RAILROAD WEEK IN REVIEW
JUNE 29, 2007

"Efforts to meet the competition of these highway carriers with lower rates were thwarted by the ICC acting on protests – not of trucks – but of competing railroads and grain interests." -- *Jervis Langdon, Letter to Shareholders, Rock Island Railroad 1967 Annual Report*

Morgan Stanley's William Greene writes, "We were surprised again this quarter at the degree of weakness in rail volumes. While we expected declines in economically-sensitive, housing, and auto volumes, the rails also posted slower volume growth (or declines) in coal, grain and intermodal. These commodities tend to have low correlation with GDP, but poor weather, mine outages, a poor wheat crop, and slowing imports all combined to create a dismal quarter for rail volumes.

"We believe many of these issues are temporary, but we are a bit concerned about the lack of volume growth over the last three quarters. As a result, we expect rail management to be conservative with guidance given the uncertainty surrounding the economy and volume." And *Barron's On-Line* suggest that the industrials are trailing the rest of the market, another ill omen for the merch carload business. "Across the board in the industrial sector, technical cracks are appearing from slowing momentum to lack of investor enthusiasm to buy more. It does suggest that new money would be better off deployed in other sectors."

Transportation is also part of the industrials sector and the Dow Jones Transportation Average has been having problems over the past month. After breaking out to fresh all-time highs on May 31, it has not been able to hold on to its gains and has fallen back below its breakout level. There was a big scramble to own railroad stocks in early April when it became known that super investor Warren Buffett was buying into the industry. However, the power of that move has disappeared as rail stocks have faded. (By way of disclosure, I've taken profits on NSC and FSTR having closed out all the other Class I and supplier positions earlier.)

The lesson for shortlines is to watch their merch carload traffic very closely. There are continuing indications that railroad price hikes and service irregularities are moving more merch business to the trucks, so much so that my conversations with private equity types as well as analysts zero in on coal, IM and ag; the merch side is almost an also-ran, even though it accounts for more than half the revenue stream on some Class Is.

The worry is that short lines getting paid handling fees are not participating in the revenue upside that may lessen the impact of traffic dips for ISS roads. And the extent to which revenues are limited by the lack of pricing power on so many shortlines is beginning to have a ripple effect. The May 2007 Railroad Industry report from Bear Sterns (BSC) isn't the sort of thing you'd want to sit down and read from cover to cover. It is, however, ideally suited for dipping into for insights on concerns like this. BSC has gown "more cautious on short-line fundamentals in general given less upside from continued pricing power and productivity gains, historically modest longer-term organic top-line growth, and less potential upside from productivity gains than the Class Is.

"Generally strong public rail valuations, firm pricing, and government tax credits for short-lines have led to increasing valuations in the acquisition market. Fortress paid nearly 12x trailing EBITDA for RailAmerica, well above average historical short-line acquisition multiples of 7x-8x. As such, we believe there is currently a premium on short-line rail properties, which could limit domestic acquisitions for Genesee."

Or anybody else. The ASLRRA Annual Meeting breakout session on private equity investments in shortlines was filled to capacity and feedback from the field suggests that shortline owners have great expectations for the amount of money their properties might bring if they decided to sell. However, give the number of highly-levered properties out there, the odds are he high bidder will try to recover something in the form of higher allowances from the connecting Class Is. This is a non-starter and a recipe for financial disaster.

As for Class I spin-offs, BSC continues, “we believe branch line divestitures from the Class Is (a major source of historical acquisitions) are also somewhat less likely over the near to intermediate term. That said, we believe acquisitions of industrial rail lines could become more available this year as those types of deals tend to occur more frequently during a slower economic environment when the industrial company focuses more on core operations and looks to shed non-core assets.” I agree with all the above and would add that any Class I branch-line transactions will be with known successful operators with strong financials, solid commercial relationships, and an outstanding safety record. If you’re none of the above, please stay home.

The truckers are still hungry and any perceived rail service lapses or over-reaching rate increases will find shippers heading for the highwaymen. JP Morgan’s Tom Wadewitz reports that “The truckload market remains out of balance with excess capacity available and spot rates generally down yoy. A pick-up in demand and low new truck builds should bring the truckload market back into balance over the next several quarters.

“While some of the large carriers are achieving flattish pricing on contracts, it is clear that spot pricing has been down yoy throughout 2Q. As a result, we expect revenue per loaded mile to be either flat or down for most of the truckload carriers.” Tom cites JBHT’s combination of strong execution, which he says “is driving growth in JBHT's intermodal in the Eastern US and favorable conditions including BNSF's final exit from providing equipment have driven what we estimate to be double digit 2Q volume growth in intermodal.

“While JBHT's 2Q growth in intermodal should be impressive, we expect flattish EPS as a sharp decline in truckload operating profit offsets intermodal.” Now pair Tom’s remarks with the predominance of second-tier trucking companies and owner operators over the Hunts and Schneiders of the world as one drives the interstate highway system. The big guys are riding the rails while the O-Os continue to put boxcar loads on rubber.

You win some and you lose some. GWR’s Portland & Western will receive some $2.5 mm in Oregon State funds to upgrade 12 miles of century-old track between Hagg Lake and Hillsboro. The track will be replaced with new CWR and upgraded to FRA Class 2 from excepted or Class 1, which will allow trains to run at 25 mph, up from the current maximum of about seven mph. P&W has committed another $600,000 for the project, which is part of “ConnectOregon” program, a $100 mm bond package that the Legislature passed in 2005. It aims to improve the efficiency of Oregon’s entire transportation system, particularly focusing on intersections of two or more modes of transportation.

Meanwhile, South of the Border, GWR’s Mexican subsidiary, Ferrocarriles Chiapas-Mayab, S.A. de C.V. (FCCM), is formally notifying the Mexican Secretaria de Comunicaciones y Transporte (SCT) of its intent to cease its rail operations and to terminate its 30-year concession from the Mexican government. FCCM expects to wind down its operations and to discontinue rail service over the next four weeks.

In October 2005, FCCM was struck by Hurricane Stan which destroyed or damaged approximately 70 bridges and washed out segments of track in the state of Chiapas between Tonala and the Guatemalan border, rendering some 175 miles of the rail line inoperable. For the past 21 months, FCCM has been working with the SCT and other agencies of the Mexican government in an attempt to develop a reconstruction plan for the damaged portion of the rail line.

Without the reconstruction of the hurricane-damaged Chiapas rail line, FCCM is not a financially viable business. In addition, due to the uncertainty of FCCM's future, its rail traffic volume has continued to deteriorate, resulting in an unsustainable situation. As a result of this decision, GWR expects to record charges in 2007 of approximately $12 mm, or $0.30 per share, the majority of which will be incurred in the second quarter. These charges will include items such as severance costs, wind-down expenses, non-cash write-off of currency translation account (CTA), and certain tax impacts.

GWR expects to complete the formal liquidation of FCCM by year-end 2007. As of March 31, 2007, FCCM had $17.5 mm in assets consisting of $6.6 mm of non-current assets, primarily locomotives and cars, and approximately $10.9 mm in current assets, primarily receivables and inventory. Under the terms of FCCM's concession, the Mexican government may acquire or lease FCCM's equipment based on fair market value. Absent acquisition or lease by the Mexican government, GWR intends to repatriate and/or sell the equipment in the United States.

GWR made its initial investment in FCCM in August of 1999. In the third quarter of 2006, GWR recorded a non-cash impairment charge of $34 mm after tax, reflecting the write-down of non-current assets and related effects resulting from Hurricane Stan. FCCM currently has 407 employees.

Connecticut's Housatonic River Railroad (HRRC) has scored a first: achieving certification with the Rate EDI network (REN), the Class I depository for through rates. HRRC is the only Class III railroad to have done this.

Whereas most shortlines that are paid an allowance or junction settlement elect to have the Class Is publish the through rates regardless of whether they show in the route or not, HRRC has always reserved the right to be shown in the route on the waybill and to negotiate its own divisions. However, the Class I Marketing Services Group has to input the document HRRC creates, thus double work. This certification will make the transaction more efficient from the Class I perspective in that HRRC will perform the backroom work thereby both establishing and maintaining the rate in an electronic format for customer billing and settlement purposes.

Getting to this point required some imagination, foresight and homework. It was a process that began in October, 2006 at the ASLRRA meeting in Lancaster, PA when Railinc held a workshop on their products. HRRC's Rian Nemerof says, "We are in a very select class to have this certification. REN is the electronic database of rates used for billing and settlement. Short lines that show in the route are automatically included. However, this allows the Housatonic to publish our private rates and contracts as well as query when we are a party to the rate/route." Nice. May this be the first olive out of the jar, so to speak.

The DM&E saga continues. Larry Kaufman writes, "As for the Fred Frailey *TRAINS* piece, I am inclined to agree with Kevin Scheiffer that it was based on a lot of speculation. The old news-guy in me is very skeptical of the story. While CP and CN wouldn't hesitate to go head-to-head with their counterparts in Omaha or Ft. Worth, I don't see either of them being willing to bite off that much just to get the origin on the coal they handle or will handle in interline service.

"The same goes for NS and CSX, I think. I don't see Kevin selling out unless he gets a good price for the whole thing. I could see a PE firm or hedge fund taking a significant percentage in exchange for needed cash to get the PRB project built. That might ensure that Kevin got to stick around. Increasingly, I think Kevin simply may have missed his time -- that the time to have built the DM&E into the PRB was back when UP was under *force majeure* and there really was a shortage of capacity. UP and BNSF today are telling a good story about their growing capacity and the lack of need for another carrier into the basin." Thanks, Larry.

Rick Paterson of UBS has just published his third annual *Short Line Survey*. He writes, "In the second quarter of 2007, we conducted our third annual survey of short line railroads to get their views on their larger Class I counterparts, with 78 responses. The short lines' views are valuable because these small railroads typically sit between the Class Is and their customers, and therefore have insights into both.

"We measure the industry across five criteria: on-time performance, equipment availability and quality, and the quality of sales & marketing and operations, and on all five categories sector performance has materially improved yoy, aided by the current freight recession. There is a storm cloud, however, with the short lines expecting pricing growth to decelerate from 6% in 2006 to 4% this year.

"Union Pacific's operational recovery comes across loud and clear in our survey, with short lines telling us that UP has staged the biggest yoy improvement in on-time performance, equipment availability, and quality of operations (admittedly off a low base). Overall, UP jumped from last place in 2006 to third in this survey.'

This report is chock full of goodies providing a clear and concise look at how the various Class Is approach the short line relationship and from that, implications of how short lines can improve their relationships with their connecting Class Is. If you'd like to see the full report, drop me a line.

As the clouds of railroad re-regulation continue to gather, BNSF's Pete Rickershauser sent me Jervis Langdon's President's Letter from the Rock's 1967 Annual report. There is a definite whiff of doom about it, something that the present proponents of re-regulation may wish to consider, especially those who lack the institutional knowledge of what went on in those bad old days before Staggers.

To begin, Langdon cites the loss of grain traffic, losses from unsubsidized passengers (Amtrak didn't show up until 1971), and spiraling cost increases (the Vietnam War was in full swing) brought Rock Island to deficit working capital by the end of the year. He asks whether the Rock can survive until the merger with UP is concluded and notes a capital shortfall of $120 million for physical plant maintenance and that the Rock's last year of fully funding its capital maintenance plan was 1956.

Then there was the ICC's decision to keep the Rock from lowering gain rates to the Gulf. "Instead of moving by Rock Island, export grain from Oklahoma was carried by trucks, hundreds of them, to the port of Houston and repeated efforts on our part to meet the competition of these unregulated highway carriers with lower rates were thwarted by the ICC acting on protests – not of trucks – but of competing *railroads* [italics his] and grain interests."

He concludes, "There is a good chance that the [merger] hearings will be concluded in 1968 but an early decision by the ICC is not to be expected. The final decision for Rock Island is some years off, if the proceedings follow the normal course." Of course, the Rock Island's merger with UP was never consummated. By the time the ICC got around to approving it, in 1974, 12 years after it was proposed, the Rock had skidded to such a state of physical decay that UP didn't want it.

The Rock entered bankruptcy in 1975, and was shut down and liquidated by its trustee five years later. The cautionary tale is that by limiting rate options the ICC effectively eliminated the cash flow from operations that the Rock needed to fund its capital program. Yet just today I see where Bear Stearns' Ed Wolfe writes that in Congress this week "the regulatory pendulum has swung modestly against the railroads compared to our last visit to D.C. nine months ago." Perhaps the Langdon Letter ought o be required reading for all those who seek to limit the railroads' ability to take trucks off the highway, reduce dependence on "foreign oil" and increase capacity to take on even more containers from China, coal from the PRB and corn from Iowa.

Chop Hardenbergh takes umbrage with Jason Seidl's comments on the pending changes to the Canadian Transportation Act (WIR 6/22). He writes, "Final offer arbitration is a great tool (ask Major League Baseball) in the couple of cases I have followed closely. Permitting groups of shippers to use it would make the whole process more efficient. Why should one company which won a FOA pay less for the same route than other company which cannot afford FOA, but runs on the same route?

"On the removal of the substantial commercial harm qualification: unless CTA has defined that term as the STB has defined similar provisions, this will permit, as your correspondent [Seidl] says much quicker resolution. No company is going to seek a CTA ruling on, say, inter-switching rates willy-nilly. I did cover one case in which MMA lost an inter-switching argument. I don't think it revolved around substantial harm, however. In today's world, the quicker one can get a ruling, the better."

Elsewhere, the CTA announced its intent to review the hopper car maintenance compensation embedded in the revenue entitlement for the transportation of Canadian grain. CP responded by saying, "The announcement of the review was anticipated by Canadian Pacific and consistent with the passage of Bill C-11. The Agency suggested that the revenue entitlement for CP and Canadian National Railway (CN) combined might be reduced by as much as $C60 to $C75 mm.

CP believes "the CTA's suggested adjustment is overstated" according to Marcella Szel, Senior Vice President Marketing & Sales for Canadian Pacific. "Over the next several months CP will be engaged in the formal review of the appropriate amount of money to be embedded in the 2007- 2008 revenue cap." There was no corresponding press release from CN, but…

They were having troubles of their own as "reportedly" armed native protesters blockaded the Toronto-Montreal main line today. CN responded by halting freight operations and embargoing all traffic on the line. Never mind CN had and obtained an injunction barring illegal occupation of the rail corridor when First Nations protesters blocked the line in April of this year. The Ontario Provincial Police (OPP) refused to enforce the order issued by Justice Campbell of the Ontario Superior Court at that time and it's no different this time.

CN says that in the interest of ensuring the safety of its employees and operations, it will shut down indefinitely halt all rail operations on its Montreal-Toronto main line, including VIA Rail passenger trains, until the company has received assurances that the OPP will remove protesters and guarantee such safety. CN's Toronto-Montreal corridor is the busiest on its system, accommodating an average of 25 freight trains and 22 VIA Rail trains on a daily basis.

My good friend Paul Vilter made the *Railway Age* on-line Breaking News bulletin board this week. "Amtrak and Union Pacific have reached an agreement on slow orders that Amtrak said will reduce delays to Amtrak trains traveling on UP while the railroad makes major track improvements. 'This agreement defines in detail the maximum number of minutes of slow-order delays allowable on each Amtrak route operated on Union Pacific, while Union Pacific makes track improvements that will increase service reliability and satisfaction in the long run,' said Paul Vilter, Amtrak assistant vice president-Host Railroads. "Our on-time performance is the single largest determinant of passenger satisfaction and these changes will make a real difference.'

"The track improvements are part of $12 billion UP is spending to maintain its track system-wide in 2007,' says Tom Mulligan, UP's director of passenger rail operations. 'This agreement is instrumental in helping our crews complete the necessary track maintenance that will further enhance safe and timely railroad operations in these corridors as well as improve ride quality.'"

Hank Wolf, Vice Chair and CFO at Norfolk Southern, retires tomorrow after 34 years with the company, having begun his railroad career in 1973 when he hired out with the N&W as a tax attorney. Writing in *The Virginian-Pilot*, Gregory Richards tells us "Hank's disciplined approach to managing Norfolk Southern's wallet impressed industry insiders and Wall Street, while also positioning the company to win a battle for its corporate life against rival CSX. Highly regarded both in the industry and on Wall Street for his intellectual abilities, leadership, integrity and – outside of the office – his humor, Wolf retires Saturday after 14 years as its chief financial officer and almost nine as vice chairman."

My personal involvement with the N&W began in the late 1950s when as a student at William & Mary I would take off weekends to chase N&W steam in and around Norfolk. N&W was one of the first stock investments I ever made and shares of the Southern were added shortly after. Hank (W&M 1964) and I became acquainted when I started WIR in 1995 and he's been a good friend and financial educator ever since. Thanks, Hank, for a great friendship. Let's drink a toast to Dr. Tony Sancetta (our mutual money and banking professor) for the financial rigor that you've put to such good use.

This sort of a double issue as there will be no WIR for the week ending July 6. Laura and I have the first joint window of opportunity to take some time off in about five years. I've been told there will be no business discussed during the week. Thanks for your indulgence.

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