THE RAILROAD WEEK IN REVIEW
MARCH 10, 2006

"The DOT predicts that freight volumes will grow nearly 70% in the next 20 years." -- AAR

AAR President Ed Hamberger writes in an e-mail that "Congress must act now to keep rail on track for the future." Specific points, quoting from his note:

Reject re-regulation. Don't co-sponsor S. 919 or H.R. 2047, which would reduce competition, discourage capital investment and turn back the clock on 25 years of advancements in the freight rail industry. Since partial deregulation in 1980, rail service is safer, cheaper for most shippers, more reliable and far more efficient.

Extend the short line infrastructure tax credit, which has yielded significant benefits since it was enacted in 2004. The initiative provides up to $500 million to make necessary track improvements, allowing the short lines to keep pace with America's freight service demands. Halfway through its originally enacted three-year period, the initiative has allowed short lines to increase annual rehabilitation and expedite completion of important projects.

Additionally, it has convinced railroad consumers to make new investments in their own facilities. By leveraging private investments well above the costs to the federal government, the tax credit encourages infrastructure improvements that are critical to keeping U.S. freight rail system efficient, strong and competitive in the global marketplace.

Support the upcoming freight railroad infrastructure tax credit, which is necessary to meet future growing freight needs. To take full advantage of the railroads' potential, investment in rail infrastructure must rapidly increase over the next 20 years. Railroads cannot fund all the investments on their own. By leveraging private investments and producing huge public benefits — reducing highway congestion and construction costs — the tax incentive would help bridge the funding gap and allow railroads to make necessary rail capacity enhancements.

The Class I freight railroads propose a 25 percent tax credit on investments that expand capacity and the option of expensing all other infrastructure outlays. Eligibility for the credit would extend to any taxpayer that makes a qualifying expenditure. The credit would place capital cost recovery for rail infrastructure on the same basis as competing modes of freight transportation.

He closes with a reminder that "railroads carry the things we use every day — from orange juice and cell phones, to cars and lumber. As we celebrate Railroad Day on Capitol Hill today, please look for us working to ensure North America's freight railroads remain the safest and most efficient in the world." See also www.aar.org for more on freight rail issues before the 109th Congress.

Fresh Del Monte (NYSE:FDP), the former Del Monte Foods, is often mentioned as a potential rail customer for those shortlines serving refrigerated warehouses and food distribution facilities. A recent note from Bear Stearns indicates a company in trouble and Bear has downgraded to *Underperform* from *Peer Perform*.

Says Bear, "We are particularly concerned about domestic banana sales because the system almost seems broken. Major contracts are locked in for another few months, meaning the firm must pay significantly higher costs without being able to pass on higher prices. And contract sales, versus bananas sold on the spot market, make up a much greater percentage than they used to." Shortlines with significant produce business may find it helpful to see what impact FDP's difficulties may have on shortline customers.

American Railcar (ARII) drew praise from *MarketWatch.* ARII is among the most successful of the 2006 IPOs thus far, winning the Number Two slot for achieving a stock price 60% ahead of its IPO. As noted last week, ARII specializes in tank cars and covered hoppers, two of the car types most in demand by leasing companies.

Railroad operating plans are finally getting to the point where transit times are predictable, so a shipper with 20,000 moves a year that had to use 2,000 cars in a ten-trip-per-year cycle can now do the same move with fewer cars. Or, and this is more often the case, the 2000 cars can handle more loads. For example, the same 2000-car fleet that hauled 20,000 loads on a ten-trip-per-year cycle can do another 6,000 loads on a 13-trip per year average. And that increased productivity might just induce shippers to find more moves for more cars leading in turn to more orders from the likes of ARII and its peers among car builders.

Greenbrier (GBX) stock rose Wednesday after Bear Stearns upgraded the railroad industry supplier on better earnings visibility. Analyst H. Peter Nesvold upgraded the stock to "outperform" from "market weight" saying that "Greenbrier's stock has had a great run but with improving earnings visibility, we believe that the best is yet to come." Nesvold writes that he sees increased orders for intermodal platforms in 2H06 plus "improved earnings and backlog visibility."

FreightCar America (RAIL) sponsored a "job fair" at the Wyndham Roanoke (VA) Hotel to talk about the company and take job applications. The company wants to hire about 200 workers for a second shift starting in six weeks. The a starting wage is11.25 an hour plus benefits and by noon more than 100 folks were lined up for interviews and still more were filling out job apps.

RAIL came to Roanoke in January 2005 with a lease to manufacture rail cars in Norfolk Southern Railway's old East End Shops, which had been closed since 2000, and started production of their aluminum OT coal hoppers last June at a run-rate of about a dozen a day. CFO Kevin Bagby says RAIL had a backlog of orders for more than 20,000 rail cars at the end of last year, enough to keep its three shops busy this year.

Full-year 2005 railroad revenues for the Big Six Class Is increased 13%. That's the good news. Revenue units increased only 2% and operating expenses above the line increased 8%. That's the bad news. Especially when one considers that a lot of the double-digit rate hikes are just to get "market prices" on a par with truck or truck-equivalents. Once those levels are reached, the elasticity for further upside for rates is not clear.

Moreover, fuel surcharges accounted for maybe four points of the 13-point revenue increase. The rails are hedging less because of two things. First, the volatile price of oil could leave them hedged at prices in excess of the street price. Second, fuel surcharges are much more flexible. Now comes word from a number of oil-watching sources that fuel prices may be coming down. Or may not be.

One such source, the estimable BMO Harris Private Banking "Basic Points" letter on Supply Side Mineral Economics, warns, "The mainstream view of the upstream outlook is that, barring a new Mideast war, OPEC and the oil majors could bring on 14-16 million barrels/day over the next 5-6 years, forcing oil prices back down below $40." However the paper suggests a more realistic view that the cost of finding friendly and reliable new sources of oil portend another outcome.

What worries me is that Class I railroad operating expenses are increasing four times as fast as volumes, which means it's costing more to move the goods. Yeah, fuel is part of it but it's not the only part and bringing yoy fuel cost increases back in line with other yoy changes won't fix labor and other increasing costs.

Now consider service quality. The ability to charge more for anything is based on the buyer's perception of relative quality vis a vis the competition. Yet AAR Railroad Performance measures YTD are not that encouraging across the board. Average train speed, a flawed metric to begin with because it excludes ops between the serving yard and customer dock, is still the best measure of how well customer shipments are moving.

Of the five Class Is reporting (CN does not play) only BNSF showed improved train speeds for the week ending 3/3/2006 over the 1Q05 average. Which is good -- until you consider half its merch carload moves involve another railroad. So, if service improvements are not that great, some of the pricing elasticity may be ebbing and ops expenses per revenue unit are increasing, what does that say about future gains in operating income?

The view from here is that there needs to be closer coordination between operating practices and commercial revenue goals. The two are very often at odds, especially where the commercial focus is on revenue regardless of cost while ops is charged with maximizing returns on assets from locos to crews to cars to track-miles. I mean, how can you take a rate increase for widgets to cover increased equipment replacement costs and then cut local service to twice weekly from five days?

Continuing the thread about shortline car counts, the response has been instructive. It appears that shortline participation in the merch carload business may be even greater than previously thought. For example, I'm not convinced either RMI or Railinc captures short-haul cars that move between points on one shortline only or between points on two different shortlines via trackage rights over an intervening stretch of Class I railroad. This is definitely a work in progress and reader experiences are eagerly solicited – confidentially, of course.

AAR Rail Traffic volumes increased 0.7% yoy for Week 9 ending March 4, down 0.4% over four weeks, and up 2.2% YTD. Intermodal continues to be the big winner, up 3.9% YTD and represents 25.3% of total revenue unit volume. Coal, 31.6% of total volume, was up 2.7% YTD. But the equipment story is most revealing.

Box car traffic (Table below) represented 11.6% of CY 2005 totals and four of the five box car commodity groups were down. Only refrigerated products showed growth based on the STCC code book. Yet open-top hoppers carried 40% of total revenue moves and covered hoppers another 14%. In other words, the carload business is increasingly a batch-process bulk business while the onsey-twosey trade is going away. No wonder OTHs and CHs are the big money-makers for the car builders. Anybody want to take the other side of this argument?

Table. Commodities and Car Types

AAR Commod Group	AAR STCC	Commod Grp	Pct total	Cume by Car	Car type	FY 2006
Motor Vehicles	371, 41118	37	5.1%	5.1%	AUTO, B	-2.5%
Pulp & Paper	26	26	2.0%	2.0%	B	-0.4%
Stone, Clay, Glass*	32	32	2.1%	4.1%	B	-0.3%
Metals	34	34	3.1%	7.2%	B	-2.0%
Waste & Scrap	40, 48	40	2.1%	9.3%	B	-1.5%
Other Farm Products	all other 01	1	0.3%	9.6%	B	-1.5%
Food & Kindred Prods	other 20	20	2.0%	11.6%	B	2.8%
Grain	0113, 01144	1	5.4%	5.4%	CH	0.4%
Grain Mill Products	204, 20923	20	2.2%	7.6%	CH	5.2%
Chemicals	28, 49	28	6.6%	14.2%	CH,T	5.2%
Lumber & Wood	other 24	24	1.4%	1.4%	F, B	3.9%
Metallic Ores	10	10	1.0%	2.4%	OTH	-6.9%
Coal	11	11	31.6%	31.6%	OTH	1.5%
Crushed Stone, Sand	142, 144	14	4.2%	35.8%	OTH	7.6%
Coke	29911,3,4	11	1.3%	37.1%	OTH	6.8%
Nonmetallic Minerals	other 14	14	1.2%	38.3%	OTH	-4.7%
Other		99	1.2%	39.5%	OTH	2.2%
Primary Forest Prods**	241	24	0.7%	40.2%	OTH, F	-5.8%
Petroleum	291	29	1.4%	1.4%	T	3.3%
			74.7%			

Source: AAR for commodity percents

* Mainly bricks and wallboard in this STCC
* * Mainly wood chips and pulpwood logs for paper-making