THE RAILROAD WEEK IN REVIEW
OCTOBER 28, 2005

Over the past week or so we've spoken with a number of WIR friends and subscribers at two shortline meetings (ASLRRA Eastern Region and BNSF) and have come away with some helpful insights. It seems the most well-received aspect of WIR is the commentary and feedback. Technical stock market stuff generates the least interest.

Accordingly, you may expect four things from WIR going forward. First, we will continue to emphasize what works best for the shortline-Class I-customer relationship. For example, senior managers from NS and BNSF have reiterated to me just this week that me the most valuable shortline relationships are the ones that maximize the efficient use of the assets of both. We will push that idea.

Second, the Class Is are paying close attention to customer supply chains because the fortunes of the railroads and their customers are inextricably linked. WIR will thus increase coverage of trends in the usual merch groups from chems to forest products to aggregates and agriculture. Third, we were struck by the ASLRRA Eastern Region meeting's heavy emphasis on the mechanics of running trains almost to the exclusion of the care and feeding of customers. With no customers you've got no reason to play trains. WIR will follow the money and talk ops only when it means making more money.

Fourth, WIR's quarterly earnings reports will focus more on cause and effect in the carload business and less on what's happening bellow the line. I'm a firm believer that yoy revenue changes tell one more about a company than eps ever will. And to get things rolling this week we'll start with a summary of the BNSF shortline meeting and seque from there into Q3 results for BNSF and others reporting this week. Commercial first, then financials and mechanics last. We'll carry that theme forward through earnings season.

BNSF's 180+ Shortline connections operate some 19,000 miles of track and will handle more than 1 mm revenue loads in 2005, a third again more than the 755,000 handled in 2000 and representing a 7.3% CAGR. The BNSF system average RPU for calendar 2004 was nearly $1,100 so the shortlines in 2005 will touch loads representing revenues of about $1.1 bn , of which the shortlines will share roughly $200 mm in divisions and allowances.

Clearly this is not pocket change. So it's no surprise BNSF really rolled out the red carpet to more than 150 shortline representatives for the annual shortline meeting in Ft Worth this week. For the first time that I can recall somebody actually suggested in open forum the traditional carload model is broken, as did Dave Garin, Industrial Products Group VP on Monday. His remarks were framed by another shortline first, a briefing on the global economy by Sam Kyie, Chief Ecomonist for BNSF.

Dave talked very candidly about the "Last Mile Team" that seeks to find solutions to the gathering and distribution inefficiencies that plague our industry and what shortlines can do about it. His remarks were essentially a continuation of the pick-up and delivery (PU&D) theme that's been running here, only this time BNSF offers another first: the AIM process, and shortlines are invited. First is Assessing the Carload Product, then comes Improving the Carload Model and then Maximizing the Carload Network.

Much of the Q&A following this session dealt with understanding the customer's logistical process and tweaking local switching can make that process work better. The federally-mandated 12 hours per crew-start is the limiting factor and nobody can afford to spend six hours drilling one customer. Sometimes all that's needed is some creative trackwork, and BNSF is ready to collaborate. With 856 yard and local crew-starts every day, BNSF has a very big incentive to identify the shortlines that can do it better, and if that requires some track, it's a small price if it makes the model work better.

John Lanigan and Carl Ice, Chief Commercial Officer and Chief Operating Officer, did a great tag-team session on meeting future challenges: what's coming down the pike, how BNSF is coping with the accelerating rate of volume growth and shortline growth by commodity through August 2005. Lanigan said the previously stated goal of having all commodity groups cover their cost of capital is on target, meaning that shortlines will want to watch their BNSF revenue-cost ratios carefully. Nobody's ever put it in exactly these terms before.

All of which led up to a spirited discussion on fuel surcharge (FSC) payments and the car hire reclaim program. The idea is to create a formula by which shortlines earn a portion of total FSC revenue based on the number of revenue units handled in the period. Next BNSF proposes to simplify the reclaim process so that it more closely reflects the total car hire exposure by shortline and incents the shortlines to turn cars faster.

Both are firsts in the shortline arena, and both generated a lot of interesting comment both in the session and at the evening reception. As one might expect, there was much discussion both during the presentation and after, and many questions were raised. But the key take-away is that at least BNSF did the heavy lifting to get the dialog going.

Let me wrap up this discussion by observing that every presenter's slide format was the same. Now that may not seem like a big deal, except that it shows an attention to detail one expects at analyst meetings but rarely sees at shortline presentations. By according the shortline audience the same degree of care and consistency BNSF accords Wall Street, it raises the bar in terms of expectations. On both sides. And that's a very good thing.

Earnings Week continued with reports from the other five Big Six Class Is (CN did its thing last week) plus FEC and RRA. Let me comment briefly on the Class Is and reserve analysis of the other two for next week when we hear from GWR and KCS to round out the earnings season. Table 1 summarizes Class I Q3 performance and a few important themes emerge. Freight revenues increased by double-digits in four of six cases and on meager volume gains in every instance.

Merchandise RPU went up nicely for BNSF, NS and UP and system RPU increased by double-digits on four of six roads. Operating income was up double-digits across the board with BNSF and CSX showing the strongest gains. Operating ratio changes ranged from down four-plus points (CSX) to up three-quarters of a point (NS) and that largely related to the near doubling of fuel prices yoy.

Something new this quarter is Table 2, Class I operating efficiency. Here I've attempted to capture the relationship between and among operating revenue and expense, gross ton-miles and revenue ton-miles, system revenue-cost ratios, productivity and some fuel metrics. Hope you find it useful.

BNSF freight revenues increased to a record $3.3 bn, up 18%, ops expenses were up 14% excluding last year's asbestos charge, operating income was up a respectable 38%, and the OR came down three more points to 76.5 (BNSF calculates OR as ops expense less non-freight revenue divided by freight revenue, fair enough as no rail assets are used to generate "other" revenue and might well be eligible for inclusion below the line.)

Merch revenues increased 35% on double-digit gains across the board on just 2% more volume. Longer hauls produced $131 mm in revenues, another $164 mm came from better pricing and fuel surcharges added another $200 mm, a quarter of which came from industrial products. In Q4 revenue gains will again be in the mid-teens, the OR about 76 as BNSF continues to work on service, velocity and asset utilization. Of particular interest to shortlines, the outlook is quite favorable for grain exports and broad-based industrial products revenue gains. Put that together with the series of firsts for the shortline meeting and one can conclude this is a very good time to be a BNSF shortline.

Union Pacific revenues increased 13% over 3Q04 on just 1% more volume, though automotive, chems and industrial products yoy volumes all came down slightly. Coal was off 3% yoy thanks in part to the track problems in the southern PRB. By comparison, BNSF coal was up 6% but remember they have the northern half of the PRB to themselves. Also note that UP assigns a separate commodity group to chems while BNSF puts that group under the industrial products group.

Mix and pricing gave UP am 11% gain in system RPU while improved merch yields produced a 16% RPU increase. This is particularly beneficial as the merch group generated 58% of Q3 revenue to 44% over at BNSF while the latter has the stronger IM franchise producing 44% of revenues to UP's 19%. Out on the railroad UP ops expenses were up 12% yoy driven mainly by a 50% increase in the price of diesel fuel. Still, UP fuel consumption was held to 1% more on flat GTMs though the revenue-cost ratio of 1.12 (ops expense per RTM over ops expense per GTM) was the lowest of all Class Is.

UP mentioned its "Customer Inventory Management System" or CIMS during the conference call (slide 33). Evidently it has something to do with railroad assistance in customer inventory control and planning, much as we touched on above in our discussion of the BNSF shortline meeting. If this is so then CIMS ought to occupy a prominent place at www.up.com. Unfortunately it does not, and that's the only blot I found on what was otherwise an encouraging call.

Canadian Pacific bested its north of the border neighbor CN in revenue growth (12% to 5%), in average merch RPU increase (6% to 5%) and in operating income gain (14% to 12%). Pricing played a key role as merch volumes grew by 5% on a one-point volume decline. Grain and industrial products produced the only double-digit revenue gains in the merch carload group while coal sales produced a whopping 38% gain.

On the expense side if the ledger CP held operating costs to a 1% gain, again exacerbated by a 30% increase in fuel expense even though fuel burn was unchanged on 1% more GTMs. However, when one considers that GTMS have been increasing at a rate of 6-7% a quarter YTD and that system velocity is 10% better than it was January 1 at 25 MPH, one must say CP has done its homework on fuel consumption. At US$1.62 a gallon average in Q3, second highest after UP, the effort has paid off handsomely.

CSX revenues lagged arch-competitor NS in both absolute dollars ($2,125 mm to $2,155 mm) and yoy percent change (9% to 16%). However, CSX is a stronger carload railroad (59% to 53% of revenues), generating double-digit revenue gains in five of nine commodity groups and 8% more yoy revenue for the carload group as a whole on unchanged volumes, indicating the favorable pricing environment shines on Jax as well. Intermodal was a disappointment with just 3% more revenue on 3% fewer units.

Operating expense increased only 4%, and that, against the 9% revenue gain, hatched a 44% yoy ops income gain. CSX finally is getting the same leverage we've seen elsewhere: higher gains in revenue than expense yields significantly higher gains in ops income while taking the OR down dramatically. In this case, it was down 4 points to 83.0 after accounting adjustments and the best yoy improvement of any Class I, even CN. During the call COO Tony Ingram noted that yoy service metrics (dwell, cars-on-line, system velocity) have at least stabilized, and that's to the good.

Given a continued favorable pricing environment, a now-proven ability to improve carload yields, and the network focus announced last August, carload shippers and shortlines can look forward to better service and lower landed costs.

Norfolk Southern quarterly revenues increased 16% though the 17% gain in ops expense did not provide the kind of operating income leverage we've become accustomed to. Even after the 61% drop in Conrail-related expenses the doubling of fuel expense and casualty expense (read South Carolina incident plus Katrina) conspired to push total ops expense up by 17%, producing a smallish (for NS) yoy operating income gain of only 13%.

Good thing Don Seale (EVP merch, auto, coal) and Mike McClellan (VP Intermodal) are out there beating the bushes for more and better revenues. Sales for every commodity group but auto were up double-digits even as total unit volume increased only 4%. The average merch carload RPU was up a healthy 14%, besting CSX and the Canadians (sounds like a singing group, eh?). NS also wins the prize for highest revenue-cost ratio among US rails and second only to CN among the Big Six.

On a personal note, I happen to think Norfolk Southern's Local Operating Plan Adherence (LOPA) metric is the best tool out there for measuring gathering and distribution performance. That in combination with TOP-2, the Operating Plan Developer (OPD) and Algorithmic Blocking and Classification (ABC) model provides NS a superior means of measuring performance by commodity lane and being able to price accordingly.

In conclusion, I said I wasn't going to dwell on what happens below the line in eps and so forth. However, it is important to note that earnings are up by percentages we're only used to seeing in dot-coms. Moreover, we're seeing more share buybacks and even some dividend increases. As Morgan Stanley's Jim Valentine writes in a note to clients, the rails are becoming less cyclical and more secular as pricing, marketing and cost control even out the quarterly and yoy variations in performance. For an industry that's been perceived as in decline for three decades, that's progress.

ERRATA: WIR for 10/21/2004 reported CN's revenue units per mile on a quarterly rather than the more customary annual basis. CN's Phil Clappison, Manager of Network Strategies, writes that for calendar year 2004 CN handled 4,654,000 loads over 19,304 route-miles for a traffic density of 242 cars per mile per year. Phil also caught my decimal errors in revenue and cost per RTM. What I reported as revenue of $40.74 per RTM and cost of $25.77 per RTM should have been $0.04074 and $0.02577 respectively. Thanks, Phil.

Table 1
Big Six Class I Commodity Carload Comps
Quarter ending 9/30/2005
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 3,317	$ 1,810	$ 1,105	$ 2,125	$ 2,155	$ 3,461
YOY Pct. Change	18.8%	5.3%	11.6%	9.4%	16.0%	12.5%
Total revenue units	2,570	1,216	670	1,819	1,992	2,433
YOY Pct. Change	4.2%	0.2%	-0.1%	0.1%	4.6%	1.1%
Carload revs (2)	$ 1,463	$ 1,311	$ 592	$ 1,249	$ 1,138	$ 1,999
Pct carload	44.1%	72.4%	53.6%	58.8%	52.8%	57.8%
Pct Intermodal	34.2%	18.3%	26.7%	15.9%	21.9%	18.8%
Pct Coal	18.8%	4.1%	17.5%	24.1%	25.3%	18.8%
Mdse Carloads (000)	702	781	286	833	713	1,026
Rev/CL x coal, IM	$ 2,035	$ 1,679	$ 2,070	$ 1,499	$ 1,596	$ 1,948
YOY Pct. Change	18.2%	5.4%	6.3%	8.3%	13.9%	16.4%
RR Avg RPU	$ 1,252	$ 1,416	$ 1,585	$ 1,168	$ 1,082	$ 1,357
YOY Pct. Change	12.8%	5.4%	12.0%	9.2%	11.0%	10.9%
RR Operating Income	$ 778	$ 665	$ 250	$ 361	$ 528	$ 481
YOY Pct. Change	37.7%	11.6%	14.2%	44.4%	12.6%	15.1%
RR Operating Ratio	75.8%	63.3%	77.4%	83.0%	75.5%	86.1%
YOY Point change	(3.54)	(2.07)	(0.50)	(4.12)	0.75	(0.31)
GTM/gallon diesel fuel	772	879	888	805	771	789
Fuel/gallon (US$)	$ 1.43	$ 1.44	$ 1.62	$ 1.34	$ 1.52	$ 1.88
YOY Pct. Change	44.7%	34.7%	30.3%	17.5%	87.6%	50.4%

Nine Months ending 9/30/2005
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 9,437	$ 5,354	$ 3,225	**$ 6,399**	$ 6,270	$ 9,502
YOY Pct. Change	18.4%	6.3%	11.9%	9.2%	16.9%	10.2%
Carload revs (2)	$ 4,219	$ 3,921	$ 1,744	$ 3,767	$ 3,372	$ 5,782
Pct carload	44.7%	73.2%	54.1%	58.9%	53.8%	60.9%
Pct Intermodal	33.2%	17.4%	26.0%	15.6%	20.8%	17.8%
Pct Coal	19.2%	4.8%	17.8%	24.4%	25.4%	19.6%
Mdse Carloads (000)	2,143	2,292	880	**2,558**	2,175	3,078
Rev/CL x coal, IM	$ 1,969	$ 1,711	$ 1,982	$ 1,473	$ 1,550	$ 1,878
YOY Pct. Change	15.2%	5.4%	6.0%	7.7%	13.9%	13.1%
RR Avg RPU	$ 1,231	$ 1,406	$ 1,554	$ 1,157	$ 1,081	$ 1,334
YOY Pct. Change	10.7%	-2.3%	13.9%	9.5%	11.0%	9.3%
RR Operating Income	$ 2,122	$ 1,904	$ 700	$ 1,134	$ 1,523	$ 1,262
YOY Pct. Change	108.4%	17.5%	26.1%	**66.4%**	22.8%	15.7%
RR Operating Ratio	77.5%	64.4%	78.3%	82.3%	75.7%	87.3%
YOY Point change	(3.54)	(2.07)	(2.44)	(4.28)	0.75	(0.55)
GTM/gallon diesel fuel	758	565	846	778	749	772
Fuel/gal (local currency)	$ 1.30	$ 1.74	$ 1.98	$ 1.22	$ 1.30	$ 1.66
YOY Pct. Change	37.6%	25.7%	31.9%	18.1%	87.6%	45.6%

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal

Table 2

Big Six Class I Operating Efficiency

Quarter Ending 9/30/2005

Revenue and income in $millions local currency

Metric	BNSF	CN	CP	CSX	NS	UP
Freight Revenues	$ 3,218	$ 1,810	$ 1,105	$ 2,125	$ 2,155	$ 3,461
RR Operating Expense	$ 2,539	$ 1,145	$ 855	$ 1,764	$ 1,627	$ 2,980
RR Operating Income*	$ 778	$ 665	$ 250	$ 361	$ 528	$ 481
GTM in millions	269,596	84,384	59,510	113,200	95,900	263,400
RTM in millions	151,419	44,425	30,825	60,200	51,200	138,200
Revenue Loads	2,570	1,216	670	1,168	1,992	2,433
Route Miles	32,181	19,221	14,000	22,000	21,300	33,000
Avg Emps in Q	39,923	22,233	16,959	33,991	30,084	49,388
Fuel Exp ($mm)	$ 499	$ 181	$ 142	$ 188	$ 189	$ 628
FSC collected ($mm)	$ 296	$ 139	$ 38	na	na	$ 271
Fuel Cons (mm USG)	349	96	67	141	124	334
EPS after items	$ 1.09	$ 1.47	$ 1.28	$ 0.72	$ 0.73	$ 1.38
YOY change	42%	24%	15%	31%	27%	80%

* From railroad operations before adjustments

Measures	BNSF	CN	CP	CSX	NS	UP
Operating Ratio	75.8	63.3	77.4	83.0	75.5	86.1
Ops exp/GTM	$ 0.0094	$ 0.0136	$ 0.0144	$ 0.0156	$ 0.0170	$ 0.0113
Ops exp/RTM	$ 0.0168	$ 0.0258	$ 0.0277	$ 0.0293	$ 0.0318	$ 0.0216
Frt Rev/RTM	$ 0.0213	$ 0.0407	$ 0.0358	$ 0.0353	$ 0.0421	$ 0.0250
Rev/Cost Ratio	$ 1.27	$ 1.58	$ 1.29	$ 1.20	$ 1.32	$ 1.16
MRTM/MGTM	0.56	0.53	0.52	0.53	0.53	0.52
MGTM/avg emps	6,753	3,795	3,509	3,330	3,188	5,333
Emps/Route-mile	1.24	1.16	1.21	1.55	1.41	1.50
MGTM/gallon	772	879	888	805	771	789
Fuel Cost recovery	59.3%	76.8%	26.7%	na	na	43.2%
YTD FCF in $mm YTD*	$ 659	$ 1,011	$ 60	$ (13)	$ 883	$ (158)
Debt/Capitalization	37.1%	35.1%	35.9%	48.3%	43.8%	42.7%

***Cash from ops less capex less divs pd**