THE RAILROAD WEEK IN REVIEW
DECEMBER 2, 2005

"We believe that service and value for our customers will support ongoing yield improvement in 2006 and beyond." – Don Seale, EVP Sales and Marketing, Norfolk Southern

The US Economy grew at a 4.3% annual rate in the third quarter, according to the US Commerce Dept. It was a faster pace than initially thought, as spending by consumers and business climbed. That's the good news. The bad news is the Class I rails may not be sharing in it. The AAR reports that 3Q05 total rail units increased a paltry 3.0% yoy (table attached). IM took the lead, naturally, up 6.2% with coal essentially flat, leaving commodity carloads (merch loads to you and me) up 0.9%.

RMI's RailConnect shortline Traffic report (attached) gives us YTD figures for each week. Subtracting YTD revenue units for week 26 from those umbers for week 39 gives us the Q3 shortline revenue unit delta, and it suggests that the shortline growth may be tempering the Class I's more modest performance. Total Q3 shortline units were up 15.7% with intermodal up 26.5% and coal up 34%, leaving merch carloads up 11.5% yoy.

This comes as a bit of a surprise as I wouldn't have thought IM was that important to the shortlines. After checking with RMI, I have to say it really isn't that important to the shortline community at large. The numbers are skewed by all the port railroads that are treated as Class III rails and thus the IM units they transfer to the Class Is get counted. In sum, the Class II and III rails figured in the routes of nearly a million merch carloads. The North American Big Six Class Is average US$1,662 per merch carload, so we're talking a $billion-six or 20% of the $8 billion in Q3 merch revenues.

The Class Is handled 4.358 mm merch carloads in 3Q05. The AAR says that represented a 1.1% increase yoy, implying 3Q04 merch carloads of 4.311, a delta of a minuscule plus 47,000 units. By comparison the shortline yoy Q3 merch carload delta was 99,381 units. Does this mean shortline gains are masking organic carload declines on the Class Is?

Perhaps. But there is a serious down-side to the shortline story. There are more than 300 North American shortlines that are too small to make my 5,000 minimum cars per year to be a thriving business (see "Rule of 100" discussion at www.rblanchard.com/resources). These guys are too small to run seven days a week and perhaps a third don't meet the event reporting timeliness standards (WIR 10/21/2005), making them "black holes" in the eyes of the shipper.

It doesn't help with the Class Is, either, where the mantra is asset utilization and car-cycle improvement. So if a market manager needs to make sure he gets his cars back he's going to keep them on his own railroad. The infamous Slide 112 from the BNSF shortline meeting told us that – a ten-day dwell in a sample shortline does not a pretty picture paint.

The flip side of this is where the Class I is guilty of slowing down the process with less-than-daily operation of their own branches. Take the transloader on a Class I branch line with three-day-a-week service. He takes in product by rail and transloads to truck for his customer. Now comes the shortliner with a warehouse facility that is half the distance to the end user. The shortline and the Class I branch both work out of the same serving yard. But the shortline train runs six days.

The rail customer expresses an interest in moving to the shortline to get closer to his customer, double the available days to take in rail loads, and grow his business by adding more value to his USP. A nobrainer, right? The Class I can shove car hire onto the shortline, take two hours a trip out of the local crew time, take two or more days out of car cycle time, and increase the volume with this customer. Net-net, the Class I loses X local units a year but the value-added shortline service adds back 2X over-the-road revenue units a year. The Class I market manager accepts the lower RPU (what the customer sees less the shortline allowance) to him but is happy to take many more cars at a slightly lower number. *That's* the kind of creative cooperation which makes the Class I/shortline relationship so valuable.

Avoidable cost per unit goes down, revenue from the customer goes up and pretty soon there's another point off the operating ratio. And isn't it interesting the North American railroad with the highest percentage of revenue from the merch carload trade also has the lowest OR by far. Duh.

Short-haul moves continue to get short shrift. I recently ran an exercise for a shortline that wanted to compare truck and rail rates for canned goods into a market 500 miles away. The usraildesktop.com waybill sample freight rate is right around $1,800 based on a 1.5 multiple on a $1,200 LTV cost for a 60' box carrying 100 tons. Pro forma transit time is 6-7 days.

My somewhat dated rail-truck cost model suggests a truck rate of $1,400 per 25-ton load assuming plain box, two days transit time, no empty back-haul. Thus the equivalent truck rate is $6,200 per 100 tons. In other words, the shortline customer could ship 3.4 boxcars, 300 tons, for the same money. The challenge comes in convincing the truck-oriented traffic manager that the scheduled RR can provide that level service. Besides, he probably has five days inventory on the plant floor anyway, and it might as well be moving in a box car as taking up floor space.

To make this work, the rail service has to look like a truck. We've noted before that the over-the-road transit times for rail and truck are not that different. But the rails lose it in terminal delays whereas the truck has none. The sample move is a shortline to a Class I yard, a through train to another Class I yard, and a local from that yard to the customer. Five days a piece of cake; four days with planning.

It's been written that dealing with the railroads is like dealing with the IRS. Buying truckload service is strictly point and click. Happily, we're getting there. But we've got to go out and see the people to tell the story. And while you're in the office, get on-line with the Class I and point and click your way through the customer's move.

We know the shortlines can do a superb job at the gathering and distribution aspects of the business, especially where they can access the Class I serving yards directly. We also know one big reason for shortline growth is local presence and knowledge of the customer's business. The shortline Q3 gain in merch carloads was twice the Class Is' in absolute numbers. The clever Class I market manager will tap this resource and discover the water in the short-haul pool is quite pleasant.

Canadian National celebrated its tenth anniversary of its privatization and initial public share offering (IPO) Nov 17. To mark the occasion CEO Hunter Harrison rang the closing bell at the NYSE where the railroad began trading as CNI on Nov 17, 1975. Said Harrison, "In the decade since privatization, we have transformed CN, a former Crown corporation, into a leading North American enterprise and the most efficient railway on the continent."

Since CN's IPO in 1995, the value of CN shares on the NYSE has increased by more than 1,000%, far exceeding the performance of the broader market and the other railroads. Market cap now stands at $US 22 bn, second only to BNSF ($24.7 bn) among NA Class Is. Milestones include the 1998 CN acquisition of Harrison's old stomping grounds, the Illinois Central, and three years later picking up Wisconsin Central to simplify western access to Chicago. Then in 2004 CN bought BC Rail to cement its foothold in Western Canada and for dessert purchased railroads and related assets of Great Lakes Transportation LLC.

Also in 1998 CN introduced scheduled railroading on a national scale. Harrison was a practitioner on the IC where they drove the OR into the 60s, best in the land. Says Harrison, "Scheduled railroading – or precision railroading as we now know it -- gave us the tools to improve service still further and to vastly improve the productivity of our assets and our people."

CN also hosted the analyst community for an evening and a day while in NY. Slides are available at www.cn.ca/ about/investors/en_index.html and are worth a look. Highpoints for carload shippers and shortlines: CN will continue to get more out of the franchise through "precision railroading," having reduced unit cost by 35% and taken 25 points out of the OR, reduced the car fleet by 20,000 units and going from negative free cash flow to a $billion-plus.

The commercial plan is summarized in Jim Foote's slide 4 with a matrix matching strategy and execution with marketing, sales and customer service. It is refreshing to note that at CN marketing and sales are discrete activities, as well they should be. Over the past five years CN has improved contribution per car by 40% and expects another 25% in the next five years.

Ops EVP Ed Harris showed that since 1997 GTMs per train are up 25% and per loco up 67%; cars per yard switching hour are up 47% and car miles per day up 42%. All of which translates to increased value of the CN product as over the road and terminal activities become more truck-like. Said Harris, "There's no limit to how far we can go" with this model. CN closed today (Thursday) at $80.86. Do I hear $90?

Canadian Pacific hosted its analyst meeting in Vancouver the same week. I found the presentations (slides are posted at www.cpr.ca under investors) a little light in the numbers department, though Ray Foot's Merchandise carload slides were quite helpful. The idea of linking marketing and operational "fluidity" (slide 5) bears further study. Most important, however, is the emphasis on execution as part of the value proposition, a common theme throughout most of the Q3 Class I earnings presentations.

CP has made significant progress in improving the quality of the merchandise carload product. Merch yard dwells are down 11%, on-time car order fulfillment is up 9%; merch car miles-per-day up 9%, merch fleet costs down 13%. As a result, contract renewals are strong, there are more volume opportunities and fuel surcharge coverage is approaching 100%.

In grain, look for more emphasis on multi-car shipments with commensurate improvements in velocity and train handling. The sulfur and ferts group anticipates bigger trains, better terminals, and continued growth in potash for export. Last but not least, CP expects 2006 operating savings of $30-35 mm through balancing traffic flows, continuing to drive down yard dwell and getting their money's worth out of available capacity. Strong growth prospects for intermodal, grain, ferts and perhaps coal will make the difference in aught-six.

Proxy for SL cars

Q3 2005

RMI RailConnect ©

YTD Thru	Week 39 2005	Ending 1-Oct 2004	% Change	Units Chg	% Total 2005	% Total 2004
Total	3,795,288	3,366,522	12.7%	428,766		
IM	657,080	521,755	25.9%	135,325	17.3%	15.5%
Commod CL	3,138,208	2,844,767	10.3%	293,441	82.7%	84.5%
Coal	345,663	322,729	7.1%	22,934	9.1%	9.6%
Ex-coal	2,792,545	2,522,038	10.7%	270,507	73.6%	74.9%

	26 2005	2-Jul 2004	% Change	Units Chg	% Total 2005	% Total 2004
Total	2,480,410	2,229,786	11.2%	250,624		
IM	418,725	333,266	25.6%	85,459	16.9%	14.9%
Commod CL	2,061,685	1,896,520	8.7%	165,165	83.1%	85.1%
Coal	231,724	237,685	-2.5%	(5,961)	9.3%	10.7%
Ex-coal	1,829,961	1,658,835	10.3%	171,126	73.8%	74.4%

3Q05	43 2005	1-Oct 2004	% Change	Units Chg	% Total 2005	% Total 2004
Total	1,314,878	1,136,736	15.7%	178,142		
IM	238,355	188,489	26.5%	49,866	6.3%	5.6%
Commod CL	1,076,523	948,247	13.5%	128,276	43.4%	42.5%
Coal	113,939	85,044	34.0%	28,895	3.0%	2.5%
Ex-Coal	962,584	863,203	11.5%	99,381	38.8%	38.7%

Class I Comps

3Q05	Week 39 Shortlines	YOY Chg Class Is
Total	15.7%	3.0%
IM	26.5%	6.2%
Commod CL	13.5%	0.9%
Coal	34.0%	-0.2%
Ex-Coal	11.5%	1.1%

Source:RMI RailConnect, AAR per Morgan Stanley

The Railroad Week in Review
12/2/2005

RailConnect Index of Short Line Traffic

Traffic Type: All

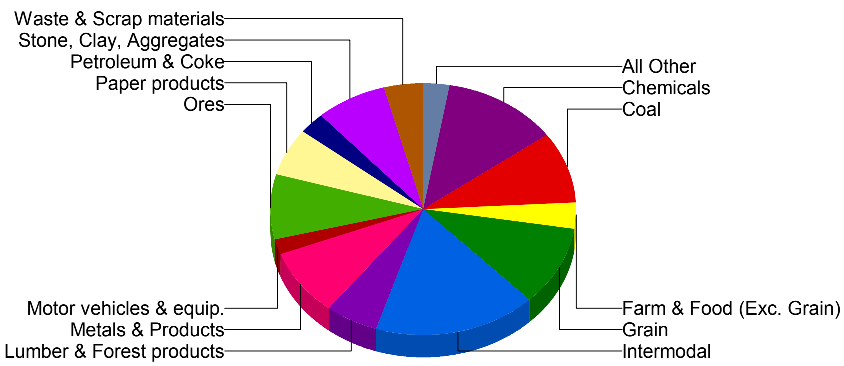
For the week ending: 10/1/2005

Week Number: 39

Carloads Handled	Current Week			Year-To-Date		
	2005	2004	% Change	2005	2004	% Change
Coal	10,912	10,541	3.52%	345,663	322,729	7.11%
Grain	10,637	9,181	15.86%	392,941	373,294	5.26%
Farm & Food (Exc. Grain)	3,866	3,633	6.41%	125,726	109,826	14.48%
Ores	7,990	7,985	0.06%	310,042	292,046	6.16%
Stone, Clay, Aggregates	8,030	8,265	-2.84%	277,969	228,504	21.65%
Lumber & Forest products	5,251	5,343	-1.72%	211,942	193,916	9.30%
Paper products	6,314	6,019	4.90%	237,220	217,293	9.17%
Waste & Scrap materials	4,698	4,551	3.23%	163,234	148,688	9.78%
Chemicals	10,530	11,693	-9.95%	463,717	415,306	11.66%
Petroleum & Coke	2,681	2,277	17.74%	106,561	82,108	29.78%
Metals & Products	9,144	8,558	6.85%	319,687	262,853	21.62%
Motor vehicles & equip.	2,200	2,397	-8.22%	79,843	82,510	-3.23%
Intermodal	18,659	14,599	27.81%	657,080	521,755	25.94%
All Other	3,026	3,118	-2.95%	103,663	115,694	-10.40%
Total	**103,938**	**98,160**	**5.89%**	**3,795,288**	**3,366,522**	**12.74%**

RailConnect Index

Year-To-Date



All Other	2.7%
Chemicals	12.2%
Coal	9.1%
Farm & Food (Exc. Grain)	3.3%
Grain	10.4%
Intermodal	17.3%
Lumber & Forest products	5.6%
Metals & Products	8.4%
Motor vehicles & equip.	2.1%
Ores	8.2%
Paper products	6.3%
Petroleum & Coke	2.8%
Stone, Clay, Aggregates	7.3%
Waste & Scrap materials	4.3%
Total:	100.0%

RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 7/2/2005

Week Number: 26

Carloads Handled	Current Week			Year-To-Date		
	2005	2004	% Change	2005	2004	% Change
Coal	10,160	9,344	8.73%	231,274	237,695	-2.70%
Grain	10,741	10,066	6.71%	257,253	257,665	-0.16%
Farm & Food (Exc. Grain)	3,273	3,090	5.92%	84,836	73,458	15.49%
Ores	8,188	7,807	4.88%	190,455	187,069	1.81%
Stone, Clay, Aggregates	7,654	7,059	8.43%	179,799	144,081	24.79%
Lumber & Forest products	5,692	5,259	8.23%	144,061	127,668	12.84%
Paper products	6,571	6,161	6.65%	161,559	144,846	11.54%
Waste & Scrap materials	4,052	4,088	-0.88%	106,366	96,105	10.68%
Chemicals	12,409	10,514	18.02%	313,818	278,180	12.81%
Petroleum & Coke	2,659	2,262	17.55%	62,978	51,340	22.67%
Metals & Products	7,064	7,603	-7.09%	204,960	164,643	24.49%
Motor vehicles & equip.	2,145	2,562	-16.28%	54,750	56,128	-2.46%
Intermodal	19,547	14,624	33.66%	418,725	333,266	25.64%
All Other	2,414	3,114	-22.48%	69,576	77,642	-10.39%
Total	**102,569**	**93,553**	**9.64%**	**2,480,410**	**2,229,786**	**11.24%**