THE RAILROAD WEEK IN REVIEW
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"Despite the current reforms, the American System is very big, very complex, with many redundancies to protest institutional interests."— Bret Stephens on the CIA

It's a little frightening how well this shoe fits the Class I railroad business. Just the other day I got a call from a shortliner who hasn't had an interchange for days because the regular *locomotive driver* is on vacation. The next day another shortline owner was telling me how crews consistently place the wrong cars on his interchange track. His customers are looking for a particular paper grade in specific cars but the instructions to the Class I crew are to deliver to interchange by car number.

A market manager says he can't accommodate a certain shortline move for want of equipment. Yet at the other end of his railroad that very equipment sits idle in a far corner of a yard. A Class I terminal manager is told to cut a local to three days a week yet cars for that local arrive at such a rate that three crew-starts a week will never get all the work done. This is not the picture we're supposed to be getting if the first quarter presentations are any guide.

All of which is further proof that the Class Is have no place in providing local service. They are great at line-haul, point to point moves, but local dray? Forget it. Remember Giblin's Rule: The three elements of any move are pick-up and delivery, terminal processing and line haul. Of these, the railroads' niche is the line haul. Let local drayers (*shortlines*, in other words) do the rest.

Fuel Surcharges are an important revenue stream for railroads of all sizes, even if the Class Is' piece of the action is the most visible. And as long as the price of a barrel of oil keeps going up, so will FSCs. But what happens if the dire predictions of $100 per bbl oil prove unfounded? Spoze oil drops below $50 and stays there?

As an active investor (BTU is a major holding) I get a lot of e-mail soliciting subs for financial newsletters and recently there's been a spate of mail saying oil prices *are* coming down. Just today Exxon Pres Rex Tillerson was quoted in the WSJ as saying that "hydrocarbons, in the form of oil, gas and coal, exist in such abundance that the challenge of technology is how to burn them more cleanly, not how to survive without them." The writer, Holman Jenkins, goes on to say how it's the politicians that have a vested interest in an oil scare, and that "only sensible opinion they're hearing on $3 gasoline" is coming from the likes of Tillerson.

Forgeting for the moment that some WIR readers liken the editorial page of the WSJ to *Mein Kampf*, the fact remains that oil futures have so many moving parts with so many varied vested interests it's hard to know where the real truth sits. That's why this week's STB hearings on fuel surcharges were highly educational. For example, take this e-mail from CURE: "Railroads impose fuel surcharges not simply to recover their unanticipated and uncontrollable increases in the cost of fuel, but rather in excess of their increased fuel costs in such a manner as to enhance their net revenues." More on this in WIR for 5/19.

Ergo the direction of future oil prices is critical. NS has announced its intention to rely les on fuel surcharges and base its rates on higher oil prices as a fact of life. BNSF is going to a highway-based mileage charge keyed to the price of highway diesel fuel. Add-ons a percentage of the rate are the norm elsewhere. But the common thread is that each assumes oil prices will keep going up and that the FCS programs will keep top-line growth ahead of that curve. We'll just have to wait and see.

Bear Stearns held their annual Transportation Conference in NYC on Tuesday. The speakers list and attendance list were impressive as usual and had it not been for events conspiring against it, I would have been there. As is, host Ed Wolfe's summary note will have to suffice. Highlights: (1) Rail demand and pricing remains strong, particularly for intermodal, coal and grain; (2) Truckload demand was soft in April and will have to accelerate in May and June if the carriers are to meet their numbers; (3) LTL demand remained solid with a strong economy and good pricing environment.

Also this week Bear released its Rail Grain report, a 130-page opus that ought to be required reading for any railroad manager (commercial, financial *or* operating) who wants to know what to expect. For example, BSC highlights factors that should foster more consistent supply, demand, and rail volume and yield growth, for grain and corn in particular. Ethanol is a particular hot topic, especially to UNP and BNI. And – no surprise to regular readers of these pages – car supply will remain the big question. I'm not sure how wide a distribution this paper gets, but if you have specific concerns, drop me a note and I'll see if I can excerpt what you need.

Railinc's decision to exit the RailSync product line (WIR 4/21/2006) is official. In a press release this week the company said that "as a result of a recent product portfolio review it has decided to renew focus on its core product lines while no longer selling or marketing its RailSync group of products." And an important group of core products it is. Railinc is the supplier of such well-known products as ***Umler/Emis***, ***TRAIN II, Interline Settlement, Steelroads***, ***RailSight***, and ***NextPath***. Railinc says it will provide "an orderly transition" for its customers away from its RailSync products even as it looks for a potential RailSync buyer.

RRA held their analysts meeting in California last week and RW Baird's Jon Langenfeld was there. He writes, "It was an encouraging message. The Five-Year plan includes more tangible targets for operational improvement and growth initiatives. With respect to the first, the Plan calls for an operating ratio of 80 or better by 2010 with accelerated improvement at least into the lower 80s in 2007/8 due to the Process Improvement Project now in place. Other cost-control initiatives include improved asset utilization, technology enhancements, continued safety focus, and more scheduled (vs. reactive) carload movement scheduling. Further network rationalization may be required. Pace of improvement and execution remain Baird's focal points.

"As to growth, the plan calls for 5% organic and 5% acquisition growth annually. Initiatives include (1) increasing pricing freedom [alluded to in the quarterly results call – rhb]; (2) capital deployment initiatives; (3) industrial development on current rail lines; (4) RADS (RailAmerica Distribution Services), which focuses on partnering warehousing and transloading providers with shippers to drive carload growth; (5) improved velocity where Class I rationalization of their customer base is providing RRA with increased opportunities.

"The acquisition strategy is more refined, targeting accretive acquisitions characterized by one or more of the following: complete existing railroads, strong FCF, solid customer base, low capital needs, and pricing freedom. Infrastructure remains underinvested [a recurring theme of mine – rhb] but more rigorous, risk-based capital deployment plans are showing early benefits. We expect to see elevated maintenance capex to persist over the next 2-3 years." Thanks, Jon.

American Railcar Industries (ARII), the latest addition to the roster of Listed railcar manufacturing companies, increased first quarter sales by 37% and tripled its operating profit to $20 mm as margins on its manufacturing business increased to 11% from 4%. ARI shipped 1,980 cars – 77% covered hoppers, the rest tank cars -- in Q1, up from 1,482 a year ago when the mix was about evenly split among center-beams, covered hoppers and tank cars. Unfulfilled orders (the backlog) increased to nearly 15,000 units from less than 7,000 a year ago.

In late March ARI agreed to acquire the stock of Custom Steel, Inc., a subsidiary of Steel Technologies Inc., which operates a facility located adjacent to ARI's component manufacturing facility in Kennett, MO. Custom Steel produces value-added fabricated parts that primarily support ARI's railcar manufacturing operations. The purchase price is approximately $13 million plus approximately $5 million for inventories. The addition of this facility increases the percentage of railcar parts that are manufactured by the Company.

In fact, during the call, it became clear ARI is building itself a whole new manufacturing infrastructure. Unfortunately, a tornado in early April took out key portions of its tank car production facility and railcar inventory in Marmaduke, AR. The major equipment items that will require replacement have been ordered, with delivery time for longer lead-time items estimated to be approximately 16 to 18 weeks with production resuming in August. Happily, no ARI customer has canceled any contracts for the manufacture of tank railcars.

During the conference call President and CEO Jim Unger said that 1,000 tank cars will go into ARI's own lease fleet and that the production facilities "are full through 2007." He said orders are like to continue at this level for some years as car ownership moves toward leasing companies and financial interests and away from the railroads, where motive power and track are consuming most of the capex dollars. Continued deliveries from all builders are expected to remaining the 55,000-65,000 units for the foreseeable future.

The State of Virginia has agreed to plunk down $22 mm for its share of the cost in Norfolk Southern's Heartland Corridor upgrade. The new intermodal terminal in Roanoke will cost $18 mm with the state picking up $12.6 mm and NS the rest. The Governor says it'll take 200,000 truckloads off the interstates, a bit of hyperbole since they'll need roads to get between ramp and dock. Anyway, congress appropriated almost $100 million for the corridor this year. It will help raise the clearances on about 28 tunnels for double-stack clearance between Roanoke and Columbus. Reader response has been instructive.

One chap writes, "I drove from Paoli down to Knoxville on Sunday. There were hardly any trucks on the PA Turnpike, but once I got on I-81 at Carlisle, it was nothing but trucks. Just to pass the time, I counted trucks in 10-mile segments for 7-8 hours. Some as many as 150-160, a lot at 120-130, the rest 90-110. There were FEDEX doubles, some tanks and flatbeds, but the vast majority were big and small trucking companies and lots of owner-operators." At that rate he must have seen maybe 8,000 trucks at 100 per hour, meaning the daily rate was more than 20,000. That implies more than 7.3 mm trucks a year northbound and that many again southbound. In this context, 200,000 truckloads a year is small potatoes. But it's a start and a good sign that Virginia at least knows it can't go on paving over everything because, as we know, if you build it they *will* come.

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