RAILROAD WEEK IN REVIEW
MARCH 23, 2007

"Teamwork allows us to provide exceptional client service across different parts of the firm and across the components of a client's transaction." Goldman Sachs 2006 Annual Report

Eyeris Redux. Last week's report of the KCS financial meeting merely touched on the *Eyeris* system for assigning costs per move to finance, operations and marketing. There's more. It confronts head-on that small cadre of railroad managers who still believe that "revenue is fact, cost is an opinion." In a nutshell *Eyeris* aggregates actual costs from car hire, fuel and T&E labor to corporate overhead and allocates expense by business unit to every move, load *and empty*. The system actually provides a "linear look" at each car as it moves across the KCS system, assigning costs as it goes.

The system is very much like the "consumables" system used by Watco and a few other shortlines.[1] It measures resistance-miles, for example, rather than GTMs because a 100-ton load going around curves and up hills will consume more fuel and track wear than an empty drifting down a tangent grade. Chems (STCC 28) will have a higher C&D exposure than a box of rocks, and that's cranked in. Branch-line operations have their own unique costs and they are captured. And so it is that within three months after the move everybody who had anything to do with is knows whether their work increased or decreased the contribution for that move. See *Goldman*, above.

If you're wondering why Providence & Worcester's year-end results have not yet appeared in WIR, take a look at the 8-K filed Feb 20 (and which I missed), "Non-Reliance on Previously Issued Financial Statements or Related Audit Report or Completed Interim Review." Excerpts: "On February 16, 2007, P&W determined that it is likely that the Company will have to restate its financial statements for the years ended December 31, 2004 and 2005 and the periods ended March 31, 2004, June 30, 2004, September 30, 2004, March 31, 2005, June 30, 2005 and September 30, 2005. Those financial statements (the 'Affected Financial Statements') should not be relied upon.

"Until the Company has either restated and reissued its results for the applicable periods or determined that no such restatement and reissue is warranted, investors, potential investors and other readers of the Company's SEC filings are cautioned not to rely on the Affected Financial Statements, to the extent they are affected by the accounting issues described in this report. This determination was made following discussions held with its independent registered public accounting firm.

"The issue involves the proper accrual of compensatory time owed to certain employees pursuant to a collective bargaining agreement in effect during the periods covered by the Affected Financial Statements. That contract provided, among other things, for awarding of compensatory time off instead of overtime pay. During negotiations for a new collective bargaining agreement with the union to replace the agreement (which was due to expire) it came to the attention of senior management that the Company had not accrued for the compensatory time owed to employees covered by the agreement and that accumulated compensatory time owed to all employees entitled to earn it, who are located in several departments, represented an obligation of the Company that needed to be reflected in the Company's financial statements.

"The Company intends to reduce its retained earnings as of December 31, 2003 by $168,000 and its net income for 2004 and 2005 by $33,000 (one cent per share) and $45,000 (one cent per share),

[1] See also http://www.rblanchard.com/resources/consumables.htm

respectively. These figures are subject to final audit by the Company's independent registered public accountants." Oops.

Rick Paterson at UBS writes, "Using March 14 closing prices NSC and CNI are our top picks in the sector. Our rationale is that these two stocks will benefit from the strong secular pricing trend that is currently underway while at the same time presenting investors with minimal execution risk given the superior quality of operations and management.

"Additionally, NSC is materially the cheapest stock in the rail sector and cheapest stock within our freight transportation universe. On a longer term basis we also favor Union Pacific, given a large proportion of 'legacy contracts.' UP has 32% of revenues under long-term contracts signed before 2004 when pricing was weak and these will be re-priced materially higher over time. In our view it's solid evidence of the beginning of an operational turnaround."

Rick also looks into rail industry leverage, something that is rarely discussed in polite company, but which definitely needs more light. He writes, "Last week we asked your opinion on the current leverage level among the six major Class I railroads. [We found] the vast majority (80%) think the rails are underleveraged, while 20% say 'optimally leveraged.' Not a single respondent thinks the sector has too much debt. Most 'under-levered' responses were adamant, with many preceding 'underleveraged' with 'significantly' and citing the sector's tight capacity and robust pricing trends to justify higher debt. Some suggested leverage should be viewed in terms of debt/EBITDA rather than the perhaps somewhat antiquated debt/cap ratio."

Meanwhile, and continuing the thread of the poorer performing railroads' better stock price performance, Bear Stearns' Ed Wolfe opines, "We note that our three Outperform rated rail stocks – NSC, CNI and BNI – are historically the best managed, best margin, best return on capital and best cash flow generating railroads in their geographies, yet each is currently trading at a discount to its lesser historically financially strong direct rail competitor (and have been most of the past 12-18 months). In other words the market has favored the potential reward and turnaround of the lesser margin railroads over the already better performing rails with better returns and less historical operating risk.

"This seems to be a mirror of the overall stock market where *investors have paid less attention than normal to risk and returns versus potential reward (emphasis added).* Our sense is in a rail environment that is going through a major transition in a quick manner from 3% positive volume growth less than two quarters ago to a 3% decline QTD currently, risk and returns will become more factored into some of these stocks over the next 6-12 months and the rails should see a modest move towards a mind-set of 'highest quality' from a mind-set of 'most potential improvement.'"

We must not lose sight of the fact that we are a *service* business and that the customer's perception of relative quality among vendors plays a big part in mode selection. This is doubly true on the merch carload sector where truck is often a lot easier to use than the railroad. The shortlines' Unique Selling Point is making a custom service out of a batch process. The first-mile-last-mile aspects of the carload business can make or break a sale and the Class I that capitalizes best on the shortlines' USP will be the soonest winner. That takes consistency, reliability, infrastructure and *money*.

California's Richmond Pacific has stepped up to the emissions plate with its recent low-emissions locomotive project being promoted to the community and the media. "In 2006 we partnered with the Bay Area Air Quality Management District to acquire a Carl Moyer Project grant from the State of California . This grant of $148,000 was used to cover the bulk of a $200,000 project to retrofit locomotive #2285 with a low-emissions package from Rail Systems, Inc of Houma , LA. This package, plus the application of a ZTR Smart-Start Anti-Idling Device have brought the 1965-built locomotive up to U.S. EPA Tier 0 standards. Richmond Pacific voluntarily covered the rest of cost of the project, approximately $52,000. Richmond Pacific operates through some neighborhoods that are heavily impacted by the emissions of diesel engines involved in the transportation industry. We feel that projects such as this are positive ways in which we can work with our neighbors to make the City of Richmond a better place to live, and a better place for us to do business."

Super-size it? Yes – by the carload. Here's an object lesson on how to revitalize a redundant branch line by identifying a logistical need and creating a product to fill it. (Reprinted with permission from *NS newsbreak* for March,2007)

A Norfolk Southern rail spur that had not seen use in 15 years turned out to be the perfect solution for a supplier of frozen food products to distribute French fries and hash brown potatoes to McDonald's restaurants. Martin-Brower has supplied McDonald's restaurants since 1956 and was transporting the frozen potatoes in trucks from Manitoba, Canada, to its warehouse in Manassas, Va. The product is distributed to 635 restaurants in the Washington, D.C., area. Todd Hopkins, general manager for Martin-Brower, was looking to lower transportation costs and help reduce congestion, exhaust emissions and pollution on Northern Virginia's already clogged highways. He only had to look 10 feet from his window for the solution.

"Martin-Brower approached us about rail transportation, and we worked to make things happen," says Bob Plain, a marketing director in NS' agricultural products group. "We knew we had a solid operating plan, the technology to support this time-sensitive service, and people dedicated to providing excellent customer service." Plain said a team of NS people from the marketing, transportation, engineering and mechanical departments worked to reopen the spur for direct access to the warehouse.

Martin-Brower worked with Cryo-Trans, a logistics company that also provides state-of-the-art refrigerated railcars. The cars are equipped with global positioning system equipment to track them and to monitor internal temperature during transit. They also are larger than most refrigerated rail cars, so fewer are required. Meanwhile, NS' service design group worked with Canadian Pacific Railway to create a service package that would facilitate on-time delivery.

Washington-area McDonald's customers consume more than 1.5 rail cars of French fries and hash browns every day, so making sure the product arrives when the customer needs it is essential…It took nearly five years to transition from all-truck to all-rail transportation. Martin-Brower acknowledged the accomplishment at a celebration in late 2006.

Labor Relations Department. Tom Brown sends this 1923 note from the desk of a Boston & Albany superintendent in Palmer, Mass to one T. J. Millett, conductor. "Your wire of the 17th asking why you are being used in snowplow service instead of your regular work: For your information, should I receive a communication of this kind again from you there will be nothing left for me to do but consider it your resignation. Yours truly…"