THE RAILROAD WEEK IN REVIEW
March 2, 2012

"BNSF efficiently serves many smaller markets by working closely with approximately 200 shortline partners." -- Warren Buffett, 2011 Annual Letter to Shareholders

Warren Buffett's Annual Shareholder Letter provides useful insight into how BNSF works and why, as as well telling the railroad story most eloquently. What follows are excerpts from the Letter and some of my thoughts on how short lines can add value to the BNSF story, starting with stability of earnings and a diversity of earnings streams -- freight revenue, car repair, transloads, property rentals, etc.

> A key characteristic of [BNSF]is the huge investment in very long-lived, regulated assets, with these partially funded by large amounts of long-term debt that is not guaranteed by Berkshire. Our credit is not needed: [The railroad has] earning power that even under terrible business conditions amply covers interest requirements. In a less than robust economy during 2011, for example, BNSF's interest coverage was 9.5x... This stability of earnings is inherent in our exclusively offering an essential service and a diversity of earnings streams, which shield it from the actions of any single regulatory body.

Now Buffett positions BNSF as having the financial wherewithal to stay Open for Business without asking for loans or worrying about Wall Street approval. This was writ large in Carl Ice's talk at the 2011 Shortline Workshop, showing the nearly "cost no object" approach to rehabbing and improving the railroad after last summer's floods.

> Measured by ton-miles, rail moves 42 percent of America's inter-city freight, and BNSF moves more than any other railroad – about 37 percent of the industry total. A little math will tell you that about 15 percent of all inter-city ton-miles of freight in the U.S. is transported by BNSF. It is no exaggeration to characterize railroads as the circulatory system of our economy. Your railroad is the largest artery.
>
> All of this places a huge responsibility on us. We must, without fail, maintain and improve our 23,000 miles of track along with 13,000 bridges, 80 tunnels, 6,900 locomotives and 78,600 freight cars. This job requires us to have ample financial resources under all economic scenarios and to have the human talent that can instantly and effectively deal with the vicissitudes of nature, such as the widespread flooding BNSF labored under last summer.

Full-year 2011 BNSF operating income was $5.3 billion on revenues of $19.5 billion for a 72.8 operating ratio. Operating income for 2010 was $4.5 billion on revenues of $16.9 billion and a 73.0 operating ratio. Revenues increased 16 percent but ops expenses grew 15 percent, limiting the operating income gain to 18 percent. Not shabby, to be sure, but BNSF can do better.

Turning to the 10-K, we note the shortline contribution gets a nod:

> BNSF's primary routes, including trackage rights, allow it to access major cities and ports in the western and southern United States as well as parts of Canada and Mexico. In addition to major cities and ports, BNSF efficiently serves many smaller markets by working closely with approximately 200 shortline partners... For the year ending December 31, 2011, approximately 31 percent of freight revenues were derived from consumer products, 22 percent from industrial products, 27 percent from coal and 20 percent from agricultural products.

Back when BNSF was a public company, "consumer" meant intermodal plus automotive. As always, my assumption is BNSF coal is largely PRB unit-train based and, with a few exceptions, not that big a part of the shortline picture. Still, ag and industrial carloads accounted for 42 percent of BNSF's 2011 revenues -- roughly $8.2 billion. At 20 percent of sales touching short lines, that's $1.6 billion spread across 200 short lines or $8 million per short line.

Though the 10-K doesn't break out carloads and RPU, one can glean further orders of magnitude changes by commodity group:

> Revenues [including fuel surcharges] from each of the four business groups increased between 8 percent and 19 percent as compared to 2010. Overall, the increases in revenues in 2011 reflected a 12 percent increase in average revenues per car/unit across all four business groups... The 3 percent increase in volume is comprised of increases of 7 percent in cars/units handled in the consumer products and industrial products groups combined with a 4 percent decrease in volume for coal products.
>
> The consumer products volume increase was attributable primarily to higher domestic intermodal and international volume. The decline in coal unit volume was partially attributable to the impacts of severe flooding along key coal routes. Industrial products volume increased primarily as a result of increased steel and sand shipments, as well as increased demand in petroleum products. Agricultural product volume remained relatively unchanged, as higher wheat exports and U.S. corn shipments were mostly offset by declining soybean exports.

And let's not forget Berkshire Hathaway's 80 percent interest in Marmon Holdings, Inc., a $7 billion private company and where "Berkshire will acquire the remaining equity interests held by the Pritzker Family in 2013 or 2014 for consideration to be based on Marmon's future earnings." Of particular interest to WIR readers is the *Transportation Services & Engineered Products* sector "including manufacturing, leasing and maintenance of railroad tank cars, leasing of intermodal tank containers, in-plant rail services, manufacturing of bi-modal railcar movers, wheel, axle and gear sets for light rail transit and gear products for locomotives, manufacturing of steel tank heads, and services, equipment and technology for processing and distributing sulfur." Sounds like mainly "heat and eat" to me. And to round out this one-to-one scale live-diesel train set, does anybody have a short line to offer?

CSX kicks off its Annual Shortline Workshop at -- where else? -- Florida's Wold Golf Village off I-95 south of Jacksonville March 4. This is CSX's 23rd consecutive gathering of short lines, the longest-running series in the industry. In addition to the Trade Show (another CSX First), attendees once again will have access to a series of commodity-specific break-out sessions. I myself have signed up for paper & forest, emerging markets, chems & ferts and ag products.

By way of background, here are some tidbits from the CSX 10-K for 2011 to help you prepare. During 2011, CSXT's transportation services generated $11.7 billion of revenue and served three primary lines of business:

- The merchandise business accounted for nearly 2.7 million carloads and generated approximately 54 percent of revenue and 41 percent of volume in 2011. This business unit has the most commodity mix and includes aggregates (mainly crushed stone, sand and gravel), metals, phosphate, fertilizer, food, consumer (manufactured goods and appliances), agricultural, automotive, paper and chemical products.

- The coal business handled some 1.5 million carloads and accounted for nearly 32 percent of revenue and 24 percent of volume in 2011. Roughly one of every three tons of export coal and nearly all of the domestic coal that the Company transports is used for generating electricity.

- The intermodal business moved about 2.3 million boxes, generating 12 percent of revenue and 35 percent of volume in 2011.

Bringing it all together is CSX's Total Service Integration ("TSI") initiative, which supports volume growth by "improving service, optimizing train size, and increasing asset utilization" in all three of the above market segments. The recently launched TSI Carload application is crucial to short lines because the focus is on "first-mile, last-mile" execution. Be sure to arrive armed with questions about how to involve your short line with specific commodity O-D pair examples, volumes and what needs to be done to increase equipment velocity. You'll be glad you did.

Requiem aeternam. Cliff Mackay, President and CEO of the Railway Association of Canada, lost his four-year long battle with cancer January 26. He was 63 years old. I had not known of this when I quoted him in WIR last week, but his passing makes it that much important that we continue his work in support of and dedication to the railroads of Canada. *Dona eis pacem.*

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe click on the Week in Review tab at www.rblanchard.com. © 2012 The Blanchard Company.