THE RAILROAD WEEK IN REVIEW
JANUARY 28, 2005

Tony Hatch listened to last week's RRA earnings pre-announcement and came away with this observation: "RRA answered some of my fears about short lines *vis a vis* their Class 1 brethren's new-found growth story – that they didn't participate in the new rate power and couldn't pass on fuel surcharges. RRA announced that as of today, UP had joined NS and CSX in providing surcharge pass-throughs, and they were in negotiations with BN. They have hedged 30% and now can surcharge 30%, and clearly are addressing that issue aggressively.

The revenue story implies that rates will be up 2-3%, though that is mostly RCAF as only about a fifth of their traffic is rate controlled via originating and/or terminating on their property. On the good news front they expect $10 mm in tax savings from the new investment law, a number that could go up to $15 mm once they get an IRS ruling. In sum, 2004 was a year of momentous events for RRA; for 2005 the new management team has a fresh slate and renewed focus, and their first official act showed a better commitment to transparency and to the investors."

Larry Kaufman makes and interesting point about the way BNSF and CN announced their interchange agreement. He writes, "Did you notice that the announcement of the new routing arrangement between CN and BNSF quoted the two chief commercial officers, Lanigan and Foote? I believe that the CN/UP announcement of similar routing arrangements also quoted Foote of CN and Koraleski of UP.

"This may be significant. When I first came into the industry, such announcements would have been attributed to the heads of operations and presented as an operating efficiency. These protocols are operating efficiencies, but it is intriguing that they are being presented as customer benefits. I think they are right to do so." So do I. This is news that benefits carload shippers most and delays at interchange are a big headache. It is well they did it like this.

Earnings Week was mostly good news. Revenues up nicely, expenses held in check, operating incomes up double-digits. Common themes: fuel hedging is diminishing as fuel surcharges cover more of the business book. Unfortunately, most still score IM boxes as "carloads" thus inflating the number of actual "cars." (I divide IM units by 1.7 to get carload-equivalents.) Customers are coming to expect better performance from the rails and seem more willing to pay for it. Best of all, private-car shippers and car suppliers tell me as turn-times improve rails get a bigger share and more goods on the rails means more cars to carry those goods.

Union Pacific started the week off reporting record revenues up 8% for the quarter and 6% for the year. Unfortunately, operating expenses were up 27% and 16% respectively, driving operating income down 65% for Q4 and 39% for the year. The big hits were fuel, up 64%, and purchased services, up 93%, including a $247 mm pre-tax asbestos charge. Put that back and ops income increases to $451 mm, still down 23% yoy.

Fuel deserves some explanation. The income statement shows fuel+utilities; you have to calculate fuel expense from gallons and price in the appendix to get the real diesel fuel consumption expense. The whole story is in fuel price, $1.46 vs $0.89 in 4Q04. Burn was 344 mm gallons, actually down a million from 4Q03. GTMs were static – 262,000 MGTM vs 264,000 MGTM a year ago. Revenue units hardly budged – 2.4 mm units each year. So, you see, the 64% increase in fuel price went right through. The OR was an astounding 93.7, yet had the same fuel price held it would have been 87.6.

The good news on the revenue side was that revenues in the industrial products, agriculture and chemicals groups (merchandise to you and me) were up 17%, 12% and 11% respectively. Revenue units were virtually unchanged and the only double-digit revenue increases were in agriculture and industrial. Intermodal was up a point and coal up 2%, even though loadings were off 6%. That's bothersome, considering the increasing popularity of PRB coal.

Still, Q4 revenues were up $587 mm, of which fuel surcharges accounted for about $23 mm or $10 per revenue unit. I don't think much UP revenue is finding its way to BNSF, either, if only because BNSF has shown in the past it is incredibly loyal to current customers and wouldn't do anything to jeopardize their service quality. That effectively makes UP the only game in town so shippers are stuck. Maybe one might ask how much of the UP carload volume is from these captive customers.

Below the line Q4 diluted eps dropped 86% to 30 cents from $2.12; for the year eps tumbled 62% to $2.30 from $6.04. Add back the $0.58 per-share asbestos charge in Q4 and we're up to the $0.87 Street estimate going in. UP earned $2.30 a share in '04 and the Street looks for $3.69 this year. As we've said before, UP is not afraid to put megabucks into the plant to make it work better. The just announced "Unified Plan," another iteration of Multimodal's TOP (NS) and ONE Plan (CSX) platform, is an example. The North Yard Bypass in Denver is another. Crews and power another. No doubt UP will continue its pricing power and once it gets its feet back it'll be a fun ride.

BNSF came to town Tuesday with quite a different story. It's what happens when revenue increases at a faster rate than expense, and something we observed several times this week. In the present case, revenue was up 20% yoy to $2.978 mm (dare I say $3 bn?), expense increases were held to 15%, and this leverage garnered a 40% ops income increase and a respectable 74.4 OR, 3.3 points better than 4Q03. The full year did not fare as well, with revs up 16% to $10.9 and expenses up 20% for a mere 1% ops income increase. The OR actually deteriorated two points to 84.6.

Fuel was the biggie, up 41% in the quarter. They generated 10% more GTMs on an 8% more gallons of fuel, getting 2% more GTMs per gallon. For the year, average fuel price was held to a dime increase Jan-Dec to 99.3 cents. Had fuel not jumped 31 to $1.14 a gallon in Q4 and had remained the same as 4Q03, the OR would have been 74.4. Below the line Q4 net was up 54% to $0.91; eps for the year was $2.10, no change, as reported. However, the asbestos charge taken in 3Q04 normalizes to $2.87 a share, up 38%.

A year ago Chief Marketing Office John Lanigan told Wall Street he expected each commodity group to earn its cost of capital. Nothing's changed. A quarter of the revenue increase was price and half of it was came from more RTMs. Each of the four commodity groups saw revenue increases well into double digits with 3.5% in same-store price increases. Consumer and industrial products lead in ROIC. The coal story is one of expiring legacy contracts and a service-consistency shift to BNSF.

Out on the railroad the Pentagon Plan announced in KC is on track, albeit with some tweaking. Recall one component is getting shortlines into serving yards and cutting the release-to-core-train elapsed time to 24 hours. BNSF shed about 1,300 miles of its budgeted 2,300 miles in 2004 and I'm told they want to get the rest done – and more -- in 2005. And that's good for the carload business where BNSF expects double-digit industrial products growth again in 2005.

While all this was going on BNSF changed its name and logo. The parent remains the Burlington Northern Santa Fe Corporation but the railroad is now the BNSF Railway Company. As if to make it stick, CEO Matt Rose rang the closing bell at the New York Stock Exchange. The corporation will retain both its name and ticker symbol. Go to www.bnsf.com to see the logo on a loco. Nice.

CSX railroad ("surface transportation") operating income increased 32% yoy for the quarter and 52% for the year, once again demonstrating the compounding effect one gets when revenues are up by more than expenses. Revenues were up 13% and 6% for the quarter and year; expenses were held to 13% and 5% increases for the quarter and year respectively. Another truism is that revenue increases pull the OR up faster than expense decreases. Quarterly carload revenues (everything ex-coal and IM) were up 13% on 5% more loads; for the year carload revs grew by 6% on a 2% volume increase. All in revenues rose 15% and 8% in the Q and year on volume increases of 6% and 3%.

Velocity, on-time originations and cars-on-line have all improved markedly after hitting the worst number of the year in Q2. On the flip side, recrews, yard dwells and on-time performance in Q4 have deteriorated yoy. Still, the One Plan has only been out there for five months. There's a major cultural shift underway as terminal managers get used to managing as a network rather than stand-alone operations. Executing to plan, asset turns and process improvement take time but the overall trend is heading the right direction.

The operating ratio, before a restructuring charge and last year's extraordinary allowance for claims, was down 130 BP to 85.5 in Q4 and 120 BP to 86.7 for the year. CSX fuel expense in Q4 increased 35% of which 27% was price. Fuel burn increased 6% but produced 8% more GTMs. What's next? We know it took NS about 18 months to get its Thoroughbred Operating Plan up to speed, so seeing CSX this far along in such quick order is most encouraging. In his opening remarks CEO Mike Ward said "value pricing and yield management are crucial." So further OR cuts are definitely in the cards.

Service improvements were clear contributors to CSX posting Q4 double-digit gains in revenue in every commodity group but fertilizers, automotive, and ag proucts. There was a nice balance between price and volume increases, unlike some other players where there were large price hikes on minuscule volume changes. In most cases the percentage RPU increase plus the percentage volume increase equals the percent change in revenue. This tells me the price hikes ought to stick. Tony Ingram told me One Plan's Phase II, local service design, rolls out in 2Q05. What timing!

Tuesday afternoon CN checked in with he best quarterly and full-year operating ratio ever plus record annual operating income, net income, and free cash flow. Fourth-quarter operating income was $607 million, and the OR came down another 110 BP to a highly respectable 65. Full-year 2004 free cash flow was $1,025 mm compared with $578 mm for 2003. And to think it wasn't that long ago that the *goal* was $500 mm. Revenues were up 15% for the quarter and 11% for the year with ops expense up 13% and 7% for the Q and year, leveraging ops income increases of 19% and 7%.

Mets and mins revenues were up a whopping 37% and 35% for the Q and year followed by quarterly revenue gains north of 20% in both forest products and coal, obviously stemming at least in part from the BCOL and GLT acquisitions. IM continued its usual heady pace with gains of 11% and 12% for the Q and year. I was pleased to see double-digit decreases in comp and benefits and casualty expense which between them account for half the total expense tab. Fuel was up 29% in the Q based on a 4% burn increase and a 25% per gallon price hike. GTMs were up 6%, though.

The C$224 mm operating income gain cost C$129 mm in additional operating expense for an incremental OR of 42.4. The point is that railroads work best on density and where the sunk cost in the plant can bring on new revenue streams at little increase in avoidable cost. Recall Hunter Harrison saying at the previous conference call that CN passing tracks are now all 10,000 feet long but the trains aren't. Which means CN can run longer trains with the same number of crew-starts. Incremental cost? Maybe some fuel and some car hire, not much else.

At the end of the day CN earned its shareholders C$1.29 a ticket, up 66% (leverage again) for the Q and C$4.34, up a more modest 31% for the year. But remember that the full effect of the GLT and

BCOL acquisitions weren't fully felt until the second half. Look for similar gains in the first half of oh-five and a nice gain for the next full year.

Norfolk Southern opened Wednesday's earnings installment with what CEO David Goode called "a strong finish to a strong year." As expected, NS reported annual revenues and operating ratio beginning with a seven – $7.3 bn and 76.7. And during the Q&A Goode added NS is "managing capacity and growth to go where the margins are good. The low-hanging fruit may be gone but we've got pretty long arms."

Across the board Q4 revenues were up 16% to a record $1.9 bn; for the year revenues were up 13%. Marketing Vice Chair Ike Prillaman said truck-like service let NS "price to a higher market," generating double-digit percentage increases in all commodity groups but auto in Q4 and in metals/construction for the full year. Intermodal volumes and revenues were up double digits for the quarter and year with four of the five segments posting double-digit volume gains in both periods.

Once again NS worked its magic holding operating expense increases to 11% for the quarter and 6% for the full year (excluding a $107 voluntary separation program charge to comp and benefits on 2003). Thus operating income rose 40% for the quarter and 45% for the full year. Best of all this sort of leverage meant an incremental operating ratio of 52%; that is to say, 48 cents of every new revenue dollar fell to operating income.

Below the line, Q4 net income was $264 mm vs. $52 mm, a five-fold increase. Eps jumped similarly, to 66 cents per diluted share from 13 cents a year ago. Full-year net income was $923 mm vs $535 mm, up a mere 73% as the Conrail reorganization, the voluntary separation program and the T-cubed write-off generated a net 11-cent per-share benefit yoy. FY 2004 eps came to $2.34 vs. $1.37 yoy. As for what's ahead, I think NS President Wick Moorman nailed it when he quipped, "We may not be able to build a church for Easter capacity, but with the church we have we can add the pews when we need 'em."

Meanwhile, five more NS folks get well-deserved promotions: Mike McClellan to VP automotive and intermodal marketing, and Dave Lawson to VP industrial products, both reporting to Don Seale, Marketing EVP; Dave Julian to VP automotive and supply chain services, reporting to McClellan; Dave Brown to VP strategic planning, reporting to Kathryn McQuade, executive vice president planning and chief information officer; Bob Bartle to GM Northern Region, succeeding Brown. All move to Norfolk but Bartle who remains in Harrisburg. Congratulations all.

Canadian Pacific earned C$0.73 a share in Q4 vs a Street consensus of C$0.70, a 3.5% surprise excluding non-operating adjustments, 2% ahead of 4Q03. For the year CP pulled down C$2.28, 10% ahead of CY 2003. Operating income didn't move all that much – 5% and 8% for the Q and year – as operating expense was up 6% in both periods, lagging revenue increases by only a point.

Commodity revenues were up 7% in the Q with gains in all groups save auto. As expected, coal was the big winner, up 23%, followed by sulfur and ferts, up 10%. RPU increased in five of seven commodity groups, again with coal taking the honors, up 22% per carload. Nowhere else were there double-digit RPU gains. Merch carload revs were a disappointment, up less than 4% in the Q and year. Recall that CP generates nearly 60% of total revenues here (see my *Quarterly Review*) and one would certainly like to see more aggressive pricing.

On the expense side compensation was up 8% for the quarter and year and accounted for 40% of total expense in Q4. That seems a bit high. Car hire and lease expenses were down nicely, however, while fuel was up 26% in the quarter, helped by a 6% increase in burn and an 18% bump in price per gallon.

That GTMs per gallon slid 4% yoy did not help. CP did recover almost half the added fuel expense through surcharges and another 25% with the hedge program.

For 2005 CP foresees modest improvements in train speeds and sizes, crew availability, and terminal dwell times. Revenues are expected to increase in the 6-8% range again with eps gains in the 14-16% range assuming crude oil averaging $48-a-barrel and an exchange rate of C$1.25 per US$1.00. The Elk Valley coal situation remains in flux, though the parties have reached agreement on non-export (eastbound) rates.

Shippers tell me fuel prices are of particular interest. As a public service therefore we've attached a chart showing how each of the Big Six fared in fuel efficiency and price changes. We've seen fuel surcharge coverage increases and decreases in the amount if fuel hedged, leading one to conclude that surcharges are becoming the tool of choice to offset the effects of fuel price volatility. I also think some commodity groups are more equal than others with high-rated commodities bearing the brunt of the surcharges. Drop me a note to say why you think I'm right or wrong.

And in conclusion, I said recently that the heady gains in rail stock prices seemed to be slowing. For proof, look no further than the relative positions of the current stock price and the 50-day moving average, generally taken by tech-sign watchers as a point of resistance – stocks falling below the MA-50 tend to go further below it. FLA, GWR, NSC, UNP all lag. KSU leads but barely. Best of show goes to CP, 6.54% ahead; RRA and BNI come next pushing 5%; PWX at 3%, and CNI at just under 2%. This is not to say holders of the laggards should bail but should pay close attention.

Fuel Summary, 4Q04

	BNSF	CN	CP	CSX	NS	UP
GTM/gallon diesel fuel	761	861	784	761	745	764
Fuel/gallon (local currency)	$ 1.14	$ 1.12	$ 1.22	$ 1.17	$ 1.07	$ 1.46
YOY Pct. Change	31.1%	24.0%	17.9%	27.3%	35.4%	64.0%

Fuel Summary, Cy 2004

GTM/gallon diesel fuel	753	851	836	761	695	753
Fuel/gal (local currency)	$ 0.99	$ 1.30	$ 1.56	$ 1.07	$ 0.91	$ 1.22
YOY Pct. Change	10.2%	7.4%	8.8%	11.6%	12.8%	32.6%