THE RAILROAD WEEK IN REVIEW

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"The true value of private equity is its willingness to take on the challenge of a badly performing company without recourse to magical relief from existing liabilities." -- Holman Jenkins, Wall Street Journal*, October 30, 2010*

BNSF takes top honors this week for going to what I call an "adult" shortline relationship, moving away from the traditional "parent-child" model. The occasion was the annual conference for short lines at the Hilton Lakes Conference Center in Grapevine, Texas, off the north end of the DFW airport runways.

In a word, BNSF seeks to streamline its shortline relationships, eliminating -- or at least lessening -- the administrative "friction" between BNSF and their short lines coming from disagreements and misunderstandings -- in some cases going back to the initial spin-off document. The formal name for the initiative is "Commercial Alignment" and BNSF Shortline manager Eddie Hale describes it with the ***ALIGN*** acronym: To ***Attract*** new rail shippers, capitalize on the short lines' ***Local*** presence, to promote ***Infrastructure*** Investment and Intensify customer focus, to ***Grow*** the existing book of business and to encourage short lines to take the ***Next*** step by redefining the terms of the financial relationship.

To me, the highlights of his excellent slide set are, first, the shift from what Eddie calls "a car is a car is a car" fee basis where the handling line has no stake in the value of the goods in transit. As I've said here many times, in an economic downturn the FAK-based handling lines suffer the most because there are no high-rated cars to offset the revenues lost in low-rated cars. Second, moving away from the freight-all-kinds (FAK), one-number-for-all-cars model creates a direct link between what BNSF is getting -- including fuel surcharge (FSC) -- for the move and the shortline allowance, thus sparing the short line from being wholly volume-dependent.

Finally, the ALIGN initiative lets you buy your way out of the existing marketing agreement and its paper barriers, etc. Hale is quick to note that setting your own rates does not necessarily mean it's all going to be Rule 11 and, if anything, there will be LESS Rule 11. BNSF still settles revenue divisions and pays the short lines.

To give credit where credit is due, CSX has long had a junction settlement process whereby short lines get a negotiated percentage of the CSX line-haul revenue plus a like percentage of the FSC. Where BNSF goes a step or two beyond is with its encouragement of lines that can do the ISS (Interline Settlement System) paperwork to go that route. Moreover, as BNSF rates change, the shortline settlement changes accordingly. No more waiting around for the annual "discussion."

As for the BNSF shortline program itself, the one-day format works. The times allotted for formal presentations kept the speakers on point yet provided ample time for questions. It was nothing if not intense and as a result I have to rank it as perhaps the best ever. The degree of openness and willingness to find solutions was most refreshing. These was also time for me to have valuable one-on-ones with Matt Rose, Dean Wise and John Orrison covering everything from working for Buffett to core operations to shortline revenue settlement changes. My chat with BNSF Chief Economist Sam Kyei was reassuring as he sees year-over-year volume deltas into 2011 leveling off at three percent ex-coal, intermodal and grain, with core prices increasing at a three-to-four percent rate all-in. There is little chance of a double-dip recession, though the marked increase in consumer saving may take 2011 intermodal unit counts down a bit more from the peak 2007-8 levels.

If I have one quibble, it's that presenters need to provide more shortline specifics and case histories. We need more signs of measurable successes: Before we did X with the short line, our revs/carloads were NNN; after we did X they increased Y% to NNN carloads and $$$ revs in the first year. I'd also like to see something on revenue/cost ratios and how BNSF measures yield in terms of average revenue per carload by commodity, showing why you make more money with chemicals than with aggregates. Doing so would reinforce Eddie Hale's ALIGN message.

But, as I say, that's minor. From the level of questions and comments during the presentations to cocktail chatter to the breakout session involvement, my sense is everybody got their money's worth and more. Kudos to Mark Schmidt and his entire staff for a job exquisitely well done.

So here I am at the Tuesday reception chatting with BNSF Railway Chief Operating Officer Carl Ice, only to see a press release several hours later saying that now he's President. Its a new position at BNSF, too. There has been an on-going discussion in the railroad industry about whether the CEO and COO/President roles ought to be split; clearly BNSF felt it was time to go down that route. So Matt sheds the President tag to focus on his CEO duties while Carl gets to take on responsibility for Operations, Marketing and Technology Services. Congratulations, Carl.

Norfolk Southern and Michigan's Adrian & Blissfield (ADBF) have come to an agreement for the latter to buy and operate the former's 47-mile line between Jackson and Lansing. The new line is the Jackson & Lansing Railroad and is an ADBF subsidiary. In a telephone interview, ADBF President Mark Dobronski tells me it's now 2,500 cars a year, a little light on the 100 cars per mile rule, with a potential for north of 4,000 revenue units in fairly short order. Track conditions will force him to use two crew-starts a day for now, with programs in place to get speeds up to 25 mph and only one crew-start per day.

The line connects with CSX and CN in Jackson. While I can't say whether there are paper barriers or not, I will say that if not then ADBF and NS are both to be congratulated for taking -- here's that word again -- an "adult" approach to the transaction. With unemployment in Michigan mired at 13.0 percent, leading even California's staggering 12.4 percent, this is no time to be playing "Gotcha" over a few thousand revenue loads a year. Let's pray that NS and ADBF are really trying to ALIGN themselves.

As for the election results, there has been a lot of crepe-hanging among owners of short lines for the uncertain regulatory and financial signs of the times. Now comes, perhaps, some relief. JPM's lead rail analyst Tom Wadewitz writes, "We believe that rail competition (bottlenecks, etc.) matters are likely to fall off the list of priorities, which would mark a significant change *vs.* the priorities of Chairman Oberstar.

“In our view, the election results are essentially good for the railroads as they will likely remove an STB Reauthorization bill from the agenda in the House T&I Committee. We believe that Senate Commerce Committee Chairman Rockefeller is likely to retain a strong interest in this railroad legislation, but it is very hard to see a scenario where it could move forward with Republicans in control of the House. We suspect there is little likelihood of this bill being considered in the lame duck session given higher priorities, such as appropriations and extension of tax cuts.” Whew.

And from fair Chicago comes yet more encouraging news. Good friend and fellow rail scribe Jim Giblin reports, “Toni Preckwinkle has been elected President of the Cook County Board of Commissioners, with 69 percent of the total vote. Teaching history in the Chicago school system has prepared her well for her new position. She has a sharp mind and, like a good school teacher, does not put up with much nonsense. She becomes the first female elected Board President.

“I first met Toni about three years ago when we both testified at the same STB hearing in Chicago in favor of the CN-EJ&E merger. I was immediately impressed by her knowledge and intellect, as well as her courage in testifying in favor of what at the time was a very unpopular position, i.e. supporting the merger. As you may recall, the opposition was being led by the state’s senior United States Senator.

“I reconnected with her at a fundraiser earlier this year after she won the primary. (This is, after all, the most political community in the world.) Here in Cook County if you win the Democratic primary you’ve pretty much won the general election and as of today she has a substantial lead over her two competitors. I have found that she loves to talk about trains and railroads, and now refers to me as ‘The Train Guy’ when we see each other at events. I think she will make a great County Board President and of course look forward to working with her on transportation-related issues.” Good news indeed, as it’s comforting to have a train-savvy person in local office.

I asked for comment on my Red-State-Blue-State redux last week. Here’s one from a former Class I’er who’s now observing from the sidelines: “Great analysis on East vs.West. I used to argue this point with my peers while working for the Class Is. The separation was clearly one of more than geography. At Conrail, my correspondent writes, there were relatively few local freights whereas in the south there were many. [*For proof, look down at the rail network as you ascend out of ATL and do it again as you descend into PHL. The former abounds with occupied industry tracks; the latter is a wasteland. - rhb*]

“When asked why so many crew-starts in Dixie, I explained that South Carolina, Georgia, Alabama and Tennessee, in fact all over the former Seaboard System, were right to work states that had long since given the high-tax, anti-business Northeast (Massachusetts, Pennsylvania, Connecticut, etc.) the 23 skidoo. And so it was that through the Conrail transaction CSX and NS gained destination points in the Northeast, via distribution, reloads, etc. from Conrail but not that many production points.

“Fast forward to now and I see the same for short lines. There is more opportunity for growth -- both inbound and outbound -- on roads like RailAmerica’s Alabama Gulf Coast and the South Carolina Central than there ever will be on their New England Central and Connecticut Southern. The numbers are the numbers, but I believe right-to-work status plays a very big role in industrial growth and I would imagine that the southeast still plays a big role in growing, or at least maintaining, rail based industry.

“Here's food for thought and maybe something that you can pose to your shortline audience: ‘How will election results influence growth on your lines?’ My hypothesis is that if the legislative branch changes as predicted, the perception will be that taxes and business regulations will be held in check and it will stimulate entrepreneurs and investors to start spending again on capital intensive projects. It won't be a flip of the switch but I bet there will be slow, steady momentum in a positive direction for rail shippers/receivers and of course the rails in particular.”

Genesee & Wyoming wrapped up the Third Quarter 2010 Railroad Earnings Season on Tuesday. And a fine *finis* it was. Operating income was up 24 percent to $39 million on 15 percent greater revenues -- $156 million -- against a moderate 12 percent hike in operating expense. The operating ratio was a respectable 75.4, a 181 basis point improvement year-over-year. However, if you back out expense adjustments for insurance recoveries, gains on asset sales and restructuring, you get an “adjusted” operating ratio of 76.5, a 260 basis point improvement, and a number that better represents actual operating exposure.

Carload freight revenue was $96 million, up 15 percent largely on the 63 percent “farm and food” commodity group that is heavily skewed by the action in Australia. Chemicals increased 25 percent and “other” -- which as I recall includes NS overhead coal in Ohio -- was up 17 percent. Total revenue unit volume was 217,390 -- a ten percent gain. Average revenue per load increased five percent; RPU was essentially unchanged if you take out the foreign exchange effects of US dollar depreciation against Canada and Australia, higher fuel surcharges and mix. “Non-freight” sales increased 14 percent to $61 million or 39 percent of the total revenue pie. This is were we see results for the smaller short lines and port railroads in the Rail Link group.

Below the line, net income was $25 million, up 14 percent from last year’s third quarter $22 million. Earnings per share came in at $0.59, up 13 percent. Year-to-date free cash flow, which GWR defines as cash from operations less net capex before sale proceeds and the cost of acquisitions, was a healthy $99 million, up 79 percent from $55 mm a year ago. Net debt-to-capital is a remarkable 23 percent, the net margin is a double-digit 13 percent and operating income covers interest expense a healthy eight times. A truly solid quarter -- well done, GWR.