THE RAILROAD WEEK IN REVIEW
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"*Safety is the cornerstone of an efficient railroad." – Charlie Swinburn, CEO, RailAmerica*

Fuel surcharges represented a significant portion of the Class I revenue gains in FY 2005. Every railroad has said it will decrease its dependence on hedges to control the price of fuel and will increase use of FSC to recover yoy changes in fuel cost through the fare box. In a period of steadily rising fuel costs, this is just good business in case fuel costs start coming down to the point where price at the pump is less than the hedge position. But what happens if the rate of fuel price increase slows and the FSC excuse vanishes?

On Friday light, sweet crude for March delivery settled at $59.88 while earlier in the week heating oil, often used as a proxy for diesel fuel, saw March futures dip to $1.74 a gallon in NY, the lowest close since Dec 27. Natural gas for March delivery came down 2.2% to $7.32 per mm BTU in NY, the lowest since July 25 and down by more than half since the Dec 13 high of $15.67 per mm BTU.

Analysts credit increased inventories and more than expected production coming on line in 2006. Gasoline supplies are up by 1.7% yoy and distillates, which include diesel fuel, are up 12.4% over the last year. It appears that higher inventories and lower than anticipated demand for heating products are "blunting the impact of global tensions," according to one industry observer.

Last week WIR mused about the ability of the rails to raise rates at a double-digit clip going forward and fretted about operating expenses going up at a rate three times that of revenue units handled. Now consider the impact of stabilizing fuel prices on fuel surcharge collections. The Amex Oil Index (^XOI) has pushed through the 50-day SMA on the downside, and there are reports that there are those who are actually shorting the index.

A friend and regular contributor to these pages writes, "Shorting the Oil Service Index would make sense because if gas goes much lower rigs will get parked and exploration budgets will get cut. All of this stuff is just as happy looking for oil and oversupply should start to show. The winter was warm and there is a boatload of crude around and a boatload of diesel as well. As a result the major refiners will probably start turnarounds on their facilities and changing the product mix more to gasoline."

Regarding railroad fuel surcharges he suggests that they're at best a "lagging adjustment" and maintaining it at present levels may not be in the cards. He cites the example of the corner gas station operator who buys a truckload of regular at $2 a gallon only to see the street price drop a dime before he's half way through that load.

My friend concludes that the spreads between RR revenue and volume increases are scary. "Revenues of smaller O&G companies have yo-yo'ed as they need to mark to market hedges and it all flows through the revenue statement. Railroads aren't ready for that. Why RR's don't buy fixed price guarantees from a major is beyond me. At least the cost is known. Instead they get hammered by markets and bandage the cuts with a FSC."

Genesee & Wyoming reported 4Q05 operating income of $17 mm, up 43% yoy, on revenues of $103 mm, up 29%. The operating ratio came in at 84.0, down 151 BP over 4Q2004. For the full year operating revenues increased 27% to $385 mm and operating income rose 42% to $71 mm. There was a $3 mm credit against FY 2005 expenses, without which operating income was $68 mm, up a mere 36%, and the OR becomes 82.4, down 110 basis points vs. 81.6, down 193 BP with the credit.

Commodity revenues were up 27% in the Q and 25% for the year on 18% more revenue units in the Q and 17% more over the full year. Revenue per revenue-unit was 7% in the quarter and year.

Below the line, equity income from GWR's 50%-owned Australian Railroad Group declined in Q4 to $3 mm from $4 mm yoy due in part to taxes and foreign exchange. For the full year the ARG contribution fell to $10 mm from $14 mm. Earnings per share increased 50% for the quarter and 32% for the full year. Net margin has finally achieved double-digit status, gaining a full point for the Q and year to 10% and 13% respectively.

Separately, GWR announced on Monday that it and Wesfarmers, GWR's 50% partner in Australia, will sell their joint operation to local interests for $965 mm and that GWR will simultaneously purchase the remaining 50% stake in the smaller South Australian operation from Wesfarmers. This leaves GWR the 100% owner of what will become the "Genesee & Wyoming Australia" based in Adelaide. During the call Jack Hellman, who has been running the AUS operation for some time, observed that the new entity will have a balanced commodity base from steel and grain to gypsum and marble. They will retain the Alice Springs contract support operation.

Commenting on the transaction, Bear Stearns' Ed Wolfe writes, "We expect GWR to end up with about $204 mm cash net of taxes for their share of the Western Ops in addition to 100% ownership of South Australia. Not bad for a total $22 mm investment eight years ago." Not bad, indeed. And for dessert, GWR has announced a 3:2 stock split payable March 14.

RailAmerica reported results for Q4 and full year 2005 on Wednesday and it's quite evident, to me at least, that CEO Charlie Swinburn is doing a lot to get rid of the many moving pieces below the line. Regular WIR readers know my focus is above the line because this audience wants to know how the commercial aspects of the core business are performing. It is not necessarily an investor audience and they want to know how the railroad works as a railroad. How and why earnings per share change yoy are nice to know and that's about it.

However, RRA deserves some special comment. The focus in the conference call was on earnings from continuing operations rather than GAAP and for good reason. It has always been plagued with many moving parts getting from operating income to net income. Thus RRA earns many points in my book for saying, "Look, this is what we would have made absent the noise." Net income from continuing operations in Q4 was 24 cents a share, up 112% yoy; for the full year it was 80 cents a share, up 48% yoy.

What I'm calling "noise" includes the $12.6 mm charge in 2004 to account for the E&N impairment, a $39.5 mm charge for debt refinancing, and $6.7 mm for the former CEO's retirement package. None of this is any reflection on how well they're running the freight business. Reported GAAP earnings including disc ops and everything else were up 74% to 20 cents from 12 cents for the Q and up 113% for the year as RRA moved from a negative 72 cents to a positive 82 cents. So much for house-keeping. Now let's go above the line where the core results are encouraging indeed.

Forgetting for the moment that RRA includes asset sales gains as offsets to operating expense, "pure" Q4 operating income was $14 mm, up 40% on revenues of $112 mm, up 16%. Ops expense was held to a 13% increase, providing the necessary leverage for the outsize jump in ops income. It didn't work as well for the full year, however. Revenue was up 15% to $424 mm but ops expense climbed 16% reducing operating income before the effect of asset sales to $50 mm, up 6%. Add back the E&N impairment as an ops expense and note that ops income increased 13% to that same $50 mm.

Continuing with the expense side of the Q4 ledger, RRA took down compensation and casualties & insurance expense as percentages of revenue by better than a point apiece, offsetting the two-point gain in fuel expense. There are two things going on here: a concerted effort to run a safer railroad and a parallel effort to use fewer consumables per dollar of revenue. For the full year 2005 RRA took its reportable injury rate down 56 basis points to 2.24 per 200,000 hours worked, par with the Class Is and a full point lower than the national shortline average.

The second is a Process Improvement Program. Field work is winding up; they will have results in a month, will have an action plan to implement the recommendations coming from the field in thee months, and will see results by the end of the year. During the call Swinburn said that'll be worth about 2.6 points off the OR this year. What all this says to me is that with Swinburn taking hold the way he has we're looking at a much more disciplined approach to the franchise. And he makes no bones about how he'll deal with non-performing railroads.

Moving to the commercial side of the enterprise, RRA produced double-digit revenue increases in seven of 14 commodity groups in Q4 with four of the seven north of the 20% rate. For the full year it was 11 of 14, though all but one is just in the teens. Sorry. Like the Class I's, the rate of revenue growth was a significant multiple of the rate of volume growth, just 4% yoy. But that put the system RPU up a respectable 10.4% for the Q and 8.2% for the year.

The 16% yoy bump in quarterly ops income was 7% from acquisitions, and 1% from same railroad carloads, which is why I put more emphasis on total growth than same railroad. It's interesting to note too that fuel surcharge revenue was worth three points of the 16-point increase. And the OR? Well, before the effect of asset sales and impairment I give RRA a "pure" OR of 87.9 for the Q, a 210 basis point improvement yoy, and 88.2 for the year, off 90 BP yoy. But, hey, this is a work in progress and what we see in 4Q05 bodes well for *all* of 2006. Bring it on.

Conversations this week with a number of Class I railroad folks about shortline performance *on their own railroads* brought some helpful insights. It appears that some shortlines are big enough that cars can't get to the interchange the same day they're released by the customer, and that causes visibility problems. We know that the event-reporting suppliers – RMI, Railinc, SDS-ROCs et al – have the tools to record and report pulls and placements on interchange. But what happens when a load goes to an intermediate yard on the shortline overnight before making interchange the next day?

A friend who handles the commercial aspects of a large shortline system acknowledges the challenge, saying that in 2005 for the first time their road saw widespread rationing of car supply specifically tied to cycle times. "The implication for the short line community is clear: we had better adopt practices and policies that increase car turns or certain Class I roads will market around us."
Look for more on this thread going forward. Comment is eagerly sought.

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