RAILROAD WEEK IN REVIEW
AUGUST 25, 2006

This is a tough time to be in the shortline business. More than half of the 550 names out there were created post-Staggers as Class Is sought to exit lines that were largely low-margin traffic coupled with high capex requirements and operating expense. There were more cars, more employees and more track-miles than what was needed to support a shrinking market share of the national transportation dollar. So if there was a way to protect a revenue stream – any revenue stream – by lowering the cost of acquiring same that was a good thing.

Fast forward to the present the railroads are a secular growth industry that needs more people, more main-line track, and better rolling stock. Now the low margin single-carload business shed to the shortlines literally gets in the way of the high-priced service-sensitive traffic. The Class Is are under the gun to price to the market and to be sure they can deliver a service at that price. Economies of scale are increasingly important and in low-margin businesses that means point-to-point unit trains with minimal gathering, yarding and distribution.

The Class I rails are spending upwards of $2 bn a year in capex. Funding that internally requires revenue streams that can grow faster than operating expense. And since the best way to increase operating income is to increase revenues, the pressure is on market managers to keep the top line growing. That in turn puts pressure on the shortlines as they are paid out of revenue. But as long as the shortline cost for producing a given revenue stream is lower than it would cost the Class I to do it internally they are ahead of the game.

Ergo it behooves the shortlines to maximize the revenue dollars they bring to the Class Is' coffers while lowering the Class I expense in terms of car hire, crew starts, locomotive availability and fuel. Personally, I'd like to see more shortlines developing commodity lanes among themselves using the Class Is almost as overhead carriers. The shortlines do the business development, support the sales effort, provide the cars, and handle the billing and collection.

Then the shortlines can start producing unitized trainloads between themselves creating point-to-point moves that eliminate Class I gathering, distribution and yarding. If the Class I model is moving to unit trains, are shortlines not best served by heading in that direction too?

Falling automotive sales is one of the strongest indicators of a recession, so says MoneyNews.com. Just recently the *New York Times* said that for nearly sixty years car sales have been a "near perfect barometer" of the economy. Ford is taking out maybe 20 percent of production. We've seen how GM is meeting its challenges, and Chrysler cannot be far behind. Happily, the transplants are picking up some of the slack, but that doesn't help offset the losses from The Big Three.

Bear Stearns sees only a "modest impact" to the total automotive transportation spend arising from the Ford cutbacks. However, the railroads will take the biggest hit, followed by forwarders, truckload carriers and the LTL guys. The rationale is the rails have the biggest stake in finished vehicles (80% of auto revenues) and the rest in auto parts.

GWR revenue units for July 2006 increased 12% yoy with a gain of 8,067 loads. But the newly merged, 100%-owned G&W Australia brought in 9,808 carloads, putting GWR's North American ops (US, Canada, Mexico) down 1,741 units yoy. The still un-fixed hurricane-damaged track in

Mexico cost 806 units. US and Canadian Forest products and minerals/stone cost another 2,910 units, partially offset by a 1,975 unit gain in other commodities.

The preceding month, June 2006, NA loads fell 6,155 loads of which 39% was coal on the I&M division. Forest products and minerals/stone were off 2,719 loads. The monthly load reports don't distinguish between paper and lumber but in Q2 they represented some 60,000 loads of which 58% was paper. Paper averages $498 per car vs $385 for wood.

The minerals and stone group looks like it took a major mix hit in Q2 as revenues were up 24% on 44% more units with RPU dropping 14% to 352 per car. Ex coal, GWR has had sequential declines in its US and Canadian business June-July of 1,610 and 935 revenue units.

RailAmerica total carloads for July 2006 were 100,540, down 1.6% from 102,157 in July 2005. The sale of the San Luis and Rio Grande Railroad, the E&N Railway and the three Alberta properties, net of the impact of the acquisition of the Alcoa railroads and the Fremont line in Michigan, accounted for a decrease of 1,623 carloads.

On a "same railroad" basis, July 2006 carloads were flat at 97,587 compared to 97,581 in July 2005. Mets were up while paper, wood and coal were lower as wood was a casualty of the housing slow-down and paper took a hit in Nova Scotia where the RR is being held hostage in a labor dispute at the shipper.

The other shoe drops. The favorable survey on the DM&E expansion (WIR 8/18/2006) has met its other side in a recent survey commissioned by Mayo. Peter Briggs (who handles PR for DME) sends this headliner: "Most Minnesotans and South Dakotans Oppose DM&E Railroad's $2.5 Billion Federal Loan Scientific poll says secretive nature of DM&E's loan request and the railroad's industry-worst safety record among top concerns."

And it goes on to tell readers "A majority of registered voters in Minnesota's First Congressional District - and more than two-thirds of Rochester residents - oppose the Dakota, Minnesota and Eastern Railroad's (DM&E) request for a $2.5 billion federal loan, according to a newly released *scientific* poll (emphasis added). The same poll conducted statewide in South Dakota found a plurality of residents there also opposes the railroad's loan request, which would be among the largest federal loans to a private company in American history."

A 15-page research note from JP Morgan's Tom Wadewitz notes that the FRA's completed enviro assessment of the DME loan app "brings them one step closer to a decision and also adds visibility to timing for this decision" which could likely come in another nine months or so. Wadewitz writes that the coal market opportunity for the DME is "large" and lists coal-fired generating plants they can reach though connections with CN, CP, CSX and NS as well as several Midwestern shortlines.

He sees the impact on UP and BNSF mostly in terms of slower growth in coal volumes as opposed to actual loss of market share. [On the other hand, it can be argued that extant service lanes to east coast utilities using PRB coal via either CSX or NS delivery are not changeable at the drop of a hat and could take many years to develop for DME (WIR 3/24/2006).]

Another take on the recent ethanol conference (WIR 8/18/2006) comes from California Shortline RR Assn President John Cockle. Excerpts from his review: Ethanol used 14% of the corn crop in 2005. Acreage is shifting from soybeans and wheat to corn. Exports of grains are on the decline. California is currently the #1 market at 1 billion gallons per year. It's cheaper to produce ethanol in Midwest and ship to CA, although a few small plants are under construction in San Joaquin Valley.

Today 75% of ethanol moves by rail, 20% by truck, 5% by water. Pipelines are right out as the stuff cannot be co-mingled with other commodities in a pipeline. Consequently rail volumes are way up with UP hauling 1.6 billion gallons and BNSF half that. This is almost all unit train business and BNSF is quite insistent about terminal capacity to unload 95-car trains in 24 hours. UP seems to be more flexible, operating “sweeper trains” in some areas. Some shortlines are looking into the RRIF loan program to meet the unit train requirements (see Steve Sullivan, below).

Producers want railroad service to be as seamless and simple as possible and do not want to be involved in switching or storing cars. Ethanol producers want to concentrate on making ethanol and do not want to have to worry about railroad issues. To be competitive shortline locations much have access to at least two Class Is.

There was a suggestion that shortline business development staffs focus on reaching the marketers who are supplied by Big Oil, rather than Big Oil themselves. This includes all the independent gas stations, the small regional gas station chains, and the big-box retailers such as Wal-Mart and Costco. Better to focus on companies that don't own oil refineries and thus are not incented to minimize ethanol in favor of petroleum.

ASLRRA’s Steve Sullivan said there are several funding sources open to shortlines. RRIF loans can cover 100% of the cost of a project, up to 25-year payback, interest is cost of capital to government, currently 5%. Permissible projects include the acquisition or improvement of ethanol-related rail equipment or facilities as long as the project site is on railroad property and developed by the railroad.

Valuing the Rails. FEC was the first back from the dead moving to a technical *MarketEdge* Long on Monday. Then came CNI “Neutral from Avoid” with an “early entry” indicator if above $41.98. CP also moved to neutral from avoid though missing the “early buy” indicator. TRN, RRA and KSU moved to neutral as well.

Meanwhile, CSX made the “Largest % Increases” list of NYSE shorts in Tuesday’s WSJ, up 60%. This is unwarranted and unfair. IMHO the company is doing all the right things to increase sales, decrease operating costs, improve asset utilization and capitalize on the strengths of its shortline connections. Yes, revenue units were unchanged in Q2 and carload (ex coal and IM) was down 1.6% or 14,000 units. However, phos and ferts were off 23,000 units largely as a result of changes in Florida’s Bone Valley, a low-margin and expensive business to begin with.

CSX trades at 13.6 times earnings certainly in a range with – and even on the low side – of its peers. The price-earnings-growth ratio is 0.85 (recall a PEG of one represents a fully-priced position) with its peers similarly clustered around one. The mean recommendation this week improved to 1.8 on a scale of one to five where one is a strong buy putting CSX at the head of its class. Short CSX? I’m not going there.

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