THE RAILROAD WEEK IN REVIEW
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"For the New York Central to pull this off [the merger with the Pennsylvania], it needed to be a fluid operation, and it had to have precise knowledge of costs and of the lowest price that could be charged to make a profit. This is what made 'marketing' qualitatively different from mere 'sales.'" – Richard Saunders, Main Lines, page 8.

The Year 2006 in *Week in Review* will be the Year of the Railroad Marketer. We talk of VPs of "Marketing and Sales" and in the well-run railroad's TO&E we see marketers and sales reps. As I see it, the sales reps have to convince buyers to use their products and, of they can't, identify which products they could sell if presented. They provide feedback to Marketing which then sets about the task of determining whether the desired product will produce a profit at market price.

Richard Saunders goes on to note the "The Pennsylvania Railroad clung tenaciously to the traditional pricing philosophy [and had an] inability to pinpoint costs." That's where the network comes in. Not every revenue unit "makes money" as a stand-alone item but in a train low-rated commodities contribute to the profitability of the train.

Think in terms of the $50 spread between Southwest's highest and lowest fares between many OD pairs. The market price for air transportation is in that range and LUV has determined that costs are such that the fare mix makes the flight profitable. In other words, the individual $50 fare may not cover LTV costs but the mix of fares on the flight will and then some.

Ike Roberts and Mike Behe, founders of usraildesktop.com and both former Conrail food products marketers, have shown that a merchandise train with both high- and low-rated commodities can make money even if some loads don't cover their own *unit* costs. The train-start costs the same with one or 100 revenue units and the train contribution to overhead remains the same regardless of train size. Take away the revenue from the low-rated loads and profitability per crew-start plummets.

The trick, then, is finding the right mix of seats on the plane or cars on the train. Marketers must know where the right mix lies and instruct the sales reps accordingly. But in the shortline model where all cars generate the same revenue there is little incentive to match business development efforts to the connecting Class I's target mix.

As noted before the FASB decrees that shortline allowances must come out of revenues yet at the same time one reason for shortlining a branch or terminal is to give power and crews back to the core operation. The shortlines have to fill the right kind of seats and ops knows what it costs to run the plane/train. We gotta get the carload pricing model to reflect the cost of the plane/train.

Then too the network costs trump carload costs. Consider the Behe-Roberts One Train Railroad model (see charts below). The One Train has four cars; two "make money" on their own, two do not. Yet the OTRR is profitable anyway. Take away the kitty litter and you take out $1800 of revenue and car cost but now have to spread the crew-start and overhead over three cars, cutting the One Train's contribution by 25%.

Now take away the other money loser, the paper car. The cost of the crew-start is still $2000 and the $2800 overhead has not changed so the now One Train Railroad loses money. But wait, you say, there's more. If you take away the two money-losing cars you can put the two remaining cars on another train. That's OK as long as there's another train to put them on, however you keep spiraling down to fewer and fewer trains until you become the One Train Railroad once again. The model also works for One Train between main yards. The fewer trains in the lane the greater the terminal dwell time. So as marketing eliminates the loads that lose money on a *per each* basis, the operating department incurs higher costs. As revenue goes down and ops costs go up, operating income goes down, and, absent shenanigans below the line, eps goes down taking share price with it. Not good.

Over the past few issues of WIR we've taken certain Class I market managers to task for pricing practices that are out of date. The mind-set needs to change. Pre-Staggers pricing was cost-based: it costs us this much to move a carload of whatever from Albany to Zanesville ergo we can charge X. The model has shifted to market-based: the price of whatever in Albany is X, the price in Zanesville is Y ergo the value of transportation is Y-X. Can we do it for that and make money?

So, some things to watch in 2006: yoy changes in volume, ops expense, ops revenue, gtms, rtms. We're looking for greater increases in volumes than ops expense so that if and when the ability to raise prices lessens, there's enough volume at the right mix to run the network at a profit. On that note, Jon Langenfeld of RW Baird & Co writes in his *2006 Preview*, "Rail service needs to change directions. Our conversations with industry participants are revealing an increased sentiment that that railroad rate increases will be met with more resistance if the service does not improve." QED.

RailAmerica has completed the sale of the San Luis and Rio Grande Railroad (SLRG) in southern Colorado to Ed Ellis' Permian Basin Railways, Inc. for a total of $7 million. Total proceeds are comprised of $5.5 million cash, $0.98 million note and $0.52 million cash from the sale on non-operating real estate to third parties. SLRG had revenues of $2.6 million for the first nine months of 2005, annualizing to $3.4 mm.

This was a fairly recent RRA acquisition, having been completed in June 2003. It was RRA's 50th shortline and was the former Rio Grande line (UP when RRA bought it) line running west out of Walensburg to Alamosa thence north to Derrick and south to Antonito. The latter was the way in to Durango and the famous narrow gauge network, the remains of which still operates as a tourist route using the original outside-frame 2-8-2s.

The press release announcing the purchase (6/27/2003) anticipated annual revenues in the $3.5 mm range. Using my shortline model that worked out to roughly 11,000 revenue cars a year, not quite enough to support a 154-mile railroad in some pretty challenging geography. Based on some other RRA metrics it looked to me like it was running an OR north of 100 and not really contributing to the network. The sale therefore is good news.

Ed Ellis is the right guy for the property. Recall he bought the Arizona Eastern and the West Texas & Lubbock from RRA a year ago and has shared with WIR a few of his successes. Ed is another one of those shortline operators who's been active for some time and understands networks and what shortlines can bring. The UP, RailAmerica and the shortline community at large will benefit.

There has been a spate of inquires from non-railroaders about how to get into the shortline business. The flip answer is, "Don't" or "The best way to make a small fortune in the shortline business is to start with a large one." There is a more serious answer, however, and I'd like to run it by the readership for a sanity check. Generally, the writers want to know first what's for sale and how does one find out where they are.

IMHO, there are very few shortlines "for sale" at any given moment. Mostly, acquirers already have shortlines and are looking to expand their portfolios because you can make more money moving more cars with the same asset base. Any shortline that makes economic sense in its current configuration will not be for sale. Ones that don't might be for sale, so the question is whether the lack of economic sense is due to management failure or the markets served. If the former, one may have a shot. If the latter, nobody has a shot and the RR will probably go away. Comments?

2006 Outlook. Shortline volume gains on a percentage basis will continue to outpace the Class Is. The key metric will be shortline gains as a whole, not railroad to railroad: acquisitions will bump the buyer's numbers but the numbers of the acquired are still captured in the industry numbers. Growth will come from shortlines picking up Class I branches plus their own organic increases.

How the Class Is do traffic-wise is directly related to performance. Quality is still measured in the eyes of the buyer and high revenue-cost multiples come only from products with a Unique Selling Point: reliability, easy of doing business, and consistency. One shortliner told me just yesterday that a cross-county carload lane terminating on his road is in jeopardy of going to truck because transit times are all over the map. The price is right, but at what cost to the buyer?

We will continue to see consolidation in the shortline business with new owners coming to established properties – see my remarks above. The better shortline operators will find short-haul opportunities on their own railroads, in conjunction with adjacent shortlines, and even with overhead rights on Class Is in the middle. After all, if the shortline is willing to write a six-figure check to the Class I for running frequent and fast mini-trains over an under-used piece of RR, why not?

Consolidation will likely take the form of contiguous buys where the acquiring shortline can connect the target with its existing network. This kind of acquisition represents an immediate unit cost take-out as more revenue units are spread over an established cost base. A shortline running with an 80 OR ought to bring a sale price in the range of twice sales or seven times EBITDA. Shortlines with multiple Class I connections are worth more than shortlines beholden to only one Class I.

Don't look for wholesale line sales from any of the Class Is. Transactions will be leases targeted to specific shortline operators with whom the Class I has an existing and successful long-term relationship. Moreover, there will be language in the lease permitting the Class I to recall the line in under certain circumstances.

The shipper will be the ultimate beneficiary. As the Class Is focus more on the core business and shortlines do a better job of contributing the right commodity mix the value of the service in the eyes of the buyer will increase. Done right, even a box of rocks in a short-haul lane can make a lot of money. As long as we don't get trapped in the OTRR mind-set.

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The One Train Railroad, courtesy of www.usraildesktop.com

OTRR Profitability

(One Train Railroad Company)

Car	1	2	3	4	Train
Contents	Resin	Clay	Paper	Kitty Litter	
Owner	PVT	PVT	RR	RR	
Revenue	4,000	2,800	2,400	1,800	11,000
Cost: Car	1,000	1,000	1,500	1,500	5,000
Cost: Train	500	500	500	500	2,000
Op Margin	2,500	1,300	400	-200	4,000
Cost: OH	600	600	800	800	2,800
Bottom Line	1,900	700	-400	-1000	1,200

OTRR
w/o 'Bad' business

Car	1	2	3	4	Train
Contents	Resin	Clay	Paper	Kitty Litter	
Owner	PVT	PVT	RR	RR	
Revenue	4,000	2,800	2,400		9,200
Cost: Car	1,000	1,000	1,500		3,500
Cost: Train	667	667	666		2,000
Op Margin	2,333	1,133	234		3,700
Cost: OH	850	850	1,100		2,800
Bottom Line	1,483	283	-866		900

OTRR
w/o ‘not as bad’ business

Car	1	2	3	4	Train
Contents	Resin	Clay	Paper	Kitty Litter	
Owner	PVT	PVT	RR	RR	
Revenue	4,000	2,800			6,800
Cost: Car	1,000	1,000			2,000
Cost: Train	1,000	1,000			2,000
Op Margin	2,000	800			2,800
Cost: OH	1,400	1,400			2,800
Bottom Line	600	-600			0