THE RAILROAD WEEK IN REVIEW
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"With the reorientation of the operating team, we are pushing decision making and execution out of the office and into the field." Canadian Pacific CEO Hunter Harrison

Canadian Pacific Wednesday announced its new senior operations team. Doug McFarlane is Senior VP U.S. Operations, Guido De Ciccio is Senior VP Canadian Operations and Scott MacDonald is Senior VP System Operations. All three report directly Harrison. MacDonald joined CP in 2003 as director, Locomotive Maintenance. De Ciccio began his career with Canadian Pacific in 1976 in the Mechanical Department. McFarlane joined CP in 1976 and also began his career in the Mechanical Department.

CFO Kathryn McQuade will step down Nov 1, passing the baton to Brian Grassley. Says McQuade, "Brian and I have been working on transition plans and with our new CIO, Mike Redeker, and now is an appropriate time for me to shift my role to an advisory position." The previous Chief Operating Officer, Mike Franczak, has left the company.

Harrison, speaking in a July 25 Bloomberg News interview, said longer-term improvements may include a reduction in terminals and a capacity cut of 20 percent to 25 percent in the locomotive fleet over four years. And now it appears these things are coming to pass. According to the *Trains* magazine *Newswire*, Harrison has met with Union Leaders in Chi and outlined some of the changes he will present to the Board and possibly at the Dec 4-5 Investors Day.

• Shut down hump yards at Montreal, Toronto, Winnipeg, Calgary and Chicago, converting some to flat-switching (I saw how CN's Tascherau Yard in Montreal improved when he did that).) Some 70 percent of CP core traffic is in bulk unit trains; the merch side will work just as well in flat yards, though CP will retain and improve the ex-MILW St Paul hump.
• Sell off former Dakota, Minnesota & Eastern Railroad lines west of Pierre, S.D. where thin traffic and bad track do not warrant further investment. Shelve PRB extension plans.
• Divest the D&H. HH maintains CP has "never made any money on it" since CP bought it in 1990. Harrison will likely look for alternate routes over connecting and parallel lines. If no takers, off it goes.
• Expand Bakken oil business to east-coast markets via NS and CSX vs the current Detroit, Toronto, Buffalo Binghamton route and using D&H rights dating back to the Final System Plan for beyond.

The immediate question for Penna and NY short lines will be CP rights into Sunbury, Scranton, and Binghamton, to name just three. I have my own ideas, but those are best discussed over a glass of fine bourbon. As Art Cashin would say, stay nimble.

The CSX Q3 call Wednesday morning had a lot of energy and positive spin, yet I didn't see much to cheer about. Quarterly revenues slipped two percent, operating expense dipped a like amount, operating income was off three percent and the OR remained unchanged at 70.5. Gross ton-miles were off two percent and revenue ton-miles slipped one percent. Gross ton-miles per gallon of fuel gained two percent as fuel consumption dropped three percent.

Total revenue units dipped one percent all-in. Coal (that's domestic, export, coke and iron ore) was off 16 percent and intermodal boxes were up eight percent. The merch carload category was off less than one percent including automotive. Ag products (the 01 grain and 20 grain mill STCCs) were off eight percent. Phosphates and ferts vols were even with last year; any upticks here depend on what and when farmers start planting as much of the nutrient value stayed in the ground given the lack of rain.

Chems were up two percent mainly on crude oil and frack sand. Metals dropped three percent on lower scrap and steel shipments. Emerging markets, a CSX catch-all for construction products from aggregates (ex-frack sand which resides in the chems group) to cement, road salt, MSW, C&D materials, fly ash and misc. machinery (windmill parts, e.g.), were off eight percent from last year.

I'm seeing a continued focus on productivity. CSX took the Personal Injury ratio down to zero-point seven from 1.07 a year ago, a 35 percent improvement, and -- along with that -- CFO Frederick Eliasson says casualty and overtime expense are down because people are paying more attention to what they're doing. On-time origins and arrivals are at record high levels.

Merch velocity is up ten percent due in part to a nine percent reduction in terminal dwell and on-time arrival at the customer. Also helping are shorter local freight trains and increased switching frequency at some customers. The one percent increase in equipment rents was more than offset by better turn times. Take-away for short lines: seek to decrease by-car intervals between interchange-on and interchange-off and coordinate place-pull with customer work loads and staffing availability.

The Q4 outlook (slide 13) is favorable or at least neutral for two-thirds of the CSX commodity groups, among them chems, phos & ferts, forest products (lumber and panel), metals. Not so good are ag products, food & consumer, construction aggregates and waste materials. Out of the shortline sphere, intermodal looks good, auto so-so, and coal will likely remain in the doldrums into 2014.

In sum, this entire call provides an object lesson in how to make money in a slow economy. And, as Michael Ward said in his concluding remarks, making the railroad work better in this economy will put you in a much better position to improve margins when vols do return.

Union Pacific scored all-time records for operating revenue, operating income, operating ratio, quarterly earnings and customer satisfaction. Seven-day carloadings (181 a week average in the

Q), safety (PI ratio of 1.04, down 10 percent year-over year) and the rate of decrease in miles of slow orders (down to 623 miles, a 35% improvement in the past year) also set records.

Total revenue increased four percent to $5 billion on no change in revenue units (2.3 million loads) and a four percent boost in system RPU to $2,153 per unit. Operating expense was held to a one percent gain, yielding operating income of $1.8 billion, up a respectable 13 percent over the 2011 third quarter. Below the line, net income was up 15 percent to $1.042 billion; earnings per share came in at $2.19 a share, up 18 percent, though absent the 15 percent reduction in diluted share count, EPS would have been $2.12, up a mere 15 percent.

The commodity mix showed double-digit gains in auto and chems offsetting small decreases in ag and industrial products, giving the merch carload sector a nice six percent gain. Intermodal was up only a point. Combining the two puts UP vols up three percent; add coal's 12 percent decline and – voila! – unchanged year-over-year revenue units.

Grain was off seven percent on lowered ethanol (lower gasoline burn – see WIR Oct 5) and DDGs, grain products were off a like amount while boxcar foods (beer, wine, fresh, canned, frozen) increased nine percent or 4,600 units – good news for short lines like Watco's Eastern Idaho or GWR's (formerly RailAmerica) San Juaquin Valley. The chemical sector's 18 percent volume gain is largely due to the tripling of crude oil movements and renewed strength in petrochemicals. Strength in frack sand and renewed construction activity were not enough to offset declines in export ore, steel and hazmat waste. IP vols finished down two percent.

The fourth quarter outlook is another mixed bag for the merch crowd. Ag is looking for increases in STCC 20 boxcar foods and export beans, with corn, ethanol and DDGs remaining a drag. Pent-up demand for newer, better more fuel efficient cars will keep that area going and chems will benefit from continued crude by rail and other essentials. Energy shale-related growth ought to be a plus for IP while the soft global steel market continues to take its toll.

The operating metrics are all heading in the right direction. System core velocity is up six percent, cars switched per employee-day is up two percent and manifest cars per train runs in the high 80s, as it has for the last three years. Trip times are likewise down six percent and industry spot and pull is at record levels for consistency. EVP-Ops Lance Fritz said in his wrap we should look for more of the same going forward.

Kansas City Southern bested the other two roads reporting thus far in year-over-year percentage change in freight revenue dollars, revenue ton-miles and operating revenue. Total revenue units increased seven percent to 552 million; total revenues increased six percent to $555 million. Coal was not the big issue it's been elsewhere: utility coal was off a mere three percent while the "other coal and pet coke" commodity group vols increased six percent. Intermodal vols jumped 17 percent.

The five fastest growing categories by revenue are automotive (+31% yoy), cross-border intermodal (+88%), container traffic to and from Lazaro Cardenas (+23%), crude oil (+354%) and frack sand (+83%). Together these five categories represent about 18 percent of total Q3 revs and are up 46 percent over last year in revenue dollars generated. At that time, cross-border intermodal was three percent of total intermodal vols. By the end of September, 2012 cross-border intermodal vols had doubled and represented six percent of total intermodal containers, even as the intermodal container count grew 17 percent.

KCS has realigned their commodity groupings to include crude oil and frack sand under the Energy heading, along with coal and coke. I put them back in the merch carload group to provide more meaningful comps with the other roads, where one finds petroleum under Chems and frack sand either in Chems or Industrial Products. And where KCS has a separate group for Automotive, here again I put it back in merch carloads to keep my comps parallel, as it were.

Total merchandise carload vols -- by my groupings -- were essentially unchanged year-over-year. The percentage gains in crude oil and frack sand, while very large, represent only 10,000 loads -- a fifth of what's in the ag and minerals group, itself off 12 percent on the loss of 7,000 units. Chems ex-crude and frack sand slipped three percent and IP lost a point on forest products, metals and scrap. My reconstructed merchandise group posted a four percent RPU gain.

Operating expense is where it gets a bit tricky. The strict GAAP numbers show ops expense up nine percent and ops income down six-tenths of a percent to $181 million and an OR of 68.7, up 2.1 percentage points year-over-year. But... KCS last year took a $26 million insurance gain from Hurricane Alex damages. Take that out and 3Q2011 ops expense becomes $388 million, the adjusted OR is 71.3, making this quarter's 68.7 a respectable 2.6 points better, and the ops income delta is plus 16 percent.

Below the line, if you must, reported earnings per share came in at $0.82, down ten percent from last year's $0.91. But put back the insurance recovery and some one-time debt requirement costs and the adjusted 3Q2011 eps becomes $0.78, making the 3Q2012 number five percent higher. It's noise like this that gives me fits. It's like keeping score in Tennis where one must ask, why can't it just be one-nothing, two-nothing, three-nothing?

Be that as it may, KCS turned in a solid quarter and I think they're set to lather, rinse, repeat for many a successive quarter.