RAILROAD WEEK IN REVIEW
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"The ethanol scam is one of America's biggest boondoggles." – Jeff Goodell, Rolling Stone www.rollingstone.com, *7/24/2007*

Scam or not, shortlines are getting into the ethanol biz in a big way. Just this week, VeraSun, the second largest US ethanol producer, consummated the purchase of three 110 mm gpy ethanol plants from ASAlliances Biofuels LLC for $725,000. Two are on shortlines and a third is on CSX with what appears to be a shortline connection to reach west via BNSF. The three ethanol plants are in Albion, Neb., Bloomingburg, Ohio, and Linden, Ind.

Albion is north of Grand Island and is on the Nebraska Central, a short line owned by Rick Bartel et al and connecting with UP only. Bloomingburg is on the Indiana & Ohio, part of the RailAmerica network of short line railroads, southeast of Columbus with access to CSX and possibly NS. Linden is northwest of Indianapolis on the CSX main line to Chicago. According to the press release BNSF now reaches Linden. A look at CSX map reveals that Linden is just south of the KBSR interchange at Lafayette. TPW is on BNSF map as an "affiliated shortline." Does this mean Linden is dual-listed in the Open and Prepaid as both CSX and BNSF? Anybody?

Separately, Redfield SD is the site of Redfield Energy's new 50 mm gpy ethanol plant. It will be jointly served by both BNSF and the DM&E, the road that asked for and didn't get a $2.3 bn FRA loan to build a 260-mile coal line into Wyoming's Powder River Basin. The DM&E connects with every major NA railroad so market access will be first-rate.

In the east, Motiva Enterprises LLC, a refining and marketing joint venture owned by affiliates of Shell and Saudi Aramco, opened its 1.5 mm barrel ethanol terminal in Providence RI, local to the Providence & Worcester. Chop Hardenbergh reports in his *Atlantic Northeast Rails & Ports* newsletter that "The facility was designed jointly by P&W and Motiva and holds an 80-car unit train in its entirety with capacity for an additional 20 cars, for total capacity of 100 cars." In addition, Motiva plans to expand ethanol capacity Sewaren, N.J. to two 80-100 railcar unit trains per day. Sewaren is local to the Conrail Shared Area Operations under Ron Batory and jointly owned by CSX and NS.

And to close this screed, a little benchmarking is in order for those readers in the ethanol space. Ethanol futures activity on the Chicago Board of Trade picked up some speed midweek as prices fell back sharply. Front-month September ethanol was going in the high $1.70s October ethanol closed at $1.675/gal; after September, the most popular contracts were April and May, settling at $1.67/gal.

DM&E Progress? Two weeks ago the Sioux Falls *Argus Leader* ran a story quoting DM&E president Kevin Schieffer as saying that the FRA application itself "helped establish potential customers" for PB coal over his line and that "a financing deal could get done by the end of this year." The paper also quotes a Chicago rail analyst who thinks funding from a utility consortium is more likely than having one of the Class Is stepping up.

Meanwhile, LB Foster (FSTR), the Pittsburgh-based rail infrastructure supplier and owner of a 13% stake in the DM&E, gave further color on this position in the 10-Q released June 30. FSTR continues to record a $million a year in dividend income, something less than the full amount due. FSTR says the DM&E is "a substantial and well run enterprise, whose operating ratios are comparable to other regional and class one railroads and it generates strong positive cash flows.

"However, certain debt covenants related to DM&E borrowings have strictly prohibited the DM&E from paying dividends for the past several years. This prohibition will become less restrictive in December 2007." As of June 30 2007 the amount of dividend income not recorded stood at some $8 mm and FSTR says "We will only recognize this income upon redemption of the respective issuances or payment of the dividends."

(For what it's worth, FSTR has increased its net income handsomely over the last three years, to nearly $14 mm from a little over $1 mm. However, inventories have been rising faster than sales, there has been negative operating cash flow and free cash flow -- operating cash flow less capex – in the same three-year period.)

And mergermarkets.com just last week speculated that second round bids are "imminent," saying the DM&E had been "satisfied" with the initial round and that Round Two bids were due a month ago. Citing "fragile credit markets," the story goes on to say that the Class Is and utilities are in a stronger position than private-equity funds due in part to railroads' financial performance YTD and set next month as a "likely" time to expect a deal to be announced.

Moreover, coal stocks have gone pretty much nowhere for the TTM period. The environmental tug of war over coal and emissions paired with a softening of NG prices have not helped. In fact, on Tuesday's *Fast Money* (CNBC, 8 PM eastern) panelist Guy Adami said hedge funds were getting out of their energy positions. And if this be the case, who wants to plow new money into building a new coal-hauling railroad going head-to-head with the likes of UNP and BNI? Not I.

***TRAINS NewsWire* reports** that The Vermont Agency of Transportation (VAOT) is close to completing its $2.7 mm project to lower the floor of the 275-foot stone arch tunnel in Bellows Falls. The New England Central owns the tunnel, which is on the former CV main just south of the Amtrak station. Amtrak, Guilford's ex-Boston & Maine, and New England Central use the tunnel. The Green Mountain Railroad (part of the Vermont Railway System) passes through it occasionally during interchange.

The tunnel was constructed in 1851. It is partially cut through solid rock and lined with rough-cut stone blocks. Clearance will change from 17 feet to a little more than 20 feet. After regular rail service resumes next week, the Agency of Transportation will conduct a test run before opening the tunnel up to double stack service. The project was paid for with $2 million in federal transportation funds and about $700,000 in state money.

The global credit crisis has caused Brookfield Asset Management to pull back from a move to acquire Canadian Pacific Railway in a leveraged buyout. The Toronto *Globe & Mail* quoted one banker as saying that 'Brookfield is telling banks that it may revisit [CPR] next year, but the file is dead for now.' CP shares, which reached a 52-week high of $91 on July 18, were priced at US$69 mid-day Friday. Nevertheless, UBS analyst Fadi Chamoun sees "a compelling investment case" for CP, with its growth in efficiency and volume, and upgraded CP shares from neutral to buy, with a target price of US$85.

At the present price CP has a TTM price/earnings ratio of 16.3, right in the middle of the rail industry range. First Call shows a target price range of US$59 to US$74 with a mean of US$67 with five brokers reporting. It is also a little more expensive than its peers with a PEG-5 at 1.32 compared with right around par elsewhere. So, using the recent price of $68 and the high and low above, it looks like six up and nine down. By comparison, NS (which I own) the present price is $52, the low estimate is $54 and the high $72. That's 20 up and zero down. I like these odds better.

In upstate New York, the Livonia Avon & Lakeville has made some well-earned changes in its senor staff. Carl Belke has been elected Vice President - Engineering for LAL and its subsidiaries B&H Rail Corp. (B&H) and Western New York & Pennsylvania Railroad (WNYP). He joins LAL with more than 30 years of rail industry experience at the Rock Island, Delaware and Hudson, Canadian Pacific, and Genesee & Wyoming.

Tom Collard adds VP to his title as GM of the WNYP. His previous railroad career includes positions at the Central Railroad of New Jersey, Conrail, and the Southern Railroad of New Jersey. Both are based at the WNYP's Olean NY office. I've known these guys for years and was delighted to learn of their appointments. LAL is fortunate to have them in these roles.

Also, Thomas C McTighe, Jr., who has headed engineering for LAL since the 1960s, has retired but will continue to oversee selected projects. Vice President Michael J. Connor has retired after a long career in the industry that has included positions at New York Central, Penn Central, Conrail, and the Ohio Central System.

The STB is sharpening its pencil on its cost-of-capital thesis. JPM's Tom Wadewitz writes, "The corrected Cost of Capital numbers produced by the CAPM method are 70 to100 bp higher than the prior results which is positive for the railroads. In our view, the primary risk for the railroads from the STB's proposed change in method for calculating rail cost of capital is that the results of the new method are significantly lower compared to the DCF method.

"In rate case disputes the cost of capital is important because it acts as the ceiling for the return on capital that the railroad is allowed to earn on a specific case. The STB corrections are a modest positive because they move up the cost of capital results produced by the CAPM method." This is not likely to affect short lines paid handling or switching fees unless rate restrictions cause some commodity OD pairs to fall in the "deficit traffic" category. ISS roads are a different matter. Homework is required.

PWX Redux: It should be noted that in my P&W second-quarter analysis (WIR 8/17) I'm using freight revenues defined as sales generated from sales and service activities using railroad assets. P&W includes asset sales above the line but I put 'em back below the line because that's what other railroads do and I'm trying to create apples-to-apples comps. That's why I use $6.682 mm for my top line whereas the P&W income statement shows $7.450 mm after adding $478,000 in asset sales.

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