The Railroad Week in Review
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W*all Street Journal* on-line's *Afternoon Report* for Wednesday describes the US economy as "lackluster" for March and thus far into April. Home building and mortgages remained strong while manufacturing slowed. Consumer spending sagged as well, thanks to crummy weather and the Iraq unpleasantness. Fortunately for us, though, the railroads reporting this week evidently hadn't seen this news as revenue gains were reported almost across the board.

In the following analysis I have omitted the cumulative effect of the newly mandated accounting changes regarding asset retirement obligations. Each railroad (CP excluded) has posted a significant credit increasing net earnings and earnings per share and is fully documented in their financial reports. Since the purpose of this discussion is to compare railroad operating performance adding them here detracts from that purpose. The summary chart shows yoy changes in the key metrics and offers some food for thought for shortline operators and carload shippers.

BNSF led off the 1Q03 railroad earnings season with a 3% increase in freight revenues against a fuel-driven 6% hike in operating expense. John Lanigan, in his first Earnings Week appearance as Chief Marketing Officer, said one point of the revenue increase came from fuel surcharges and that the surcharge program would extend to more commodities as fuel prices will continue to be volatile. Even with the BNSF hedge, diesel fuel averaged 94 cents a gallon vs. 65 cents in 1Q02.

The fuel increase added $90 mm to the expense line for a so-so OR of 84.5; keeping the same actual gallons used in 1Q03 but using the 1Q02 price pushes the OR down to a more meaningful 80.7. Outside of fuel, the biggest expense changes yoy came from Purchased Services, up 9% on IT and other outsourcing, and equipment rents, down 3% on more BNSF-owned equipment in the fleet and lower loco lease rates. Look for that to come down still further as BNSF has opted to buy rather than lease $72 mm worth of new locos based on NPV.

Intermodal led the revenue gains, up 10%, followed by industrial products (merchandise less ag and auto) at 4%. Recall that last October CEO Matt Rose projected intermodal and carload to grow at 5% and 3% respectively through 2010 (WIR 10/11/2002), so this pace in this economy bodes well. Ag was off a point and coal off 5% due to a combination of factors, largely product mix offsetting pricing gains. Of particular interest to shortlines, average RPU was up 1% and 8% respectively in industrial and other consumer, chiefly perishables, while system-wide RPU drifted down 2.8% to $1,079.

On the operating side COO Carl Ice said locos were running at 92% availability and mean time between failures was down 16%. Local and yard train starts are down 6% over the last four years and units per train have increased by 5%. These numbers help explain how BNSF can reduce its fleet by 8% and increase car velocity 16%, also since 1999. Ice calls it "tidying connections." I venture to say it tidies a whole lot more than that.

Norfolk Southern rode into town on Wednesday to report highest railway operating revenues of any first quarter in NS' history -- $1.6 bn – up 4% yoy. Merchandise carloads (ex-coal and IM, including auto and grain) were up 6% and IM was up 7% mainly on international. Operating income rose 5% on significantly higher costs for fuel and weather-related items like car hire and derailment expense from track repair to lading L&D.

As a result operating income drifted south 3% and the OR bumped up to an uncharacteristic 85.2, up a point yoy. If one were to normalize fuel and the weather-related lines to the same percent of revenue experienced in 1Q02 the OR would have been 82.9, an improvement yoy. Conrail rents and services dropped 5% yoy thanks in part to the relentless efficiency drive of the Shared Area management team. So, you see, even though operating income remained flat, we have in the main an improved rail operation.

The real meat of the report is in merchandise carload revenue. Every one of the six categories saw revenues increase more than volumes, and half the 6% revenue increase was attributable to RPU and mix. During the Q&A it was remarked that price increases were sticking where service improvements were quantifiable. Paper and steel seem to be the most receptive. In one instance a customer let NS re-price the whole book of business to show the rail economies. The task remains to convince still more customers that better service is worth more.

A final note has to do with line sales and plant rationalization. CEO David Goode noted that the ECBU concept, now entering its second year, has achieved many of the anticipated cost savings and revenue goals, however there is still more top-line growth to be tapped. As for future line sales, it's been documented here that the NS Infrastructure Team has identified the core and tactical route structure and it encompasses most if not nearly all of the NS system. Reading between the lines of David's remarks I conclude any minimal line sales or leases will be highly targeted to known players in the vicinity or repeats of the ECBU process.

Canadian National revenues were off a point on diminished results in fertilizer and grain (cars off 6%, revs off 13%), automotive, coal and forest products. Intermodal (up 13%) wasn't enough to offset. In the conference call CEO Hunter Harrison said CN suffered a $C49 mm drop in Canadian Grain alone. Operating expense rose 2%, operating income fell 8% and the OR picked up 191 BP to 75 even, hardly typical for CN where the mid-60s is more the norm.

Fuel was up 13%, modest to what we've seen elsewhere, casualty and other was up 15% and (now the good news) car hire was down 11%. Weather took carload trip plan compliance below 80% due to extreme cold in the plains and northern Ontario plus heavier than normal snowfall in the east. One bright spot was free cash flow before dividends, up 48% to $C240 mm yoy even though capex was $C120 both years. Debt to cap is now at a comfortable 40.3%.

CFP Jim Foote stepped to the plate next to say that for the balance of 2003 one should expect continued strength in the core merchandise and intermodal lanes but warned that grain will continue to rain 15-20% below normal levels, again due to drought in the plains. (Clearly, this is not Spain as everybody knows where the rain stays there.) And if that's not enough some Canadian coal mines will close.

Here again we see a property beset by costs over which it has little control -- fuel and weather. Total merchandise carloads (74.2% of revenues, highest of all rails) were flat yoy and the negative ag mix pulled RPU down 2%. In fact, only automotive posted any yield gain at all, up 2% per unit, while all others were flat to down. But it's always going to be bitter cold for some of the year in Canada and fuel prices are unpredictable. IMHO the scheduled railroad is alive and well at CN and probably worth more in RPU than what CN is getting.

Union Pacific's conference call was upbeat in spite of fuel costs eating up the revenue and productivity gains to the tune of about 30 cents a share. Corporate revenues rose 4% to $3.1 bn of which rail contributed $2.7 bn, up 3%, and Overnite the rest. As an aside, CEO Dick Davidson noted during the Q&A that the trucking arm covers its own costs and contributes about a $billion a year "to Omaha" in the bargain. The synergies between O'nite and UPRR are few, however, and "if anybody wants Overnite more than we do" an offer might be considered. That's a first.

But I digress. Rail freight revenues were up more than units in every category but coal, down 4% in revenue and carloads. Canceling 70 trains ($10 mm in revs) for weather didn't help, though some coal not shipped in Q1 could very well move in Q2. Also, most of the "legacy" coal contracts will soon be history. Industrial products was the winning category with cars up 5% and revenue 8%, in line with the patterns experienced elsewhere. Auto was up 7% in both. For details, download the PDF slides at www.up.com or drop me a note and I'll send 'em.

Rail operating costs were $2.4 bn, up 9%, causing ops income to slip 25% yoy. Fuel was up 56% to $1.00 a gallon vs. 60 cents in 1Q02 and adding $125 mm to total expense. Factoid: A one-cent change in cost per gallon of fuel means $13 mm in pretax income at an average annual consumption rate of 1.3 bn gallons. UP figures fuel surcharges added about $15 mm to the revenue line for a 12% recovery rate.

Perhaps the biggest take-away is UP's continuing focus on controlling what they can and minimizing the earnings effects of what they can't. For example, trip plan compliance, car connection and to/from industry performance hit all-time highs and recrews were the lowest ever. Failure cost at 10.5% percent of revenue represents a steady yoy decline. Customer satisfaction has now exceeded 80% and GTMs per employee are up 3% continuing the yoy trend.

Canadian Pacific operating income slipped 32% on flat revenues and 9% more cost. Fuel was the biggest culprit (no surprise there), up 26% in spite of CP's aggressive 57% hedge. Purchased services jumped 27% on insurance and derailment costs. Old Man Winter hit CP with increased fuel use though CP must be credited with protecting customer service obligations leading to more train starts and higher crew and maintenance expense and an 86.5 OR, up 6.6 points.

"The benefit," said CEO Rob Ritchie, "was a quick rebound in business by the second half of March." The momentum will come in handy. Average RPU was down 4% on 4% less merchandise carload revenue. RPUs were down in every commodity group but industrial products, and that up only 1%. Across the board CP was dragging more cars for less money.

COO Ed Dodge said, "Extreme cold weather cost us an extra $C18 mm as average train weights were down 5% and GTMs per loco day fell 10%." But by the end of March GTMs per day were up 15%, train weights up 10%, fuel burn per GTM eased 10% and trip plan compliance was up 5%. Chief Commercial Officer Fred Green added that same store (lane) sales are on plan, average length of haul is up 3% and fuel surcharges will be extended across more commodities in Q2.

Looking ahead to the balance of 2003, Green says the outlook for "modest growth" is unchanged. Fertilizers and sulfur are likely to be the bright spots; auto and grain will perhaps lag. In closing Ritchie said CP will "stick to the game plan" that calls for modest carload growth, picking up in Q4 and fuel prices remaining in the $25 per barrel range. Let's watch.

Wayne August, RailAmerica's IR guy, a good friend and one my best critics, has sent this clarification to the "same railroad" question (WIR 4/11) along with a proprietary spreadsheet to show exactly how it works. In a nutshell, RRA calculates "same railroad" carloads on an apples-to-apples basis, taking old railroads out of the barrel as they are sold and adding new railroads as they come of age, which makes sense.

Wayne adds, "There are some occasions where we restate numbers due to incorrect/missed data from our railroads, similar to how we did at CSX when I was there. For example, in December 2001 we missed 5,739 cars at one of our railroads and restated that month's data later." That's understandable, given changes of ownership and reporting practices. But, when you come right down to it, what's 57 hundred cars out of a universe of 1.2 million? Half a percent is not a big deal. Thanks, Wayne.

For dessert, I wanted to say a word about Steve Friedland's very clever and user-friendly solution to the shortline event-reporting dilemma. Steve's answer is the Railroad Operations and Control System (ROCS) and it came into being as a result of his daily work managing an actual shortline. As his needs grew, so did the capabilities of ROCS. What I like particularly about ROCS is it's a Microsoft Access-based tool that keeps all the data in-house and reports events automatically to Train II on a schedule to be determined by the user.

I think ROCS is particularly well suited to the smaller shortline with about 10,000 loads a year, max. Specifically, Steve says, "ROCS Version 6.0 gives the shortline the ability to do all the required EDI and Train II chores economically and in one sitting." A visit to the website, www.sdsrocs.com is highly recommended.

Chart 1. Class 1 Railroad Results for 1Q03 Reported through 4/25/2003.

Class I Commodity Carload Comps
Revenue and income in $millions
Quarter ending 3/31/2003

Metric	BNSF	CN	CP	NS	UP
Railroad revs (1)	$ 2,232	$ 1,496	$ 835	$ 1,561	$ 2,737
YOY Change	3%	-1%	0%	4%	3%
Carload revs (2)	$ 1,021	$ 1,110	$ 512	$ 918	$ 1,579
YOY Change	2%	-1%	-4%	6%	5%
Pct carload	45.7%	74.2%	61.3%	58.8%	57.7%
Pct Intermodal	31.2%	17.7%	26.2%	18.5%	17.1%
Pct Coal	21.7%	4.9%	12.5%	22.7%	20.5%
Mdse Carloads (000)	631	604	267	674	980
Rev/CL	$ 1,618	$ 1,838	$ 1,914	$ 1,362	$ 1,611
YOY Change	-1%	-2%	-4%	3%	1%
RR Operating Income	$ 346	$ 374	$ 118	$ 231	$ 369
YOY Change	-9%	-8%	-32%	-3%	-25%
Interest Exp (3)	$ (106)	$ (85)	$ (58)	$ (127)	$ (151)
Net Income (3)	$ 148	$ 204	$ 102	$ 85	$ 155
RR Operating Ratio	84.5%	75.0%	86.5%	85.2%	86.5%
YOY Change in pts	2.1	1.9	6.6	1.0	4.9