OLIVER WYMAN

Surface Transportation

Stopping the Downward Spiral in Terminal Performance

Despite spectacular growth in intermodal and coal traffic, general freight still accounts for a significant proportion of revenue for individual North American railroad companies. More importantly, from a financial perspective, carload traffic remains a profitable business for railroads—all the more so since railroads have been able in recent years to raise rates and induce customers to implement more cost efficient shipping patterns.

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Yet the future of the general freight business is hardly secure. Railroads necessarily have focused their investments, management talent, and network design on supporting intermodal and coal traffic. As a result, on several railroads, the general freight business is:

- **Capital starved**, particularly for unique assets such as terminals. General freight terminals represent huge investments, the original justification for which was largely driven by historic volumes. For a wide range of operational, financial, and commercial reasons, these facilities today often are underutilized. Justifying investment in these circumstances has become increasingly difficult. As one rail official commented: "We could justify capital investment [in a key terminal] if we could increase volume from 1,500 cars per day to 1,800."
- **Failing to attract the new management talent** required to support the business going forward. The decline in general freight supervision/management qualifications and experience resulting from the shift of available management talent to other activities has resulted in many cases in a "bi-modal" age distribution of terminal managers—either very young (and inexperienced) or older and approaching retirement—which only reinforces the serious nature of the "talent gap."
- **Challenged by a lack of focus on general freight's unique processes and interrelationships.** More than for any other component of railroad traffic, the ability to handle general freight efficiently is dependent on the quality and execution of a network plan linking the activities of individual terminals and train service. These relationships are more numerous and more complex than for any other traffic segment.

The General Freight Terminal Challenge

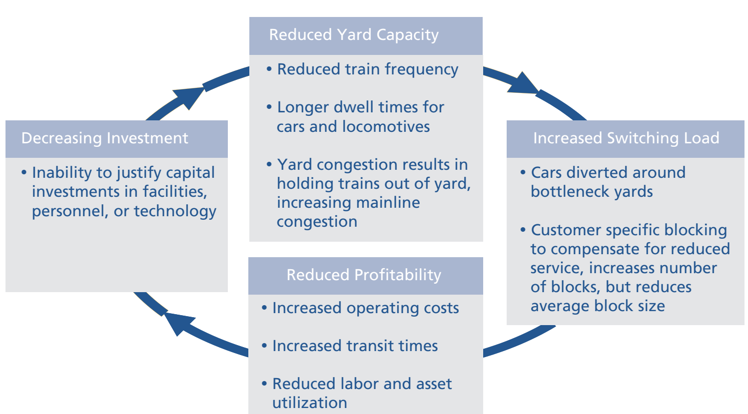
The implications of these trends have become apparent at a number of railroads, including reductions in freight car velocity and service levels and increases in unit costs. Unchecked, these trends will lead to a decline in the general freight segment.

Senior management at some railroads now recognize that deemphasizing general freight is not a viable solution—beyond the financial impact of the loss of revenue, the "shared assets" characteristic of rail networks results in other traffic segments being impacted by declines in the movement fluidity of individual traffic segments.

Perhaps nowhere is the general freight dilemma more critical than in terminals tied to carload freight—classification yards, local terminals, and local routes to serve individual customers.

Internal efforts to address terminal performance issues—process improvement efforts, terminal operating plans, and even "airlifts" of experts into trouble spots—often have had only limited success in creating long term improvements. Why? These types of efforts typically do not address the investment, management, and network process issues that underlie the general freight dilemma.

The downward spiral in yard performance



A Path Forward

Major railroads have been searching for new approaches to address carload freight terminal and yard performance issues while minimizing capital investment needs. Certainly, they are no strangers to finding solutions to major challenges that require specific expertise, new investment, or management focus. In many of these situations, they have turned to outsourcing—for example, transferring low-density lines or local services to shortline spin-offs, contracting locomotive maintenance to manufacturers, turning to the investment community to finance railcar investment, and contracting out operation of intermodal terminals.

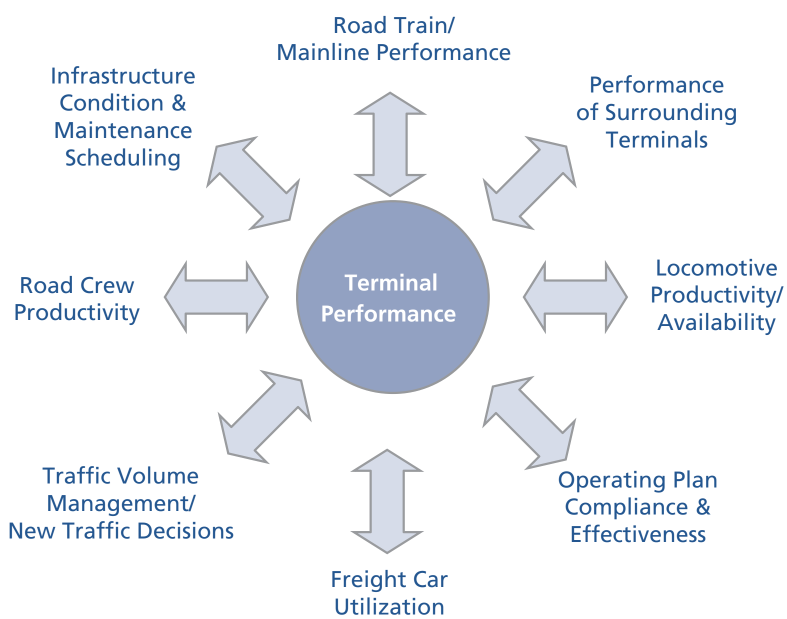
Could railroads leverage the lessons learned from past outsourcing initiatives to address terminal performance and investment issues? Perhaps. In Oliver Wyman's view, for this approach to work, the new entity must be able to address the key challenges being faced today:

- Provide capital required to support improved performance or throughput, perhaps with financial returns tied to the ability to generate additional revenue or produce cost savings
- Establish consistent incentives for managers, or where appropriate, import best practices or new managers from other rail operations or industries
- Develop, in conjunction with the railroad, the structures and measures needed to address critical network interfaces (consistent supply of locomotives and train crews, consistency in making connections or dispatching on time, for example)

Furthermore, two characteristics of major terminals make them far more complex to outsource than, for example, a branch line:

- Network criticality: Should outsourcing of a major terminal fail, severe repercussions will be felt throughout large portions of the carrier's network.
- Interdependency: Effective terminal operations require that network inputs (train services, crews, locomotives, blocking plan) are all aligned and provided in a timely manner and the right quantities.

Terminal interdependency: bi-directional linkages



Next Steps

Consequently, developing the structures and frameworks necessary to support successful terminal outsourcing requires a clear understanding of functional interrelationships, the obligations of all involved parties, and a set of measures and incentives based on a detailed network operating plan.

Several Class I railroads have indicated interest in the terminal outsourcing concept. In fact, some senior managers have embraced the concept as part of a more expansive vision of terminal consolidation among railroads, greatly expanding the potential benefits.

Applying the management effort required to properly address the range of issues that will impact success (and protecting the railroads should a third party not meet its commitments) presents challenges, however, that few railroads are able to undertake on their own. Oliver Wyman has assisted both railroads and potential operators/financial institutions in effectively applying outsourcing to general freight operations, including:

- Identifying opportunities based on potential benefits or implementation hurdles
- Detailing the improvements and anticipated benefits that would accrue from addressing major deficiencies in current performance:
  - Quantifying the value of new investment on both a local and network basis
  - Establishing the proper performance measurement, incentive, and training structures to address managerial and supervisory deficiencies
  - Establishing the "network" responsibilities of both the railroad and new operator necessary to support coordinated operations (road locomotive supply, traffic characteristics and volumes, train arrival and departure performance)
- Developing the contract terms and bidder qualifications necessary to support the project
  - Developing clear, quantifiable objectives for the project, including potential staging of operations transfer
  - Establishing appropriate contract terms, incentives, and measures to support the objectives of both the railroad and the new operating entry
  - Assessing the managerial and financial capabilities of potential operators
- Structuring the deal (responsibilities, incentives/penalties, performance metrics)

These capabilities support further development of terminal improvement structures.❖

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Oliver Wyman
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Oliver Wyman's rail capabilities
Oliver Wyman employs the largest and most experienced staff in the world dedicated to the rail industry and is widely recognized as the premier management consultancy to state owned and private freight and passenger railroads. It has carried out major strategic, operational, and financial planning and evaluation assignments for nearly all major railroads in North America and for state owned railways in Europe, South America, Africa, and the Pacific Rim.

If you would be interested in discussing Oliver Wyman's perspectives on terminal performance and outsourcing, please contact your Oliver Wyman representative or one of the following partners:

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