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Union Pacific Corp. (UNP)

Deutsche Bank Global Industrial & Materials Summit

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Analyst, Deutsche Bank Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.

All right. Great. First of all thanks a lot for joining us. Welcome to Deutsche Bank's 10th Annual Industrial and Basic Materials Summit. Happy to kick it off with Union Pacific, the largest transportation company in the country and certainly one of the most relevant right now. The nice thing about this conference is we've subdivided into some sectors. So if you're interested in the rail sector we've got Union Pacific here, Kansas City coming up next, CEO, CSX after that. We've got Canadian National, Canadian Pacific. So you don't need to go anywhere if you're interested in the rail sector for the next half a day or so.

But I'm very happy. By the way my name is Amit Mehrotra, Transportation and Maritime Shipping Analyst at Deutsche Bank. Very happy to introduce Union Pacific's Jennifer Hamann, Senior Vice President of Finance, 27-year veteran of the company, former Vice President Planning and Analysis. Also in the audience Nate Downard along with Mike Miller, one of the best IR teams in transportation. So thanks, Nate, for being here as well. I guess we only have about 35 minutes here. Maybe we can just jump right into it.

QUESTION AND ANSWER SECTION

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Obviously we have a lot of questions about PSR, a lot of questions about operating ratio, a lot of questions about cash flow; so maybe we can just start with the macro environment.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Sure.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Volumes are not great. Tariff risks, Mexico tariff risks, China tariffs in effect. How are you seeing the world? How are you guys thinking about the business environment today and more specifically what are your customers thinking?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Okay. Well, so thank you for having us here. In terms of our business volumes, our first quarter volumes were down about 2%. And that really was impacted by weather, not – it wasn't an economic picture. It was the weather. We had severe flooding across our Central Corridor in the March timeframe. We think without that flooding, those effects, and we also had some winter weather earlier in the quarter. Without that, we probably would have been up about 2%. So, pretty significant swing. Here, quarter to-date, in the second quarter, our volumes are down 3%. Unfortunately, again weather is having an impact on that. So, we don't have a clean look right now at the economy.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

That's the flooding [indiscernible] (00:02:31).

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

And that's flooding, yeah. Right now we're out. As of yesterday, we had about seven routes that were out in Kansas, Oklahoma, Arkansas due to some of the flooding that we're having in the Midwest; so, it's definitely having an impact on our volumes again here in the second quarter. But we see opportunities for growth and we've talked and we reiterated that our volume outlook for 2019 is low-single digits. And we sit kind of at the low end of that, but we still see an opportunity for positive growth. The tariffs, that's something I think that is causing uneasiness in the consumer base. Uneasiness with some of the producers and so certainly when you look at our intermodal volumes, we're seeing some impact there.

We've seen some impact in grain when you think about soybean, but we see strength in things like our plastics, industrial products and the construction related activities. I think that's still going at a decent pace here. We have opportunities with biofuels and some of the food and beverage sector. So that's the thing we like about our

franchise is we've got a very diverse base and we cover a lot of different markets. And so it's pretty rare that you see all of our markets up at the same time and it's rare that you see all of them down. And so that gives us a good balance overall. We need some resolution I think on the tariff front that would help I think to a certain extent, but still some opportunities for growth obviously.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

If the volumes are down low-single digits accelerating, so down 3% quarter to date, to get to that low-single digit growth for the year, it just have to be that much better in the back half of the year.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Right.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

So, Is what the company is hoping for is really this resolution on the tariff front that drives a reacceleration of volumes? Also the other thing is that with respect to the weather, you were pretty proactive. The company is very proactive in the first quarter of taking our train. I think what, 50 a week or something like that. And that would obviously helped fix cost absorption given the revenue decline. So what are you doing in the second quarter to maybe mitigate some of the revenue headwinds from a cost perspective?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Yeah. So in terms of the actions that we're taking, I mean we've put some embargos in place because we don't want to congest our network while we can't run fluidly across it, so we have some embargos; some of that affects our intermodal business. We're holding some of our bulk networks. So thinking about grain and coal, those are intentional steps that we're taking to keep the network healthy that's delaying some of our [indiscernible] (00:04:58) we talked about that in the first quarter. We said we might have a little bit of carry over into the second quarter in terms of some grain and coal movements that didn't move. And we started April – first part of May, we had some pretty good coal volumes that we're going [indiscernible] (00:05:11) coal is actually flat quarter to date for us. So...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Yeah.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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...there's some opportunities there that we feel good about, but you're right. We are certainly when you think about starting the year down two in the first quarter down three quarters to date that does say we've got to see some pretty significant turnaround in the back half. Some of that for us as comparisons to, I mean, we'll come through the [indiscernible] (00:05:32) comparison, so we'll see some easier comps we think towards the back half of the year as well.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And then this is happening in an environment where you're doing some pretty significant restructurings to the network, precision scheduled railroading started in October, accelerated, I would say, in the middle of January when Jim Vena joined.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Yeah.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Can you just give us an update of where you are in PSR? I think you expect it to be done with the initial phase middle of this year. I assume that's on track but it's an evergreen process that you guys have talked about. So, help us think about where you are in the process? How you feel about how it's gone? And maybe some of the other heavy lifting things that need to be done over the next six to nine months?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Yeah. So, we're very bullish about our PSR implementation. We're calling it Unified Plan 2020. As you said, we announced this back in the fall, started off with some transportation plan changes. We initially were going to go through it in three waves as we went across our network and doing just some T plan changes, and that was going to go through mid-part of this year. We've largely completed what we've say that first round, but that was just laying the ground work in large part to a lot of the other things that we're doing, and then of course bringing Jim in first part of January.

He has brought a whole new life to the effort. I mean we're very committed to it. We're committed to it before we brought Jim in. But, when you bring somebody into a company that has a new set of eyes, they bring in a different perspective. He obviously has a great background, a great track record with the CN, and he's bringing that to us. The team has really embraced him coming in. Tom Lischer had laid the groundwork for that in terms of some of the initial work that we did. And it's showing through in our results in the first quarter. Despite the severe impact of the weather, we still improved our operating ratio by a point and we recovered very quickly from the weather impacts. And I think those are things that to me are proof statements of what PSR is doing for us. Some people think, oh, well, you're taking assets out; that's going to make it harder for you to recover. It's done just the opposite. We've been more resilient as a company with those fewer assets in the network. And we continue to do that. So sitting here today, we have roughly 2,400 locomotives parked that...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

That was a 2,100 maybe three to four weeks or so.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Well, yeah.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Yeah.

Q

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

So, that number just continues to climb...

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Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Right.

Q

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

...as we work on the PSR implementation and as we work to get more efficient. We have idled a couple of our hump yards. We have 14 total, we have idled two of those, one in Pine Bluff and one in Hinkle. We continue to look at terminal rationalization efforts; that's very much ongoing. We announced that we're going to make some changes here in Chicago, a big intermodal hub for us. We've got six intermodal terminals here. We've said we're going to take that down to three. I think some of those closures actually start in the July timeframe. So just a lot of great...

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Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Are you going to exit intermodal lanes as a result of maybe turning Global – getting out of [ph] idle in (00:08:35) Global III, I think it is, and then reallocating some of the resources creating international, domestic, intermodal terminals?

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Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

We have done some of that already. I would it has a pretty minimal impact in terms of our actual intermodal volumes. But we have done some of that and some of that's been in conjunction with the CSX and the NS in terms of as we work together, where do we have lanes that just weren't moving a lot of business.

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Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

And CSX got out of hundreds of intermodal lanes, some of them – a lot of them didn't have any freight running through them anyways but Norfolk has been a little bit more surgical, a little bit less on that front. I mean are there are a lot of lanes on the intermodal side that just don't have the density; and so it makes sense to maybe exit it as you [indiscernible] (00:09:16) the Chicago footprint.

Q

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

No, I mean, again we're going to be prudent about it. We have to this point not really had a significant impact in terms of our intermodal volumes by the changes that we have made. The Chicago changes will be another round of those but we're not anticipating a significant loss. We've been pretty diligent, I would say as a company, over

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the last many years of making sure that the business that's moving on our network is profitable; that's been a big focus for us. And the pricing that goes along with that, we had 2.7% price in the first quarter and that was up sequentially from the fourth quarter. So feel good about that. And we'll just maintain that discipline, but we don't necessarily see a significant fall out of volumes as a result of our PSR implementation, whether it's intermodal or other.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Before we get into pricing, one question on some of the operating metrics. So you talked – I mean locomotives are coming off pretty significantly going to stores at a fast pace. What's the opportunity there? What's your active fleet today? Where do you think you can get to when you benchmark against company like CNI for example or other companies that maybe are best-in-class? And then the whole premise in PSR is moving the cars faster. And I think one of the key metrics you look at is miles per car per day. You're about 185 miles, 200 miles, up 8%, which is quite good.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Yeah.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

But talk about what the opportunity is there over the next year as you further implement PSR?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Right. Well, on the locomotive front, like I said we've got about 2,300 locomotives, 2,400 locomotives that are idled and that's out of the total locomotive count of around 8,000. So that's what – and that's total low horsepower and high horsepower. So, we've really done a great job in rationalizing that. And we think there's more opportunity. I mean, when you think about the fact that we're taking that out in the face of some of these weather challenges, which is a time when we would typically be pushing more locomotives into service...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Right.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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...again that shows some of the benefit that we're seeing from the PSR. Obviously the volume environment is a little lighter. Quite frankly we'd like to see those volumes pick up and be able to keep the locomotive fleet flat. But if we need to continue to pull out assets to match what's happening on the demand side, we'll do that. We're prepared to do that. Freight car velocity is one of the KPIs that we're using to measure ourselves; you mentioned that. We've seen significant improvements up 9% again in the face of some of these weather challenges. So, we'd like to get a clean fleet behind us and just some dry conditions and really be able to run the network; I think you'll see further opportunity.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

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And then PSR – and by the way, if there are any questions, just raise your hands [indiscernible] (00:11:55) as well. But PSR has always included some significant reduction or a nice way to put it labor productivity and you certainly saw some of that in the first quarter. Average head count was up about 4% I think in the first quarter.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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4%.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

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But, it believe you furloughed employees in the beginning of February that – so I don't know if that's a true sustainable head count reduction number if that's the way to look at it. First, did you furloughed employees in the second quarter to maybe counter some of the revenue headwind and, two, is this restructuring the network and then ultimately you see 6%, 7% of the workforce leads to attrition that don't have to be replaced, but at what point is more meaningful reductions in the employee head count which is the largest part of your cost structure going to be part of the OR plan that you guys have set up and laid out.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Well, for us to reach our productivity targets and our OR targets for 2019, which we've said we are going to be sub-61% here in 2019; sub-60%, 2020 and to reach our productivity target of \$500 million and that's net productivity, we have to have significant labor productivity and so that means that that head count number has to continue to shrink. We did furlough employees first quarter. We continue to furlough employees here in the second quarter. Some of that is related to buying, but some of it is also related to our terminal rationalizations and the fact that we're shrinking that locomotive fleet. As we shrink the locomotive fleet, we don't need as many mechanical employees. As we shrink our freight car fleet, we don't need as many mechanical employees. We're taking train starts out, our train length is up about 8% since the first of the year, so that's up a little bit further than it was at the end of the first quarter. We continue to make gains there so that's consolidating trains, taking starts out, and that's the TE&Y opportunity.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And when you look at train engineering yard employees as a percentage of your total comp wages and benefits line. What is that opportunity? What is that actual number?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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We've not put an actual number on that, but it's significant. I mean the TE&Y workforce – in total 85% percent of our workforce is unionized, and a...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

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Yeah.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

...large chunk of that, probably 70% to 80% of that – 85% is our TE&Y forces. So...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Right.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

...they are the line share of our labor expense. And so that really is where our leverage is; it's in running that train network much more efficiently.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And when you guys put out your net productivity number of \$500 million, Rob Knight, CFO, talked a lot about volume being a good guy as he likes to say.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Yes.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Volume has been a pretty bad guy year-to-date. And productivity, there is obviously, across the board, idiosyncratic cost [indiscernible] (00:14:38) taking cost out. But then productivity is also more leveraged, operating leverage, positive operating leverage on volume growth and revenue growth.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Yeah.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And so, pricing is ticked up a little bit, accelerate a little bit, but it's still not enough to counter the negative volume effect. And so, you have to really see a pretty sharp acceleration and starting in the second quarter I would imagine relative to \$60 million net productivity you did in the first quarter to be able to hit that sub-61% OR target this year. So, how do you think about your ability to start showing meaningful improvement as early as the second quarter on that front given some of volume challenges that you've endured?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Well, the volume doesn't help and volume can certainly be our friend. But, we also don't – so you quoted my boss; I'll quote him. We can't let volume stand in our way and we don't use this as an excuse. So because we're not

getting the volume, we're not going to say I'm going to back off of our financial targets. We think there is plenty of opportunity to do just what you said in terms of getting the productivity. First quarter is always your worst quarter...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Sure.

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Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

...from a productivity and OR standpoint just because of the seasonality of our business, a little bit lower volume, usually a little harsher operating condition. Certainly, it was even harsher than normal this year. But we're expecting some of that normal seasonality; and we have full confidence that we'll be able to accelerate and are accelerating our productivity efforts so that you'll be able to see that show itself throughout the course of the year including in the second quarter.

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Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Okay. And do you think the improvement to get to that sub-61% OR is more backend weighted as a result of maybe this volume environment we're in or do you think the cadence of it is much more even over 2Q, 3Q and 4Q?

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Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

I'm going to say it's going to be part of our normal seasonality, that normal cadences is, Q1 is the worst, 2Q is better, 3Q is usually your best quarter of the year and then fourth quarter usually a little bit less.

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Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

And then when we were in Omaha, three, four weeks ago, one thing that struck me in the comments from you and the other senior management team was you're not necessarily counting on positive mix. You can't really, given some of the [ph] sand (00:16:45) volumes and things like that, that they are not going your way or the industry's way. So I think that was positive in the context of your OR target. But I also got the sense that volumes can't be down 4%, 5%. And if they are down a little bit, they are up a little bit, a lot of your OR targets are volume agnostic in that context. So, just help us sensitize that a little bit. Is that when your sub-61%, sub-60% OR target for the next two years, this year and next year, how much of that is predicated on volume being even slightly a good guide because you do run a very high cost business and volumes are important as you said?

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Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

I mean we're certainly not forecasting. When we talk about sub-61%, sub-60%, we're not saying we're going to – that's not in a recession – what I'll call a recessionary environment.

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Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Yeah.

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Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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That's an environment where we're able to get positive pricing or able to see a little bit of volume growth. And like you said, we can be on either side of that ledger a little bit, but if we're going to talk about the recessionary economy that's really not part of what we're considering when we're giving you that guidance.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

How do you think about Union Pacific? I won't talk about Union Pacific structural advantage relative to certainly the Eastern Rails; and length of haul is a big component of that. We usually get revenue per carload for Union Pacific and obviously not mix adjusted, significantly higher than Eastern Rail; and that makes sense given the length of haul and nature of your cargoes. So when you think about the structural benefits, I'm sure you guys have thought about this or analyzed this internally. We're not operating in a vacuum. CSX is operating at a 59% OR already. They're below kind of where you expect to get in 2020. So how do you think when you calibrate your performance relative to all the other ecosystem? How you think about UNP structural advantages from that perspective?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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Long term we really like our position and like our structural advantages for many of the reasons that you just laid out. We do have good length of haul. We've got a very diverse franchise that I mentioned earlier and that lets us whether some economic ups and downs. We think we should fundamentally have the best OR in the industry. We've said that. We feel that very firmly. We're committed to that and we feel like we're doing the things now that are going to help us get there. Maybe our pace is a little different than others. We started at a lower point than arguably some of the others, but obviously CSX has had good success. We're enjoying good success right now. We just need a little break from the weather. If we can get a little volume, that will help, too.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And the pricing environment seems to be getting a little bit better. You saw acceleration in the first quarter; it was like 2.75% acceleration. The day after – I mean at the Berkshire meeting the second question I think Warren Buffett got was about precision scheduled railroading. It seems like there was an implicit endorsement of it. So I want you to just talk about the pricing environment. How has that evolved over the last six months or so as the service has gotten better and you guys are investing in the service and the network, which creates pricing opportunities I would imagine? And then also how do you think about the landscape as maybe your direct competitor also start to maybe embrace precision scheduled railroading?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Well, on the pricing standpoint, as we adopt PSR and Unified Plan 2020 and improve those service schedules, we do think that gives us opportunity. We've always said we want to price the value of our service. We've said that for 2019 we expect our pricing dollars to well exceed our inflation dollars. We believe we have one of the most if not the most rigorous method in terms of calculating prices...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Right.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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...of any of our competitors. So, we continue to see good opportunities in the marketplace and we're going to take advantage of those as we can. We do have a competitor in the West. And not just [ph] BN (00:20:46), we also compete with trucks; and you've heard and mentioned earlier the trucking environment is a little softer, so that's become a little bit more competitive. Coal and intermodal are probably the areas where we've seen the most pricing competition, pricing pressure [ph] from the BN (00:21:02). But, again, we're committed to maintaining profitable business on our railroad. We're committed to it being – every piece of business has to stand on its own and has to earn good return. And so we haven't wavered from that; and we're going to stay committed to that; and we think that long-term, we still have good opportunities. And hopefully as we get further into the PSR implementation, that's just going to be further supporting those pricing opportunities for us.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And I know the way you calculate yield is very pure in terms of the yield dollars over the total revenue base of the company. Any color on how I think about maybe same-store pricing or how that's comping, is that comping 4%, 5% but it's being diluted by the way you calculate yield?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Well, certainly the way that we calculate yield is going to dilute the same same-store sales pricing, but we've not given any commentary about what that looks like.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Any questions in the audience? [ph] Re: (00:22:01) Union Pacific. Okay. I've got a bunch more. So you're obviously were in Chicago, you talked about kind of reducing the footprint from [ph] six to three (00:22:11). One, you also don't count real estate gains in your OR which is also great, but obviously that impacts cash flows and so does that create real estate monetization opportunity to the company? Does that also been a pretty big hallmark of PSR at least in the initial phases?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Yeah. We have a large real estate portfolio that we're always buying into and selling out of every year. Some years, as you know from following us, we have larger land sales than others. Through this terminal rationalization program, it may give us some opportunities, but we also want to make sure we're prudent. We've been in this business for 155 years. We want to be in it for another 155 years. So just because I'm going to rationalize a terminal today in a certain location, it's not to say that in another 30 years or 40 years I may want to go back to those places. So we'll see how that all plays out over time. But I don't see any immediate boost or jump up because of the land sales related to any of those efforts.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And what is that rationalization, that restructuring in the Chicago footprint do for you from a service perspective could bottleneck congestion perspective? Just help us kind of think about operationally how that helps the service?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Well, it really simplifies our traffic flows and it simplifies our equipment repositioning. So when we're bringing – because the way that works right now, we've got six terminals around the Chicago area that we're bringing, in large part, mix traffic into those terminals. So we're bringing both domestic and international freight into various terminals.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

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Yeah.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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There's different equipment types related to the handling of those businesses. What we're moving to is an environment where G4 is going to be our international terminal; G2 is going to be our domestic terminal. And then we have the Yard Center, which is largely an intermodal auto parts facility for us. And so that's going to allow us to be much more simplified with our equipment flows. It's going to reduce repositioning that we have to do between terminals from time to time, and just make that more fluid. We're also – and this has been in conjunction with our interline partners we've been working to do more steel rail interchange instead of rubber-tire interchange across the Chicago metroplex.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And part of this restructuring, again it's not going to lead to wholesale exit of 50, 100 intermodal lanes or something like that?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

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We don't anticipate that, no.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Okay.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

But it's early innings. I mean there's also no sacred cows in this implementation of PSR. I mean we really have said everything's fair game. We want to look at everything objectively. And if it doesn't make sense for us to be doing it, whether it's operationally or business line, we want to we want to take – put that on the table and again that's why we're bringing somebody like Jim in. It's helpful because he's helping challenge us about some of the things that we maybe institutionally thought we always had to have. And we're looking at it differently now.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Can we talk about the regulatory environment a little bit? It's obviously gotten a lot of interest over the last few weeks. And you've actually responded. The company has responded in terms of lowering certain fees from \$10,000 per occurrence to \$2,500 and then a couple of others as well. So one, it seems like you're taking a more [ph] conciliatory (00:25:34) approach with your shippers, doing this together with them, and try not to be disruptive. So I want to talk about how the shippers have responded to what you've done and then the regulatory impact. How you see that shaping because you certainly reacted in a way that others haven't in terms of lowering certain fees, something like that?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Sure. Well Kenny Rucker and his team I think have done a really good job and they worked very closely with Jim and Tom on the operating side to communicate proactively with our customers about what we're doing with Unified Plan 2020. We certainly saw some disruptions in the east when changes were being made and customers weren't being communicated with; and we're trying to learn from that and make sure that we're having that dialogue. So they've been spending a lot of time talking to our customers. That's not to say that there hasn't been angst within the customer base. That's not to say that customers haven't pushback. If you listened to any of the testimony last week...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Yeah.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

...or two weeks ago, I guess now, certainly there's some grumbling about some of the accessorial. We're doing those accessorial to improve fluidity and help all of our customers long term. Best case scenario – and I'm sure customers think we're – people may be thinking we're not genuine in saying this but we are. We'd rather not collect any of those accessorial dollars and just move the cars more fluidly, keep the network fluid. That can reduce costs for the customers. If they've got their own private car fleet; if we can take cars out of their fleet, that's a savings for them. And so we think that's important to really emphasize the benefits that they can see from PSR, from Unified Plan 2020 not just in more reliable cycle times, but faster cycle times and ultimately fewer assets to move the same amount of goods. So I think that's important.

In the accessorial front we've tried to have a very open conversation with our customers, where we've realized we maybe [ph] haven't set (00:27:34) something right. We have been willing to make adjustments. But long term, we really do want to drive the behavior change to move the assets and not hold on to the asset.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

There has also been a change in terms of how the STB is – they have a paper out talking about different changes and how shippers can maybe protest rate increases in terms of not creating a whole new rail, but applying the rate increase to the existing cost structure of the company and the asset base. So, how do you guys think about that? I mean seems like that's happened before. It's kind of a routine thing that they have to be dealt [ph] year earlier or a few years (00:28:13). So, how are you guys thinking about the impact from that?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Well, so the STB hasn't been fully constituted; some of them fully constituted. They're supposed to have five members there and they only have three. So for a long time, they only had a couple [indiscernible] (00:28:27) at one point. They really didn't have the quorum that they needed to be able to really do anything; and so now that that dynamic has changed, I think they're looking to amp up some of their efforts. They've put out – when their staff put out the paper about rate reform. We would be supportive of something that could streamline the process in terms of looking at rate disputes. It is a very cumbersome time consuming expensive process. And so, to the extent that there can be some things done to make that a little bit more streamlined while still getting to the best right resolution, we would be supportive of.

We want to be in an environment where we're allowed to earn the returns that we need to, be able to support the business. I mean we invest – we're going to invest \$3.2 billion of capital this year into our network and that's going to help us stay fluid. It helps us operate safely, providing good reliable products, and serve our customers and grow with our customers. And that's really, at the end of the day, what I think everybody wants. And so, we want to be in a position where we maintain a regulatory environment that can support that long-term.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And the \$3.2 billion of CapEx, capital spending, this year. Is there any reason CapEx dollars need to go up as you continue to implement PSR over the next year or two? Or will that really just depend on growth. But help us think about like the capital you're spending today on a run rate basis and how that should evolve on an absolute dollar basis over the next couple of years?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Sure. So we spent about \$3.2 billion last year and that's – we're looking at an equal level here...

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Yeah.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

...in 2019. We've said long-term our guidance is that we expect that to be below 15% of revenue. And I think that's a clear indication that we think that we've made ample investment in our network over the years. You know we're not buying any new locomotives today certainly with 2,300, 2,400 locomotives parked. That's an investment that we don't need to be considering for quite a while. We've shifted some of our dollars around in terms of our capital investment. That's one thing where Jim coming in and the emphasis that he's putting on in helping us grow our train length and consolidate trains. We're doing some more exciting investments, but we're able to absorb that within the current budget. So, in the long-term, I think we feel good about where we're at from a capital spending perspective; and with that guidance on less than 15% of revenue, we feel very confident that we'll be able to do that.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

I guess you're just reallocating two from Brazos for example...

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

True.

A

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

... [indiscernible] (00:31:01), and things like that, so that make sense. On capital return, you talked about 40%, 45% dividend payout or is going up, and you talked about – is it safe to say that all the free cash flow that comes in is just going to ultimately go into further share repurchase and maintain that payout ratio of 40%, 45%?

Q

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

I mean we feel very good about – we think 40% to 45% is a competitive dividend payout ratio for us to be at. And we feel confident to be able to sustain it at those levels. And as earnings grow, then obviously that will continue to give us some room to grow that. We're at the low end of that today, around 40% to 41%. And so, yeah, then the excess cash is being devoted to share repurchase. Our first call for our cash is our capital investment.

A

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Yeah.

Q

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

But again we feel good about that. And we're redoing our capital structure. We announced that last May that we're taking some setup. We're going to go there 2.7 times...

A

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Yeah.

Q

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

... debt to EBITDA; we're about 2.6 times today. We've completed about 60% of the share repurchase plan that we announced back at that point. And we said we're going to buy about [ph] \$20 billion (00:32:11), so we've accelerated that. We've done some ASRs. So, we're in a really, really good spot to return cash to our shareholders to continue to reward them; and as we continue to improve the OR through PSR, just further opportunities there.

A

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Any last questions? We've a couple of minutes left, but I have a few more, but any last questions? Peter?

Q

Q

You've mentioned that your [indiscernible] (00:32:36-00:32:42)

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Yeah. So the question was, that we've completed the first round and that was really the transportation plan changes going around the network. I would say the second rounds and its many rounds, right. This is going to be an evergreen process. It is going through and really looking at some of the terminal rationalizations and the opportunities to consolidate our operations both from a terminal standpoint, intermodal facilities, our mechanical facilities, locomotive shops, car facilities. Again, there is really nothing that's off limits there.

Q

[indiscernible] (00:33:17-00:33:18)

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

Continue to do it all again. I mean the nice thing is when you're doing something like this, once you make one set of changes and make one consolidation, you are able to identify other opportunities; and so, think about it like peeling back an onion. We just continue to peel those layers back and keep identifying other opportunities. And we're really in the early phases of this. We see a lot of headroom ahead of us.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

How confident – as maybe a last point. How confident are you in that sub-61%, sub-60% OR target this couple of years because UNP does have a recent history of pushing out their OR targets over the last couple of years, for example, because of volume driven weakness, a lot of stuff that's out of your control. So as you do this PSR initiative and optimize the business from an efficiency perspective, there's a lot of uncertainty out there. You have a lot of business in Mexico, right?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

There is.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

And so how confident are you in that sub-61% OR target this year despite all that uncertainty on the volume side?

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

A

I would say we're very confident. Coming out of the first quarter when we had just horrible weather impacts and even sitting here today, again, we've got flooding that's impacted us with the Unified Plan 2020 implementation, bringing Jim Vena in to super charge that. We just feel very confident as a company. There's a lot of energy in the company. I feel like the momentum is really very, very strong and we're very confident we'll hit that target.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

I think that's a good note to end on. Hopefully, you come back next year and we'll be talking about the 55% OR target.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

Absolutely.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

Thanks a lot, Jennifer. Really appreciate it.

Jennifer Hamann

Senior Vice President-Finance, Union Pacific Corp.

Thank you.

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