RAILROAD WEEK IN REVIEW
DECEMBER 21, 2006

"The combination of poor service and rising prices tends to lead to customer discontent" – Wick Moorman, CEO, Norfolk Southern, as reported in the Virginia-Pilot*.*

Rail Analysts have issued a flurry of downgrades of late and the common theme is slowing carload volumes. Jason Seidl of Credit Suisse puts it succinctly thus in his Dec 20 note: "Union Pacific's decelerating 4Q06 volume growth has led us to reducing our EPS forecast to $1.47 thereby implying an FY06 EPS from continuing operations estimate of $5.52. Overall carload growth has remained positive on a year-over-year basis however the run-rate throughout 4Q has trended well below forecasts.

"For FY07, we see a negative mix shift and a lower growth base from this year. Despite some margin pressure associated with lower volumes and high fixed costs, strength in coal should help to buoy the operating ratio somewhat taking it down another 50 BP to 79.5. Union Pacific remains one of our Top Rail Picks given the inherent long-term benefits associated with the company's ongoing turnaround initiative (Unified Plan). Indeed, as secular growth and pricing trends continue to fuel the industry's rise, Union Pacific's steps toward growing margins through pricing and service improvement should provide substantial opportunity over the coming years."

Jason wrote similar notes on BNSF and NS the same day and the message is consistent: Q4 and 2007 vols are nothing to get excited about however these players are using the relative lulls to get their houses in shape for the next upturn. Re BNSF, Jason writes, "Our assumptions for pricing remain wholly unchanged. The one thing that the industry has clearly committed to is the pricing story that—in many regards—has been the driving force behind the 'Rail Renaissance' observed over the past 2-3 years."

As for NS, he says, "Despite our near-term concerns for the group, we maintain our Outperform rating for NS as secular growth trends combined with sustained pricing gains continue to present significant opportunity for the coming years. Although softening volumes may indeed prove a headwind for earnings over the coming months, opportunities to improve service levels and overall margins should continue to present favorable upside for longer-term focused investors willing to ride out what could be a shaky few months."

As for shortlines, it goes again to a sustainable model based on better asset turns, lower unit cost, and improved margins per revenue unit. If the recent RRA announcement is any indication, we're heading toward some serious fallout in the shortline community. Fewer shortlines in number, less low-margin single-carload business, and a greater emphasis on what Iowa Pacific's Ed Ellis calls "agriculture and extraction."

The DM&E comments (WIR 12/15/2006) brought responses both pro and con. Though DME has "no paper barriers" (DME President Kevin Schieffer to Minnesota Public Radio), one has to ask what destinations are likely to be open to PRB coal coming out over this route. Surely not any generating stations local to the UP or BNSF and I'm doubtful either CSX of NS will open up their stations if it means jeopardizing the status quo with the western roads. Of course, it's possible the eastern guys might be open to DME for bigger divisions but that'll hurt the latter's margins.

Then there's the matter of moving around within the PRB itself. Neither UP or BNSF is going to let DME use the Joint Line and they won't get on BNSF to the north. From the maps I've seen it looks like DME could serve maybe six mines in the southern PRB that lie to the east of the Joint Line as long as DME builds its own connections to the individual mines. Thus DME will have access to a considerably smaller part of the basin than even UP which doesn't get into the northern PRB.

One of my correspondents who knows the Washington DC scene rather well suggests that even though we're talking RRIF money it's doubtful the FRA will make the decision, suggesting that "it will be made at the OMB, which institutionally doesn't like programs like these." And with the possibility of Harlem's own Charlie Rangell running Ways and Means some observers doubt that he'll buy into a huge loan for GOP stalwart Kevin Schieffer without getting something of equal value in return.

On the other hand there are those who argue that the demand for low-sulfur coal has been overwhelming, that BNSF and UP haven't been able keep up (for whatever reason), and that more rail capacity is in order. That being the case, having an alternate route such as DME to the east makes sense from a national security standpoint. It is also argued that the utilities and energy companies helped spur initial interest in the PRB project and that there was Wall Street interest early on. Bottom line, DM&E still has to persuade FRA and to do that, the railroad is going to have commitments from utilities.

In a related development, BNSF told the STB in a Dec 11 filing that should the Board authorize DME to haul PRB along the former IM Rail Link's line, it could "cause substantial additional delays to time-sensitive BNSF trains at Savanna IL." Seems reasonable. I've been over that route courtesy of BNSF and can see where coal trains crossing the Savannah diamond could (BNSF filing again) "substantially increase delays regardless of what route into Chicago is used by DME."

BNSF in its filing also said the STB "should study whether DME's proposed shipment of PRB coal into Chicago over the former IMRL line could have other environmental impacts not addressed in the Environmental Appendix filed by DME and Iowa, Chicago, & Western Corp., successor to IMRL, including impacts to air quality and transportation systems, all of which could be faced by each community situated along the former IMRL lines in Iowa and Illinois."

Genesee & Wyoming will realign its North American operations effective Jan 1, 2007. There will be a new Southern Region made up of 13 names formerly part of the Rail Link switching and ports division. They are the Arkansas Louisiana & Mississippi, A&N, Atlantic & Western, Bay Line, Chattahoochee Bay, Chattahoochee Industrial, East Tennessee, Fordyce & Princeton, Kentucky West Tennessee, Little Rock & Western, Louisiana & Delta, Meridian & Bigbee, Valdosta Railway and Western Kentucky Railway. Billy Eason will head up this group.

The new Rocky Mountain Division will include the coal-hauling Utah Railroad plus the PRB contract switching operation formerly under Rail Link. And the Tomahawk Railway moves from Rail Link to the Illinois Region. The reconfigured Rail Link Region will be under Bill Jasper and includes Industrial Switching and Port Operations as well as the Commonwealth Railway, First Coast Railroad, Georgia Central Railway, Riceboro Southern Railway and York Railway Company.

This is an excellent move as it will give more visibility to the former Rail Management and Georgia Pacific properties. Readers will recall that Rail Link car counts are not included in the monthly tallies, being subsumed by the Rail Link "non-freight" revenue line in the quarterly financials. Now if only GWR would once again separate Australia and NA car counts we'd have an even better picture of how their carload business is faring.

This week Bear Stearns held a conference call on the outlook for basic materials. The remarks concerning included rail cars, corn, and ag machinery were most instructive. The rail car analyst confirms that tank car builders have booked car orders at a rate of 2.8 times the number of cars they've actually delivered and they're delivering at a run rate of 12,000 cars a year. The current backlog is 2.5 yrs which puts them into 2009 for delivery or orders placed in 1Q07. He expects the 2008 build could run in the range of 15-18,000 cars. American RailCar (Nasdaq: ARII) is "the most levered" to this space at 25% of production and that could escalate to 45% in short order. The second biggest tank car provider is GATX (NYSE: GMT) leasing.

The machinery analyst says the outlook for Deere (NYSE: DE) is positive. As corn demand goes up, corn prices go up encouraging farmers to replace old equipment with bigger newer equipment to farm more acreage. Rising input costs for ethanol producers combined with stabilizing gasoline prices may start putting pressure on ethanol producers.

My take: tight supply of rail cars plus higher corn prices against increasing demand for ethanol will increase the pricing power of domestic producers, making the building of new processing plants that much more attractive. The down-side is that ethanol gets more expensive, alternatives will become economically attractive, just as oil shale is becoming economically feasible as the cost of crude goes up. Reminds one of the old Chinese curse: Be careful what you ask for; you might get it.

Pinsley Group's Florida Central Railroad has celebrated its 20th year as a freight rail operator. FCEN operates on 70 miles of ex-SAL trackage in the Orlando area and was one of the first CSX shortline spin-offs. The shortline, whose red and yellow locomotives are a familiar site in Central Florida, handles some 10,000 revenue units annually for such Central Florida stalwarts as Rinker Materials, Florida Rock, Commercial Metals, Schenck Distributors, BOC Gases and many others. Congrats are due to Ben Biscan and his merry team. They run a clean shop with well-scrubbed equipment and a well-maintained roadbed. They do an excellent job of carrying on the Pinsley tradition of nearly 70 years running.

Shares of car-builder Greenbrier Industries (NYSE: GBX) have the dubious distinction of being farther below (28%) the 50-day SMA than any other company in my rail industry watch list that runs the gamut from American Rail Car (ARII) to Wabtec (WAB). The company warned Wed before the open that it will miss its prior estimates for the quarter and year, citing production difficulties and inefficiencies on the introduction of certain conventional railcar types. It also cited lower than anticipated gains on equipment sales, a delay in the timing of revenue recognition on a marine barge order, and fewer business days included in the first quarter results from two recent acquisitions.

This is the last 2006 WIR. As you will recall, I take Christmas week off every year, as I do Thanksgiving Week. Thanks to all of you who've written in and otherwise helped make WIR the success it is. Please accept my best wishes for a Merry Christmas and a Happy New Year.

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