what they offer now."

Lastly there are still some shortlines that are their own worst enemies. ASLRRA President Rich Timmons cites a shortline population of more than 500 properties nation-wide. Yet Judy Petri, chair of the Shortline Integration Team that heads up the event reporting effort, says that among the Big Six Class Is there are still more than 50 shortlines that are behind the curve in this effort. A large number of the non-reporters do less than 1,000 loads a year, and if anybody needs help, they do, lest they be found redundant.

When I asked Judy what she thought was the biggest single reason for non-compliance, she said, "Attitude." It may be a holdover from the early days when shortliners thought event reporting was an evil invention of the Class Is. The unfortunate part is that proper event reporting can save car hire and add value to the transportation product offered. One shortliner from upstate NY told me how the "velocity report" actually helped him with a particularly difficult customer who thought the rails were sitting on his shipments.

Elsewhere, the conversations during the breaks and the social events were as illuminating as the presentations themselves. I found out that paper barriers can even help to build trade, now that the Railway Industry Working Group has defined what constitutes "new business." We talked about car cycle time and one leasing company rep told me their shortline experience has been outstanding.

Rail Freight Assistance programs in NY, Penna and Ohio have doled out a total of nearly $100 mm in infrastructure funding to their shortlines this year. This presents a bit of a dilemma. Here the states are funding projects to increase single-car business even as the Class Is seem to be heading way from that business. But the good news is that where there is profitable single-car business to be had the Class Is are ready to take it.

I'm reminded of Jim Giblin's Lexington Group presentation in Harrisburg three weeks ago. He said that all transportation products have three components: pick-up and delivery, terminal time and the long haul. Trucks, he said excel at all three where as the rails can do only the non-stop long-haul really well. In a follow-up note this week, Jim writes, "Shortlines and regionals are at higher risk than

Class Is when it comes to the whole issue of increasing service requirements and truck transportation. As I said at Harrisburg, transportation consists of three segments and rails only do well on the line-haul portion. The danger here is that the shortlines are usually responsible for the two portions where rails do the poorest (terminals and PU&D).

"The Class Is realize and understand the terminal-PU&D issue and that's why we see so much emphasis on the concept of network simplification and ideas like BNSF's Logistics Park. This is great for shippers and the supply chain but has the real potential of leaving the shortlines out in the cold. The key here is for the shortlines to find ways to reduce and eliminate delays in terminal operations and the PU&D function."

Which segues into the "protecting the franchise" notion. If the Class I rails are poorest at PU&D, how can these services remain part of the franchise? It's something every other service provider can do better – from the shortline to the highway hauler – and nobody else would want to do it the same way as the incumbent Class I anyway. Since PU&D the Class I way has no value to anybody else, it has no value as a franchise. Ergo "protecting the value of [that] franchise" in effect becomes "protecting the value of nothing."

I think the leading shortline operators, based on what I saw and heard this week, understand that their business is service delivery and railroading is the technology they use in their business model. The smaller shortline owners seem to lose sight of the business-technology proposition and view their business as – Giblin again-- "running a giant Lionel set rather than a transportation company."

And that's what these meetings ought to be about: building a successful transportation service company first and fine-tuning the technology second. My only quibble with the ASLRRA program is that there was just one, and toward the end of Day Two at that, presentation on business development out of 12 sessions over a day and a half. Next time let's push for more on how to make the PU&D-terminal portion of our technology better suited to the transportation product the shipping public demands. Because if *we* don't, you know who will.

Canadian National in 3Q05 took its operating ratio down another two points to 63.3 on 5% more revenue while holding ops expense to a 2% increase, increasing ops income by 12%. (Revenue, carload and expense data were reclassified to be consistent with 2005 data and reflect CN's results as if GLT and BCR had been acquired 1/1/2004.) Shareholders benefited from 15% and 21% gains in net income and eps as the share-buyback program reduced the diluted share count by 4%.

RPU increased 6% on no real change in the number of revenue units handled, thanks mostly to increased freight rates. An important contributor was a higher fuel surcharge (though they didn't day how much) owing to increased crude oil prices. Partly offsetting revenue gains during the quarter was the unfavorable $80 mm foreign exchange effect. Grain and fertilizer revenues benefited from higher export shipments of Canadian peas, barley and canola, while improved coal revenues reflected metallurgical coal shipments originating at new mines in western Canada.

Strong container imports over the Port of Vancouver helped to increase intermodal revenues. CN also enjoyed strong demand for construction materials, which benefited its forest products and metals and minerals revenues. Automotive revenues increased in part as a result of higher imports of vehicles over the ports of Vancouver and Halifax and increased finished vehicle traffic in the southern U.S. Petroleum and chemicals revenues were adversely affected by soft market conditions and reduced petrochemical production in the hurricane-stricken Gulf Coast region.

Third quarter ops expense was held in check by cutting equipment rents by 27%, labor and fringe by 3% and purchased services by 2%, partially offsetting the 36% hike in fuel expense CN paid for 1% more fuel burn on 2% more GTMs. The $50 mm FX benefit helped, too. Out on the railroad, CN generated C$40.74 per RTM at a cost of C$25.77 per RTM, yielding a healthy 1.6 revenue-cost ratio.

CN still leads the pack in carload revenues with 73% of revenues coming from the merch (non-coal, IM) side of the house. (Nobody else has reported but with a 12-point spread with second-place UP in Q2, it's unlikely CN will yield the top spot). But what's amazing to me is that CN manages a 63 OR with a traffic density of about 63 revenue loads per route mile.

As to the rest of the year, CN said at the conference call that the merchandise outlook is favorable, there are "solid prospects" for the bulk franchise and pricing remains strong. Next week we hear from BNSF and CP (Tuesday), NS, CSX and RRA (Wednesday) and UP (Thursday). Let's see how the others do.

BNSF holds it annual shortline meeting this coming Sunday evening through Tuesday lunch and the agenda looks squarely at the service delivery business. The technology presentations follow and support the business sessions, and that's as it should be. Writing *finis* on Monday's meeting is a discussion of fuel surcharge sharing, and, as it happens, BNSF this week confirmed that its mileage-based FSC program for coal and ag kicks in 1/1/2006. An effective date for the mileage-based program for intermodal, automotive and other carload customers will be announced later.

According to BNSF Chief Marketing Officer John Lanigan, "Customer feedback indicates that while a mileage-based fuel surcharge program is considered more fair and equitable than the current percentage-based program, some customers need more time to make adjustments to their own information systems to accommodate the new program."

BNSF is making and testing the changes to its information systems required to implement the mileage-based fuel surcharge program, and expects to complete that process later this year. For agricultural products customers, the mileage-based fuel surcharge will reflect rail mileage between origin and destination points instead of highway mileage as originally announced. For coal unit-train customers, the mileage-based fuel surcharge will be based on rail mileage between origin and destination points, as originally announced. See also BNSF's on-line rail mileage inquiry tool at http://www.bnsf.com/bnsf.was5/RailMiles/RMCentralController .

Intermodal, automotive and carload customers other than coal and agricultural products customers will continue to pay a fuel surcharge based on percentage of their freight transportation bills until a change-over is announced at a later date. Non-Rule 11 interline shipments also will continue to use the percentage-based fuel surcharge because the system used by the rail industry to electronically exchange interline billing and settlement information cannot accommodate a mileage-based fuel surcharge.

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