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Buffett Takes on Chokepoint in Chicago With Burlington Northern

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By John Lippert



Feb. 10 (Bloomberg) -- **Warren Buffett** and **Bill Gates** face a roadblock on the route toward payoff on their investment in U.S. freight transportation.

Chicago, whose railroads made it hog butcher for the world a century ago, is a tangle of bottlenecks where a quarter of the nation's rail freight stalls while trying to navigate the city.

"We can't keep running trains from Los Angeles to Chicago in 55 hours and then take 36 hours to get a rail car from one side of Chicago to the next," said **Matt Rose**, chief executive officer of Burlington Northern Santa Fe Corp. "We either need to fix

Chicago or avoid it."

For Buffett, 79, a solution could help overcome skepticism about his \$26 billion bid for **Burlington**, which shareholders are to vote on tomorrow. For the Chicago area, speedier passage could head off a loss of rail traffic, jobs and tax revenue when the city is coping with a drop in trade-show business.

Part of the answer may come from Calpers. The California Public Employees' Retirement System is backing two and possibly three rail yards outside Chicago to handle intermodal freight -- containers that switch between ships, trains and trucks. The yards would help reduce the typical day-and-a-half slog across the city's intersecting Amtrak, commuter train and freight tracks, helping railroads in their quest to take more shipping from the trucking industry.

The first is a \$1 billion Burlington yard that opened in 2002. Calpers's real estate unit, CenterPoint Properties Trust, is scheduled to open a \$2 billion Union Pacific Corp. facility nearby in September. Negotiations are under way with **Canadian National Railway Co.** for a third yard, said **Michael Mullen**, CenterPoint's chief executive.

Gates's Stake

The **Bill & Melinda Gates Foundation** is one of Montreal-based Canadian National's **10 biggest** shareholders, with 1.8 percent of the stock, according to data compiled by Bloomberg. **Michael Larson** of Cascade Investment LLC in Kirkland, Washington, investment manager for Gates, 54, didn't return calls seeking comment. Amy Enright, a spokeswoman for the foundation, referred calls to Larson.

A train ride through Burlington's new yard caught Buffett's attention, Rose said. He briefed the **Berkshire Hathaway Inc.** chairman on the rail connections to the West Coast and on a surrounding network of distribution centers in April 2008, a year after Buffett first invested in Burlington.

"He loved it," said Rose, 50. Nineteen months later, Buffett offered to buy the rest of the Fort Worth, Texas-based company. Buffett didn't respond to a request for comment e-mailed to his assistant **Carrie Kizer**.

Efficient Deliveries

Buffett was impressed by how the facility works with big retailers such as Wal-Mart Stores Inc., Rose said. Bentonville, Arkansas-based Wal-Mart owns a distribution center half a mile away to receive goods arriving from Asia.

Being so close to the yard slashes shipping costs: Retailers spend about \$2,000 to send each container from Shanghai to Joliet, Illinois, then \$25 more to reach nearby distribution facilities, Mullen said. The additional cost would shoot to \$200 a container for a facility 5 miles away, he said.

What Buffett called his "all-in wager" on the U.S. economy's future prompted Standard & Poor's to strip Berkshire of its last AAA credit rating. Oil prices in the \$70 to \$80 range favor railroads over long-haul trucking as an investment, said **Eric Marshall**, research director of Dallas-based Hodges Capital Management. Berkshire's Class A shares have gained 15 percent to \$111,700 since Nov. 2, the day before the Burlington deal was announced.

"All the railroads will do well because they're the low-cost provider of transportation," said Marshall, whose firm sold 500,000 Burlington shares after Buffett's offer and used the proceeds to acquire 556,000 shares in Kansas City Southern. "When oil was at \$20 a barrel, that was not the case."

Mexico Connection

Kansas City Southern, based in Kansas City, Missouri, is installing new intermodal technology to connect Chicago and other U.S. cities with Mexico, Marshall said. Its shares have risen 26 percent to \$30.33 since Nov. 2.

Burlington is the largest purchase ever for Berkshire Hathaway, which agreed to pay 60 percent of the \$100-a-share price in cash and the rest in stock. The market capitalization of Burlington, **Union Pacific** and Canadian National more than tripled in the past decade as the Standard & Poor's 500-stock index dropped 21.4 percent.

Their shares rose as railroads rediscovered customer service, said **Dan Ortwerth**, an Edward Jones analyst in St. Louis. For a century, government told railroads where to lay track and what to charge. Customers accepted lousy service or paid more to move their freight on trucks, he said. After mergers spawned by President **Jimmy Carter's** deregulation of the industry in 1980, railroads began thinking about customers in the past decade, Ortwerth said.

Intermodal Success

Success in railroads now hinges on which companies best take advantage of intermodal shipments, which produce more revenue per carload than other freight. **Donald Broughton**, a St. Louis-based analyst for Avondale Partners LLC, has a "buy" rating on Union Pacific because it's winning intermodal freight from Burlington.

By the end of 2009, Burlington's weekly lead over Union Pacific in intermodal container shipments had dwindled to 11,355 from 32,500 in late 2008, Broughton said in a report. Omaha, Nebraska-based Union Pacific is the biggest U.S. railroad by sales. It had revenue of \$14.1 billion last year, compared with \$14 billion for Burlington.

Union Pacific's Yard

Union Pacific is likely to capture even more business from Burlington, Broughton said, when its intermodal yard opens in September about 40 miles (60 kilometers) southwest of Chicago in Joliet. Union Pacific shares have gained 12 percent in the wake of the Burlington agreement, while Canadian National's have gained 2.4 percent.

Buffett's investment in Burlington opens doors for the entire railroad industry on Wall Street and in Washington, Rose said.

"It's a vote of confidence that railroads can provide significant value to the capital markets and great social value," he said. One gallon of diesel fuel moves a ton of freight 415 miles by rail, compared with 155 miles by truck, and generates a quarter as much greenhouse gases, Mullen said.

After the recession ends, population growth and economic expansion will spur U.S. freight shipments to rise at a compounded annual rate of 2.2 percent for the next decade, and intermodal traffic to increase 3.6 percent per year, estimated **Charles Clowdis**, an IHS Global Insight analyst in Lexington, Massachusetts.

Bigger Moves Needed

The new intermodal freight yards near Chicago will digest some of this growth, said **Hani Mahmassani**, director of Northwestern University's **Transportation Center**, in Evanston, Illinois, which studies global transportation systems. But they're not big enough to shift large volumes of traffic out of the central city, so they won't solve all its rail traffic problems, he said.

"As we see an uptick in the economy, congestion is going to be totally unbearable," Mahmassani said. "If we don't solve it, freight will go elsewhere."

Losing its role as the nation's premier rail hub would harm the regional economy for generations, said **Jeffery Sriver**, director of rail infrastructure at the Chicago Department of Transportation. Chicago faces growing competition from new intermodal switching yards planned or built by Burlington near Kansas City and by Canadian National in Memphis, Tennessee.

Chicago's Challenges

Unemployment in the Chicago metropolitan area rose to 10.6 percent in December from 6.9 percent a year earlier. The Society of the Plastics Industry Inc. and the Healthcare Information and Management Systems Society both informed Chicago last year that they're moving their trade shows to cities in the South.

Chicago's first railroad was built in 1848 by a former mayor, William B. Ogden, said Dominic Pacyga, author of "Chicago: A Biography" (University of Chicago Press, 462 pages, \$35).

Unable to find investors in New York, Ogden sold stock subscriptions to farmers along the proposed route to Galena in northwestern Illinois. The line was so successful that by 1855, 17 railroads converged on Chicago from all directions.

The railroads helped Chicago become a center for slaughterhouses, mail-order retail and steelmaking. In the process, Chicago developed expertise that allows it to compete as a global city today, said **Saskia Sassen**, a Columbia University sociologist.

"New York does finance," Sassen said. "Chicago has legal, financial and transportation skills that are rooted in the material practice of making things."

Calpers's Strategy

Calpers bought CenterPoint, an Oak Brook, Illinois-based real estate investment trust, for \$3.4 billion in 2006. Starting in 2001, CenterPoint purchased 6,000 acres of land on an abandoned U.S. Army arsenal in Joliet. The core of the Burlington yard is a set of parallel tracks where four trains, each 1.5 miles long, are loaded and unloaded simultaneously.

Workers need 10 hours to unload trains onto tractor-trailers -- half as much time as a decade ago -- for companies such as Wal-Mart, which uses global positioning satellites to track each container, dispatching truck drivers via e-mail as trains approach.

Such improvements grew out of a crisis. After winter storms snarled traffic in 1999, Chicago Mayor **Richard Daley** formed a coalition of six freight railroads, plus city and state officials and Amtrak. The group wants to fix 78 local bottlenecks at a cost of \$2.5 billion, according to its Web site. The coalition has secured \$761 million so far, about a quarter from railroads and the rest from government.

Federal Funds

It has applied for \$300 million of the \$1.5 billion in rail infrastructure grants President **Barack Obama's** administration will award later this month. The group also is seeking \$700 million from a transportation bill pending in Congress.

When Obama announced \$8 billion in high-speed rail grants Jan. 28, he included \$133 million for a new overpass near 63rd Street and Interstate Highway 94 on Chicago's south side. Each day, the overpass will allow 82 passenger trains and 46 freight trains to pass by at different levels, instead of having to take turns for a clear track.

Federal Railroad Administrator **Joseph Szabo** called Chicago infrastructure the most significant freight bottleneck in the U.S.

"You don't achieve much traveling 110 miles an hour in a cornfield if you can't get into the city," Szabo told reporters last month. "Chicago has to get fixed."

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