THE RAILROAD WEEK IN REVIEW
FEBRUARY 10, 2006

"*Coal prices continue to be high but as an alternative to oil and natural gas is still a much cheaper commodity*". *– Tom Leritz, Argent Capital Management*

Watco Lake Oswego has signed on with Greenbrier Management Services for its car hire payables and receivables processing services. GMS will process car hire payables on all rail equipment, trailers and containers that are interchanged onto Watco's network of 17 shortline rail properties. GMS will also process the car hire receivables generated by Watco's fleet of railcars. What this means is GMS is gaining traction in the non-trunk line railroad sector for these crucial back-office services. Recall FEC signed on with GMS back in October (WIR 9/2/2005).

Greenbrier says their car hire processing system is a robust, web-enabled, state-of-the-art proprietary product that integrates the processing of car hire payables and receivables data. The payables system allows customers to manage their car hire payables expense by obtaining daily updates of car hire liability and by automating many facets of the process including special reclaims.

Once again, Watco takes a leadership position in the way shortlines manage cost of sales. I've written before (http://www.rblanchard.com/resources/consumables.htm) about Watco's "consumables" approach and how it's one helluva way to monitor performance and profitability. No reason to keep doing stuff in-house that somebody else can do better and more cheaply. After all, managing car hire etc. is GMS' core business. Watco's is providing commercial value to transportation buyers.

What goes around comes around. In case you missed it, CN bought the three Alberta properties RRA has had on the block for a while. The purchase price was C$26 million (US$22 million) in cash with a provision to pay up to C$4 million more, depending on the amount of future business development. CN will also spend about C$40 million over the next three years to upgrade track on the lines to haul heavier freight.

Two of the railroads -- the 600-mile (1,000-km) Mackenzie Northern Railway and 118-mile (190-km) Lakeland & Waterways Railway -- were formed from branch lines in northern Alberta that Canadian National sold in the late 1990s. A spokesman for CN says, "These lines became available because RailAmerica intended to divest them. We looked at them and said they make sense. We're a different company than we were eight or nine years ago."

The lines carried about 50,000 carloads of freight last year and employed about 130 people, but CN said upgrading the northern Alberta lines will allow them to haul heavier materials needed for construction of oil sands and pipeline facilities being built in the region. Most of the capital expenditures will be done on the Mackenzie Northern, whereas the third railroad in the deal, is the 21-mile (34-km) Central Western Railway, will be used primarily used to train new rail crews.

RailAmerica recently held a conference call providing guidance on anticipated results for the 2006 full year, which was interesting because it came before the 2005 earnings announcement. There was no press release per se, so the take-aways are pretty much in the eyes of the beholder.
This beholder tends to behold what's going on above the line, even though the call was largely intended for the stack analyst crowd and their interest in eps and other below-the line minutia.

For openers, CEO Charlie Swinburn said 2006 revenue would be in the neighborhood of $460 mm, up "8 to 10 percent" over 2005, which, recall, won't be out till next week. But if $460 mm is 109% of

2005 revs, then the implied 2005 number is $422, up 6% over the $396 mm reported for FY 2004. RRA previously (Jan 16) reported 2005 carloads of 1.3 mm, up 5.6% yoy so revenues up 6% isn't a stretch. Be mindful too that shortlines don't necessarily see the same double-digit RPU gains as the Class Is because the former are paid FAK allowances that may or may not be negotiated up on an annual basis, depending on the Class I and the nature of the relationship.

Swinburn said the 2006 car count would be up a point or two over 2005 – call it a 1.324 mm vs. 1.305 mm. There are no acquisitions or line sales in the calculations, though we all know it's a buyer's market and there are several hundred shortlines crying out for new owners. As for the Alberta sale above, Swinburn said a major concern was the need to put capital to work where it can earn the best return and it wasn't up there. He also trotted out the observation that the operating ratio isn't the holy grail. A railroad could have an OR in the 90s but as long as it was generating free cash flow and earning a respectable ROI it would probably be a keeper. I like that.

The 2006 guidance included an OR in the high 80s, little changed from what we've seen in the past. The OR for FY 2004 was 87. Leaving it unchanged for 2005 and 2006, the implied operating income is about $60 mm, up 9% on the same OR. What I'm hoping for is a more rapid payoff from the strategic programs, the capex program for track and the anticipated $13 mm benefit from infrastructure tax credit program. But, truth to tell, Swinburn does not see an OR "in the low 80s" for another two years.

Lastly, and not particularly good news for the industry, is that the 2006 revenue guidance is about $15 mm less than it would be were the Class Is taking everything offered. Swinburn said Class I congestion is the big drain, though pricing practices and paper barriers are taking their toll as well. Be sure to tune in next Wed to hear the 2005 results. (FWIW, I just wrote a piece on the effect of paper barriers on chemical products shippers on shortlines. It'll run in the March 2006 issue of *Railway Age*.)

Class I revenues for 2005 were up 13% yoy. That's the good news, especially for those who rode the rails' stock prices for the year. Increases ranged from just under 40% for CSX to more than 60% for BNI. The question is, however, how long can it continue? The not-so-goods news is that a good chunk of it came from fuel surcharges and total revenue-unit volume increased only 2.3% yoy.

The shift to market pricing is a major factor as rails have begin to price according the place value of goods rather than what it costs to make the move. Long term, the delta in place value of western lumber in Chicago over what it is in Spokane isn't going to change much. And once the railroads have priced in the place value, where else can they go?

My thesis is that once the shift to market pricing has reached par, earnings gains will depend more on volume gains than on RPU increases and to make more money on more volume operating expenses may not increase at a greater rate if change than volume does. But in 2004 total Class 1 operating expense increased 7.6% yoy – 3.3 times faster than the rate of volume change.

We've all seen the powerful leverage of increasing revenues faster than expenses – NSC and BNI have done it repeatedly. But imagine the dark side where ops expense increases at a faster rate than either revenue or traffic volume. What then?

Railinc's RailSync Mobile Command for shortlines has come down in price. This is good news because it'll be especially helpful to smaller roads that are having trouble complying with the rail industry requirement for timely event reporting. The benefit is that Mobile Command eliminates the need to re-key movement data from the Wheel Report to the data warehouse, be it Railinc, RMI or

SDSROCS. Because it generates movement events in real time it Mobile Command enhances the timeliness and accuracy of information to both the railroad and its customers. Let me say once again: the shortline that is behind the curve in event reporting is doing itself and its customers a disservice. I think this tool can help.

Commodities Corner. *Lumber traffic* may be in for a slowdown if home-builders share the downside announced by Toll Bros. A note from Goldman Sachs suggests that "home builder's woes, caused by weaker home prices and softer demand, signal broader weakness in the housing industry." Building products from plywood to studs to OSB are all affected. Yet, for what it's worth, the aggregates guys like Florida Rock (FRK) and Martin Marietta Materials (MLM) are knocking 'em dead.

Energy stocks got badly beaten down this week. Peabody really took in the drawers Friday morning, off 2% in the first hour. Run that chart against BNI see how the two ran in parallel through Jan at which point BTU headed sharply north while BNI stayed the course. This week, however, BTU headed sharply the other way while BNI (and UNP) essentially marked time.

As for what happened to BTU, Arch Coal (ACI) is what happened. Early Friday ACI reported 4Q05 eps down 58% yoy on a slew of temporary setbacks from high labor costs to lower than expected volume, with the latter laid at the feet of the rails. (Yeah, there was a wobble last summer due to track problems, but that's been fixed and a friend at the UP said they still can move coal out of the PRB faster than the mines could produce it.)

Happily, by noon cooler heads prevailed and both BTU and ACI had begun their recovery. Both were down 15% on the week. But what gets me is there is a growing demand for coal and it's a resource that isn't going away. Similarly other energy stocks. And steel. Yet all three groups have fared badly this week. To me it looks like lemmings' work and I for one am not selling.

(Disclosure: I may have sworn off owning railroad stocks because it's not fair for me to downgrade A when I own B and praise it, but for suppliers and commodities the gloves are off. I own BTU, HAL, SLB, HXL, and ATI in these sectors at the moment. TRN and GBX are on my Watch List.)

Errata. The Operating Efficiency table in WIR for 2/3/2006 was somewhat misleading and inconsistent as to the meaning of "MGTM" and "MRTM." Sometimes M meant thousand, sometimes thousands. The numbers are reworked in the attached chart, and thanks go to BNSF for their lucid layout of these metrics on page 11 of their *Annual 2005 Investors Report* to help check my results.

WIR thanks the sharp-eyed reader who caught my error and spent some time on the phone with me to make sure we had apples-to-apples. WIR regrets any inconvenience.

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Disclosure: Blanchard does not and will not own stock in the companies covered in Week in Review though he does and seeks to do project work for these companies.

Big Six Class I Operating Efficiency

Full Year Ending 12/31/2005

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP*
Railroad revs	$ 12,987	$ 7,240	$ 4,392	$ 8,618	$ 8,527	$ 13,578
RR Operating Expense	$ 10,065	$ 4,616	$ 3,390	$ 7,069	$ 6,410	$ 10,673
RR Operating Income	$ 2,922	$ 2,624	$ 1,002	$ 1,549	$ 2,117	$ 1,795
GTM in millions	1,061,108	342,894	236,451	463,200	375,800	1,043,900
RTM in millions	596,575	179,701	123,627	246,800	198,300	548,800
Fuel Consumed (mm gals)	1,402	403	286	596	513	1,353
Route Miles	32,154	19,221	13,626	21,537	21,300	32,615
Average # of Employees	39,254	22,246	16,295	na	29,851	49,747

Measures	BNSF	CN	CP	CSX	NS	UP
Operating Ratio	77.5	63.8	77.2	82.0	75.2	78.6
Ops exp/Thousand GTM	$ 9.49	$ 13.46	$ 14.34	$ 15.26	$ 17.06	$ 10.22
Ops exp/Thousand RTM	$ 16.87	$ 25.69	$ 27.42	$ 28.64	$ 32.32	$ 19.45
Rev/Thousand RTM	$ 21.77	$ 40.29	$ 35.52	$ 34.92	$ 43.00	$ 24.74
MRTM/MGTM	0.56	0.52	0.52	0.53	0.53	0.53
MGTMs/gallon	756.85	850.85	827.33	777.83	731.98	771.54
Thousand GTMs/emp	27,032	15,413.74	14,510.65	na	12,589.19	20,984.18
MGTMs/route mile	33.00	17.84	17.35	21.51	17.64	32.01

CN, CP in $C

MG/RTM = Millions of Gross/Revene Ton-Miles

Revenue line includes freight revs plus other ops rev.

CN includes partial year for GLT, BC Rail

* UP before asbestos charge in 4Q04

Source: Company financials

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