RAILROAD WEEK IN REVIEW
JULY 14, 2006

"Consistent with slower overall domestic economic growth, the manufacturing sector of the U.S. economy will likely continue to expand during the next three to six months, but at a slower rate than it did during the first six months of 2006." -- Manufacturers Alliance

AAR carloads for Week 27 (July 8) increased 4.9% yoy with gains in coal (+9.0%), grain (+14.6%) and metals (+30.2%) leading the way even though the week included the July 4 holiday. Significantly, loads increased 7.1% in the west and just 1.5% n the east. US intermodal was up 3.8% yoy. Total freight volume for the week was up 6.1% yoy. Cumulative volume for the first 27 weeks of 2006 grew 2.8% yoy.

Week 27 Canadian carload business was down 1.5% from a year ago and IM was up 5.1% yoy. Cumulative carload originations for the first 27 weeks of 2006 on the Canadian railroads decreased 1.8% yoy but IM was up 5.9% yoy. Combined cumulative carload volume for the first 27 weeks of 2006 on 13 reporting U.S. and Canadian railroads increased 0.9% while IM was up a whopping 6.3% yoy.

RMI's RailConnect Index (attached) lags the AAR by a week, but it's still helpful for the trends. It shows shortline revenue units for Week 26 up 3.4% with metals (+30.6%), waste/scrap (+20.0%) and aggregates (+14.0%) the double-digit gainers. For the full 26 weeks, the leaders were metals (+9.5%), aggregates (+8.0%) and aggregates (+7.5%). Oddly enough, intermodal units accounted for 14.1% of all shortline revenue units captured by RMI, but these numbers include port roads like Anacostia's Pacific Harbor Lines and the SC Docks Railroad.

RailAmerica revenue units for June dropped 2.5% yoy. Recall that in the intervening year RRA sold its three Alberta properties back to CN, transferred the E&N on Vancouver Island to a local authority, and sold the San Luis and Rio Grande to Ed Ellis' Iowa Pacific Holdings. Also in that time frame RRA closed the Alcoa purchase and added the Fremont line in Michigan. The net effect of these transfers was a decrease 1,532 revenue units.

On a "same railroad" basis, June 2006 revenue units were down by less than 1% or 1,000 units as ten of 14 commodity groups posted losses. Shipments of paper products continue to be negatively impacted by a work stoppage at a shipper's facility in Nova Scotia. In addition, the Southern Ontario Railway was hit with a Native Indian blockade in Caledonia, Ontario lasting until June 14 and it kept what was primarily petroleum products traffic off the Hagersville Subdivision.

For the six months ended June 30, 2006, total revenue units decreased 2.7% and on a "same railroad" basis for the same period were down 1.7%. Note that RRA excludes from "same railroad" units associated with railroads, or portions of railroads, sold or acquired by RRA after January 1, 2005. Even so, one would expect the shortlines to track – if not lead – the Class Is in YTD carload changes. A one percent swing from these non-recurring events should still have left RRA up a point or two.

Anecdotal evidence from the field appears to reinforce the feeling that the Class Is are enjoying considerable pricing power. There are signs they are using it to increase yields from high-rated traffic and discourage low-rates business from cluttering up their networks. What seems to be happening is that cars used in these lanes do not move promptly from origin to destination and back again, driving car cycle times down and equipment costs up.

To make their numbers market managers then increase rates, volumes drop still further, cycle times degrade and the cycle starts all over again. It's really insidious because it hurts shortlines and their customers more than the Class Is. However, eventually it will degrade Class I train-start yields. Every merch train is a mix of commodities and every revenue dollar contributes to the avoidable cost of running that train. Take away one car and the cost doesn't change much but the numerator shrinks.

I recognize that pricing power raises yield across the board, but running off the traffic you don't like can actually increase the operating ratio. Class Is have to encourage market managers to think in terms of trains not carloads and system impacts rather than their own yoy revenue bogies. Until that day shortlines and shippers deal in stuff like aggregates and wood chips will be at risk.

Shortline event reporting is more critical than ever. Running a railroad network efficiently requires knowing where every empty or load is all the time and whether that position is in compliance with the trip plan. Systems like LOPA at NS not only track performance by the individual car but also link the car's performance with the individual employee responsible for the car, whether T&E or elsewhere.

Taking a car off the Class I network too often removes the car from the tracking system, degrading the trip plan compliance measuring process. There has to be total visibility of every element in the system – loads, empties, crews, locomotives – to insure every customer gets his money's worth and the service provider isn't wasting assets in the process.

That said, Class Is owe it to the shortlines and their customers to provide the same data quality they provide themselves and this includes advance consists. It will not do for one Class I to notify a shortline when any car shows up on the network that is heading for the shortline every and another Class I to say nothing. Sometimes it gets so bad the first time the shortline learns of a car is when the customer happens to see it in the Class I's yard short of the shortline interchange track.

In an environment like this it's doubtful even the most assiduous shortline event reporting will ever be captured by that Class I. On the other hand, the Class I that creates a single-car trip plan when the car is actually pulled, loaded or empty, from the customer, requires real-time reporting from the shortline. After all, if it gets that real time report when its own crews pull cars, it ought to get that same data quality with shortlines doing the work. The prospect of inconsistent data quality is just one more reason for a Class I with high data quality not to shortline branches that otherwise ought to be shortlined.

Adding to current efforts to legislate some re-regulation of railroads, U.S. Senator Herb Kohl (D-WI) introduced "The Railroad Antitrust Enforcement Act of 2006." The act would repeal antitrust exemptions that, according to the honorable Member, "enable freight railroads to abuse their dominant market power and raise rates for those who rely on them to ship dozens of vital commodities."

Later in the week, *USA Today* published a report quoting several shippers who allege that high rail rates and poor rail service have significantly increased their costs. The report noted the case of Dairyland Power Cooperative of LaCrosse, WI, who said that they were hit with a 93% freight rate increase when their 3-year contract with their serving railroad expired January 1. Not surprising, given the above observations on pricing power. Getting greedy is not the way to create long-term value and only adds fuel to the re-reg fires.

Responding to last WIR's ethanol remarks, Phil McFarren, president of the Harrisburg (PA) McFarren Group, writes, "Roy, Better do more research on the ethanol subject. Exploding is the only way to describe it. The oil industry has quit MBTE and the only oxygenate available is ethanol. We

need about 10M gals per year by 2010, today only produce 4.5M from 97 plants. A number of SL's are profiting handsomely from the opportunities. And, DDG, CO2 and other crops in lieu of corn (cane, sugar beets, etc) have the potential to expand markets and product movement.

"Your analysis of ethanol economics makes no sense at all from our perspective. Best proof is overflow crowd of investors and transportation officials at every ethanol conference being held across the country. There have been only decreases in the corn price for the past year and you completely ignore the economic impact of dry distillate grains — a by-product which becomes an important feed stock for chickens as well as livestock. (The distillate grains are cheaper than corn prices.)

"If the price of oil stays above $40 per barrel, ethanol prices will hold steady and make all of the ethanol plant capital expenditures very good investments. We believe the price of oil will average $75-80 a barrel for the next three years. The best rail scenario for an ethanol plant is competitive rates via use of more than one Class I railroad or put another way the best location is on a regional railroad with multiple class I connections.

"The demand for ethanol in mid-Atlantic states is 900 million gallons per year without any major growth in E-85. Auto manufacturers, however, are swiftly redesigning more models capable of using E-85 and several states are approving matching capital monies to facilitate more corridors with adequate supply of the new fuel. Ethanol cannot generally be shipped by existing pipeline and is best handled by rail or truck to distribution centers. We are going to see a tremendous increase in demand for these transportation services."

Phil is in a good position to know. He has just been named to the Governor's Alternative Energy Task Force so surely ought to be in the loop for even more information. He writes, "We have just received a feasibility study on the issue for Pennsylvania and we expect the Governor to embrace an alternative fuel standard for Pennsylvania similar to that declared for electric power generation. I believe that standard will be no less than 15%. As you may know, there is a federal standard being discussed in Washington for 25% in 2025." Excellent news, Phil, and congrats on your appointment.

Entrepreneurship, ingenuity and hard work yield differing amounts of reward depending on the industry. At one extreme we have money managers such as one might encounter in mergers and acquisitions or hedge funds where these traits can generate significant rewards for one. The name of the game is ROE, which limits the amount of capital that can be dispersed in the service of dept or massive capital programs. At the other we have the railroads, where ROE can be limited by the demands of high capex to stay ahead of the wasting asset to say nothing of dealing with a debt load that represents half of total capitalization.

Evercore partners, a New York investment banking, has hired away GWR's General Counsel and Secretary to take on the same mantle plus Senior Managing Director. What this says is the competition for top talent is fierce. Could it be that personal rates of return on effort invested are found wanting in our favorite industry?

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RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 7/1/2006

Week Number: 26

Carloads Handled	Current Week			Year-To-Date		
	2006	2005	% Change	2006	2005	% Change
Coal	15,741	14,712	6.99%	380,116	357,920	6.20%
Grain	13,193	12,147	8.61%	318,456	302,142	5.40%
Farm & Food (Exc. Grain)	4,242	4,080	3.97%	110,701	102,475	8.03%
Ores	10,074	9,563	5.34%	219,536	230,258	-4.66%
Stone, Clay, Aggregates	11,672	10,225	14.15%	245,406	226,686	8.26%
Lumber & Forest products	6,848	7,091	-3.43%	163,080	170,939	-4.60%
Paper products	7,327	7,633	-4.01%	175,153	180,137	-2.77%
Waste & Scrap materials	6,259	5,218	19.95%	149,007	138,668	7.46%
Chemicals	13,615	14,162	-3.86%	353,083	358,287	-1.45%
Petroleum & Coke	5,537	4,988	11.01%	145,411	135,401	7.39%
Metals & Products	12,363	9,469	30.56%	302,713	276,525	9.47%
Motor vehicles & equip.	2,296	2,403	-4.45%	59,459	59,092	0.62%
Intermodal	15,191	19,608	-22.53%	444,079	419,131	5.95%
All Other	3,546	2,708	30.95%	82,931	76,982	7.73%
Total	**127,904**	**124,007**	**3.14%**	**3,149,131**	**3,034,643**	**3.77%**