THE RAILROAD WEEK IN REVIEW
JANUARY 20, 2006

"Shortlines are retail providers of wholesale transportation" – Todd Hunter, North Shore Railroad

Earning Season began Thursday with UP (see below). As usual, I'm looking for rates of change in the core business. I'm going to watch relative rates of change in top-line revenue vs. revenue unit volume changes and in operating expenses relative to GTMs. I will back out one-time or "extraordinary items" but keep a sharp eye for items shown as one-time but really normal costs of doing business.

There has been some concern voiced among WIR readers that volume increases are not keeping up with revenue increases. What happens, they ask, when revenue increases can't mask volume-related operating expense increases? Shortlines ought not to be challenged here, but posting proceeds from asset sales as revenue is worth a closer look. No less than the WSJ reported Wed that "a company might categorize cash from an asset sales as an operating activity when it actually was an investing activity" to bulk up the top line.

As to "same-store" sales, we're looking for the deltas in volume. To me, that means carloads today less carloads a year ago. Carloads on rails sold in the period were still there at the beginning of the period and ought to count against cars at the end of the period less acquisitions during the period.

Union Pacific kicked off the Q4-year end earnings reporting season with healthy double-digit gains in operating income for the Q and year – 18% and 16%, $522 mm and $451 mm respectively – before the $247 mm cautionary pre-tax charge for asbestos claims taken last year. Operating revenues increased 13% for the Q and 11% for the year -- $3.6 bn and $13.6 bn respectively -- while ops expenses were held to plus 2% and 8% for the Q and year respectively. The pre-asbestos ops ratio dropped 70 BP to 85.3 for the Q and 60 BP to 86.8 for the year.

It was largely a pricing story as revenue units increased but 1% Q over Q and yoy. IM and coal showed the only volume gains in the Q, 5% and 1% respectively; IM +4% and coal flat for the full year. Ag, auto, chems and industrial products all took RPU gains in both periods. This will come as particularly good news to shortlines and – yes – shippers because with price increases go better service as evidenced by the rising "customer satisfaction" curve (UP is the only railroad to report anything like this, BTW).

Let me hasten to add that a little more than half the 13% quarterly revenue gain was from fuel surcharge collections. That naturally raises the question of how much of future revenue gains will be from "core" pricing and FSC. During the Q&A both Jim Young and Jack Koraleski stressed emphasis on the former. In fact, the main thread throughout the entire Q&A session, regardless of speaker, was matching pricing to capacity to asset management. Young even picked up the "price around" thesis first broached by CP's Rob Ritchie in November (WIR 12/9/2005).

This is refreshing. We've heard all kinds of anecdotal tales of UP taking on new business or pricing existing business to capture volume. Koraleski said rate increases for ag and industrial in particular will come from tariffs and public pricing more than legacy contract increases. Young added that a full railroad puts increased values on train slots. COO Dennis Duffy put it to customers to turn cars faster this way: One day out of customer dwell adds 100 miles of railroad capacity.

Said Dennis, UP has to do a better job managing “customer behavior.” That means (1) keeping tabs on the individual customer pipeline of cars, loads and empties, (2) matching local switching capacity to local requirements, and (3) working with customers to improve load-unload practices. Pretty basic stuff, that, and we’ve seen how well it can work – look at CN, for example.

Investors must have been impressed, too. The stock gapped up $4 – five percent, folks – in the first two hours of trading. EPS jumped 25% to $1.10 per diluted share for the Q and 18% to $3.41 for the full year, both adjusted for the asbestos charge. As for 2006, Jack K. predicts a 10% revenue gain on 3% more revenue units, indicating a shrinkage in the spread between volume and revenue growth rates. Jim Young told analysts he expects FY 2006 eps of $4.60 to $4.80, up 40% on the high end. UNP trades at 17 times that number for a PEG ratio of 0.42. No wonder they’re buying.

(*Note to readers:* WIR is more concerned with operating performance as it relates to shortlines and shippers than it is with below-the-line changes in net income or eps. There’s a whole army of analysts out there doing a great job on that side. WIR’s unique selling proposition is providing insights on operating income derived from the core business of making and selling a transportation product.)

North American revenue units for December increased 16.1% yoy for GWR and 6.0% for RRA. Recall that in June GWR completed the Earl Durden acquisition, punching up yoy carloads for a 32.8% gain the first month and it’s stayed at double-digits since. RRA Dec loads came in with a 6% yoy gain net of the effects of acquisitions and sales – Alcoa plus CSX’ Fremont (MI) branch less sale of the SLRG (WIR 1/6/06) and the Arizona Eastern in Dec 2004.

It’s been instructive to watch as RRA has assembled a nice concentration of lines in Ohio and Indiana, building first on its Indiana & Ohio (ex-DT&I) franchise, adding a second north-south route in the ex-B&O line between Cincy and Columbus and pulling at all together with the ex-PRR Chicago, Ft Wayne & Eastern. Here they begin to approach the contiguous railroad model that has served GWR and others.

For the full year GWR finished with loads up 16.5% and RRA with a 5.3% gain yoy. The AAR reported a mere 0.9% increase in total 2005 revenue units over FY 2004 and RMI’s RailConnect credited the shortline community with a 6% gain yoy. That’s in-line with the RRA number, and since GWR and RRA carloads gains were both running in the plus-or-minus 8% range for the first five months of 2005 one has to conclude GWR plus RMC for 2004 also approach the RMI number. Same-store, GWR was off 1.8% for the month to RRA was up 3.3% for the month so they’re in the same space essentially.

Steve Friedland of SDS-ROCS fame provides this take on matching car counts on both sides of he interchange (WIR 1/13): “Per the railroad accounting rules, you can have three flavors of interchanges -- delivery RR report counts, receiving RR reports counts, or each side says their peace, and LCS makes the decision who got what when. Rules aside, short lines count every car to the nth degree of accuracy, because they are the ones who have to make sure that they get paid for the car.

“At ROCS we count interchanged cars in our system for our car counts, not settled cars, which should match anyway, even if the cars settle at $0.00. I would believe a short line number long before a Class 1 number. Maybe the Class 1 RRs should check with their short line partners for their car counts, so they can check their own numbers?” The gauntlet has been laid down. Anybody?

The focus on asset management, execution, and customer satisfaction in a growth environment is a relatively new railroad phenomenon. Larry Kaufman, writing in JOC, observes that the new breed of young Class I CEOs (Mike Ward is eldest at 54) on the new breed of CEOs and the new growth mentality. “Each is dealing with different issues than his predecessor as the railroad industry transitions from one where cost-cutting is the ticket to survival to one where managing growth is the order of the day. Different demands call for different skills. The biggest reason is that they represent the future, not the past. The men they succeeded all came of age during the era of railroad cost-cutting. They were good at what they did, but it takes a different set of skills to manage growth than to cut costs.”

That the cost-cutting mind-set is still has some life left was writ large at last week’s MWARS meeting. Shippers’ remarks seemed generally to say there is a frustration with this vendor that wants double-digit rate increases but does not even have people to answer the phone. Another will say he can’t get cars and nobody will tell him why. Or the shortline looking to add business yet the market manager discourages it because it’s “deficit traffic” – the revenue doesn’t cover car cost. (Left unsaid is that in the lane under discussion a car spends as much time in terminals as it does on the road.)

Based on purely anecdotal evidence there is good reason to believe that Kaufman has it exactly right and that the New Breed will be adept at managing what is now a growth industry. As UP’s Jim Young said during this morning’s call, “There is a failure cost to misallocating an asset.” And to a man, each is drilling down to execution and asset management as the main drivers of customer satisfaction.

The Western NY and Pennsylvania, one of shortlinedom’s newest, has extended operations west to Meadville, PA, and will get upgrades and new track worth about $1.5 mm according to an article in the *Meadville Tribune*. Traffic has grown to 40 coal trains a month since the WNYP came to town, up from mere crumbs just two years ago. Then in March 2004 the railroad began a run-through service with NS and since then has hauled some 230 trains carrying upwards of 9,000 tons each.

The Meadville extension represents a $2.7 mm project using state funding to rehabilitate the rail line from east of Corry to Meadville. Ties and ballast were funded by a Penn DOT Capital Grant, borrowings from the Pennsylvania Infrastructure Bank, and the newly-enacted tax credit program which WNYP cleverly used to help finance the local match for the project. WNYP now operates over the entire 186.5 miles of ex-Erie main between Hornell NY and Meadville.

In addition WNYP has leased from NS another 45 miles from Meadville to Rouseville to provide operating efficiencies needed by both roads. This is was the Erie’s way into Oil City so it could compete with the NYC and PRR for the Rockefellers’ oil business. Much of the line is FRA excepted or class 1 track and the shortline has committed to handle the upgrades.

Back in Meadville, plans are to build additional yard capacity to facilitate interchange and run-through service for the 100-car unit coal trains that Norfolk Southern runs into New England from the Monongahela coal fields it inherited from Conrail. WNYP President and CEO Bill Burt told the Tribune that it’s a $million-plus project though the details have yet to be worked out.

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GWR vs RRA Revenue Units							
2005 by month, YTD							
	2004	2004	2005	2005	Change	Change	2005
RRA	month	YTD	month	YTD	Month	YTD	ch MTM
Jan	97,821	97,821	105,508	105,508	7.9%	7.9%	
Feb	95,506	193,327	106,256	211,764	11.3%	9.5%	0.7%
Mar	108,214	301,541	118,115	329,879	9.1%	9.4%	11.2%
Quarter	301,541		329,879		9.4%		
Apr	102,035	403,576	111,993	441,872	9.8%	9.5%	-5.2%
May	99,407	502,983	109,648	551,520	10.3%	9.6%	-2.1%
June	101,429	604,528	105,429	656,949	3.9%	8.7%	-3.8%
Quarter	302,871		327,070		8.0%		
July	104,662	709,190	102,158	759,107	-2.4%	7.0%	-3.1%
August	106,631	815,821	109,287	868,394	2.5%	6.4%	7.0%
Sep	104,406	920,227	107,570	975,964	3.0%	6.1%	-1.6%
Quarter	315,699		319,015		1.1%		
Oct	109,839	1,030,066	112,360	1,088,324	2.3%	5.7%	4.5%
Nov	107,097	1,137,163	109,304	1,197,628	2.1%	5.3%	-2.7%
Dec	101,388	1,238,852	107,450	1,304,852	6.0%	5.3%	-1.7%
Quarter	318,324		329,114		3.4%		
GWR							
Jan	48,462	48,462	52,705	52,705	8.8%	8.8%	
Feb	49,291	97,753	53,316	106,021	8.2%	8.5%	1.2%
Mar	53,455	151,208	58,765	164,786	9.9%	9.0%	10.2%
Quarter	151,208		164,786		9.0%		
Apr	53,586	204,794	57,787	222,573	7.8%	8.7%	-1.7%
May	53,464	258,258	56,919	279,492	6.5%	8.2%	-1.5%
June	50,412	308,670	66,937	346,429	32.8%	12.2%	17.6%
Quarter	157,462		181,643		15.4%		
July	52,942	361,612	66,213	412,642	25.1%	14.1%	-1.1%
August	55,114	416,726	67,141	479,783	21.8%	15.1%	1.4%
Sep	53,736	470,462	65,734	545,517	22.3%	16.0%	-2.1%
Quarter	161,792		199,088		23.1%		
Oct	54,700	525,162	66,418	611,935	21.4%	16.5%	1.0%
Nov	54,370	579,532	63,616	675,551	17.0%	16.6%	-4.2%
Dec	53,817	633,349	62,471	738,022	16.1%	16.5%	-1.8%
Quarter	162,887		192,505		18.2%		
Source: Company material							
Blanchard's Week in Review, 1/20/2006							

RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 12/31/2005

Week Number: 52

	Current Week			Year-To-Date		
Carloads Handled	**2005**	**2004**	**% Change**	**2005**	**2004**	**% Change**
Coal	10,025	8,870	13.02%	491,363	504,685	-2.64%
Grain	8,887	8,260	7.59%	538,431	524,549	2.65%
Farm & Food (Exc. Grain)	3,356	2,921	14.89%	177,763	160,971	10.43%
Ores	8,897	7,795	14.14%	403,879	410,970	-1.73%
Stone, Clay, Aggregates	6,453	5,172	24.77%	396,429	353,238	12.23%
Lumber & Forest products	4,319	4,103	5.26%	263,218	252,295	4.33%
Paper products	6,281	5,660	10.97%	315,908	303,212	4.19%
Waste & Scrap materials	4,241	4,082	3.90%	218,988	219,024	-0.02%
Chemicals	11,011	9,792	12.45%	619,021	580,941	6.55%
Petroleum & Coke	4,620	3,277	40.98%	145,866	127,783	14.15%
Metals & Products	9,149	8,027	13.98%	405,928	394,960	2.78%
Motor vehicles & equip.	1,381	1,517	-8.97%	106,402	108,843	-2.24%
Intermodal	13,866	11,485	20.73%	893,104	711,686	25.49%
All Other	2,249	2,917	-22.90%	139,373	154,748	-9.94%
Total	**94,735**	**83,878**	**12.94%**	**5,115,673**	**4,807,905**	**6.40%**