THE RAILROAD WEEK IN REVIEW
OCTOBER 23, 2009

"We could not have done what we did in this environment without outstanding operating metrics that are all once again records for this organization." -- Hunter Harrison, Canadian National CEO

Earnings Week continued with (in order) Canadian National, Union Pacific and Burlington Northern Santa Fe. Year-over-year comps are generally tough as third quarter 2009 represented peak volumes in revenue units for the six trailing quarters since the second quarter of 2009. Of the four reporting to date, CN is closest to the pre-peak car count in 2Q08, down 13 percent; CSX lags the most, down 18 percent. The year-over-year percentages below track the 3Q09 peak.

A key thread among all calls to date is running faster, smarter and to plan. We see improved cycle times and car miles per day increasing at a decent pace: a fleet of 1,000 cars turning in four days rather than six is like adding 2000 cars to the fleet – for FREE. Short lines have a critical role here, as well. Even though we see decreased frequencies of interchange, it's because the Class Is can move faster and generate more revenue per crew-start. Just get the cars on the interchange and let the Class I do the rest. Onward to the individual stories...

Canadian National total revenue was off 18.3 percent vs. the third quarter of last year as revenue units dropped 15.2 percent though the downward drift in revenue per revenue unit was a modest minus 3.7 percent. Every commodity group save petroleum and chemicals took a double-digit negative hit in volumes; all but grains/fertilizers and coal were down double-digits in revenue.

Operating expense came down 18.2 percent and operating income took a hit of 18.4 percent so the operating ratio was essentially unchanged at 62.7, though many a road would kill for a number like that. Fuel, as everywhere, was a major factor in the expense decline, down 50.8 percent. GTMs dropped 9.9 percent on lower volumes, fuel burn came down 14.1 percent and GTMs per gallon were up five percent.

The third quarter 2009 results show revenues, revenue units, operating expense, operating income, operating ratio and operating expense ex-fuel all improved over the first and second quarters of the year. During the call, CEO Hunter Harrison cited "outstanding operational performance" that let to significant improvement in such measures as car miles per day, GTMs per train-mile and available horsepower, yard dwell and system velocity.

EVP and Chief Commercial Officer Jim Foote said in the call, "Volumes clearly hit bottom in late May and showed steady sequential growth throughout the quarter, rising above the preceding week 10 out of 14 times. Sequential growth was experienced in the vast majority of our commodity groups." The fact that the operating metrics are improving quarter-to-quarter tells us most new revenues will fall directly to operating income because the smarter, faster system can take on more volume for less incremental ops expense.

This was Hunter's last quarterly call before he officially retires December 31. He's going to be a tough act to follow and I have to personally thank him for his friendship and readily shared insights over the years, going back to the time he and Gil Lamphere were running the Illinois Central. His book, *How We Work and Why*, enjoys a prominent spot close to my desk and it is well thumbed, indeed. Thanks, Hunter, for a great ride.

Union Pacific stepped to the plate Wednesday morning with another tale of making silk purses out of sows' ears. Yes, total revenues dipped 24.2 percent year-over year and total revenue units sank 15.1 percent, but operating expense took a 25.5 percent haircut, propelling UP to a best-ever operating ratio of 73.7. Jim Young, Chairman and CEO, said in his opening remarks that best-ever service levels "increase the value proposition" and that "ongoing efficiency gains" will help take more revenue to the bottom line.

Like everybody else, UP volumes are severely depressed since last year's third quarter, off 15.1 percent. However, RTMs slipped only 14.9 percent on 16.6 percent fewer GTMs, meaning more revenue tonnage and fewer empty miles as a percent of the total. Operating expense less fuel fell 10.3 percent against a decline of 18.5 percent in gallons burned and a 2.4 percent gain in GTMs per gallon. Looks like the innovative fuel conservation tools I saw on my Railex ride in August (WIR 8/21/2009) are paying off.

Chief Commercial Officer Jack Koraleski said third quarter carloads per week increased 9.5 percent to 157,000 over the second quarter performance. We already know that UP is set up to be a 200,000 car-per-week road (an intermodal box is a "car" in this context) so there is room to add revenue dollars without adding proportional expense dollars. In fact, CFO Rob Knight said they've so tuned the railroad that eighty percent of the expense line is volume dependent, meaning that if they don't run a train the expense line goes down. With 50,000 freight cars and 1,700 locos parked plus 4,100 TE&Y employees on furlough, it's easy to see how ops can be ramped up at little incremental expense.

The Morgan Stanley note was most encouraging: "We saw/heard nothing during the earnings call that caused us to question the sustainability of the three key pillars of our UP Overweight: 1) A productivity oppt'y greater than peers, 2) Legacy re-pricing driving relative pricing out-performance, and 3) A multi-year volume recovery. With these growth drivers in mind, UP is the cheapest stock in our universe on our above consensus 2010/11 estimates. Therefore, we recommend revisiting shares once expectations correct."

One more thing. I've written before about UP's going to more distributed power getting more tonnage per train start, greater trip plan compliance and improved customer satisfaction. COO Dennis Duffy touched on this in his remarks. Look at his slide 18 and see how the percentage of "duped" trains runs parallel to the increase in carloads per week AND improved system velocity. It's this kind of performance that UP short lines need to be able to support by moving more loads to fewer destinations with fewer "railroad events" between OD pairs.

BNSF batted cleanup on Wednesday and it was yet another tale of diminished year-over year comps: revenues (-28 percent), car counts (-17.5 percent) and operating income (-25.4 percent). Yet there were real signs of improved productivity and asset utilization. The operating ratio improved half a point to 74.9 (BNSF uses operating expenses less other revenues divided by freight revenues to get 74.2; I use the classic total revs over ops expense) using 17 percent less fuel on 13 percent fewer GTMs; car miles per day jumped eleven percent and loco miles per day improved six percent.

Every commodity group took hits in revenues and volumes; merchandise (industrial, ag and auto) sales dropped 28 percent against the third quarter of 2008 and volumes slipped 20 percent. During the call Chief Commercial Officer Jack Lanigan said, "These results continue to reflect the impact of the US recession highlighted by weak consumer spending. [However] the declining volume trend in the first quarter has stabilized through the second quarter with a modest increase in the third."

That fits. Third quarter revenue units are still down 15 percent from second quarter oh-eight but improved from this year's first quarter (down 15 percent from 2Q09) and second quarter (down 19 percent). The six-trailing-quarter peak performance at BNSF was the fourth quarter of 2008 and the only improvement has been operating expense less fuel per GTM. However, in the all-important heat-and-eat commodity groups (mainly coal and ag), BNSF has a commanding lead: 45 percent of revenues vs. 40 percent of revenues at second-place Union Pacific.

Like the other rails reporting to date, BNSF sees coal demand softening against ag improving, so "heat and eat" ought to be OK – granger short lines take note. Lanigan warns of another slow quarter for the industrial products group (roughly STCCs 14, 20, 24, 28, 29, 33) which was down 34 percent in revenues and 27 percent I carloads.

Reader Jim Giblin, who knows a thing or two about supply chain management and transportation's role therein, writes, "For some time now (at least 10 years), according to ATA and the Census of Transportation, the trucking industry has enjoyed about a 69 percent market share of all intercity freight tonnage (not ton-miles). Rail carload is about 13 percent and rail intermodal just at about one percent. Within the trucking industry, tonnage has been about evenly split between the for-hire guys and the private fleets.

"For freight revenues, the truckload sector has been put at around $275 billion, which is very close to what has also been estimated for the private fleet sector. What I generally tell my railroad friends is that about half the heavy trucks on the road today are private fleets hauling their own tonnage. The average length of haul for private fleets is around 345 miles according to a recent survey by the National Private Truck Council, so this rather large market segment looks like it's totally off-limits for any portion of the rail freight industry.

"The private truck market share might actually be somewhat larger than generally reported. There are a number of companies that also use dedicated carrier programs operated by the large for-hire truckload carriers. J.B. Hunt reportedly gets about one-third of its gross revenues from this market segment, but its difficult to figure out how the Census and the ATA actually classify this kind of business. Is it true for-hire business or a private fleet operation, or some hybrid combination of the two?

"Another aspect of this story to consider is the rather underwhelming success of domestic rail intermodal. Even with all the improvements of the last 25 years, including total deregulation, almost 60 percent of today's rail intermodal volume (by unit) consists of international steamship traffic. I have yet to find any larger intermodal customer that uses the service for deliveries to customers or end users. Virtually all of the current customers (that I am aware of) use intermodal for shipments between plants, from plant to warehouse, or between warehouses. I have yet to find anyone who uses it on a regular basis for deliveries to retail stores or end users/customers. Again, the point here is to simply demonstrate the rather limited appeal the service has, and the rather limited opportunities for shortline operators to secure new business when it consists of manufactured or finished goods." Thanks, Jim.

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. A publication of the Blanchard Company, © 2009. Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned in WIR. Specifics available on e-mail request.