RAILROAD WEEK IN REVIEW
OCTOBER 5, 2007

"At times it has taken us longer to get a train to South Chicago from North Chicago than it did to get that same train to Chicago from Winnepeg." -- Hunter Harrison during the Q&A on the EJ&E acquisition conference call

Canadian National will pay US Steel (X) some $300 mm financed from cash and new debt (during the conference call CFO Claude Mongeau didn't seemed particularly concerned about the specifics) for the J's $100 mm annual revenue stream generating $20 mm in ebitda. Now, 15 times ebitda may seem like a lot when you recall that CN paid on average ten times for the IC, WC, Great Lakes Transp (DMIR, BLE and the lake steamers) and BC Rail. However, as we've seen before, the combination brings additional ebitda lowering the effective multiple for the transaction.

During the conference call (give it a listen – good interplay between and among Harrison, CFO Claude Mongeau and marketing guy Jim Foote) Mongeau noted that combinations and synergies could add another $40 mm in ebitda cutting the effective multiple to five or so, seven and a half if you only credit half the extra. Harrison said they'll put another $100 mm into physical connections and other plant improvements funded partly with the proceeds from the sale of CN Chicago area properties that are made redundant.

Not only does acquisition of the J get CN through Chicago more quickly, it also hooks up other CN acquisitions with the rest of the system. Starting in Waukeegan and heading south and east (see green map, courtesy of the EJ&E website) the J crosses the WC (Leithton), CCP (Munger), IC (Matteson) and of course the Grand Trunk (Griffith). The J (or "Outer Belt" to some old heads) also touches each of the other Big Six Class Is, as well as Bill Gardner's WSOR and the Wisconsin & Calumet, absorbed by WSOR in 1997.

What this does for CN is to take a day at least out of transit times from the PNW (Think Prince Rupert) to Memphis and the soon-to-be-built intermodal site at Kirk Yard (now CN's biggest after Toronto's Mac Yard) adjacent to the US Steel Gary Works. The move gets CN off the IHB (600 cars a day out of Blue Island, for example) and BRC. The new company of some 200 route-miles will be called EJ&E-West and the potion retained by X will be renamed the Gary Railway.

What's next for CN? Stay tuned. Harrison remarked during the call they've made $7.5 bn in acquisitions since he came to the CN and there may be others on his list. Patience is the name of the game, however, as we now know CN has had its eye on the J for some time.

RailAmerica (RRA) has embargoed its Coos Bay line in Oregon, part of its Central Oregon & Pacific (CORP) unit, citing "unsafe tunnel conditions." This segment, from Eugene to the Pacific Coast then south to Coos Bay, was originally an SP property that was acquired by RailTex in 1994 which in turn went to RailAmerica in 2000. According to the RRA press release, "the line segment has nine tunnels, each more than 115 years old, several of which are no longer safe to transit."

In late 2006 CORP started repair work in the tunnels but in the process one tunnel caved in and cost more than $2 mm to be put back in service. RRA has since determined that "three of the nine tunnels require extensive, immediate repairs to be made safe for rail operations and minimize the risk of collapse." RRA seeks a public-private partnership that could keep the line open however that could take $7 mm and five years to complete. For the nonce, CORP is making space available for customers that want to truck their goods to the carrier's Eugene to Roseburg line (one of the routing options on the former SP “Shasta Route”) for transfer into rail cars.

RRA says previous efforts to increase rail rates on the line through a surcharge were unsuccessful. “The Coos Bay line just doesn't have enough business on it today to justify us making the repairs,” said CORP Marketing and Sales Manager Tom Hawksworth. “Even if the money were suddenly available, it’s not safe to make the repairs until after the rainy season next spring.”

The local press takes excdeption. An editorial in the Eugene *Register-Guard* Sep 30 takes the position that “the railroad company should have sounded the alarm as soon as it became aware of the situation. Its failure to do so raises the possibility that the company is shutting down the line without notice for business rather than safety reasons. A government inspection of the line last fall noted that one of the tunnels was in ‘poor condition,’ though not serious enough to prompt federal action.”

What’s really frightening is the editorial writer’s lack of knowledge of how the railroad business actually works: “Representative Peter DeFazio (D-OR) has asked the Federal Railroad Administration to look into the matter, but the agency has dismayingly little control over private railroads.” Oh? Try telling that to the short line that gets fined $12,000 by the FRA for not having its paperwork in order.

And, “The short line shutdown is symptomatic of a larger national rail infrastructure crisis that is the result of inadequate government regulation and public and private investment. The closure of a single 120-mile stretch on the Oregon Coast graphically illustrates the price that communities and businesses across the nation will pay if that neglect continues.” And if he thinks HR 2125 will help, have I got a bridge I can sell him.

Maybe DeFazio should look homeward first. An article on the worldlink.com website “serving the South Coast of Oregon” quotes Kelly Taylor, the administrator of the Oregon Rail Division as saying, “There aren’t state funds - or federal funds for that matter - to help a railroad like this when they get in a pinch. There are funds for airports and other transportation modes, but not rail. Oregon actually has a state statute in place to do that, with the State Railroad Rehabilitation Fund. But nobody [in the legislature] has ever put a dime into it.” Sound familiar?

[This just in: ASLRRA’s *Views & News* for Oct 1 reports that two eastern shortlines have received FRA grants that add up to $4.7 mm for track rehab and expansion.]

Speaking of HR 2125 et al, Wall Street is beginning to take notice. Bear Stearns Rail Analyst Ed Wolfe went to the Oberstar hearings and came away with the sense that both the rails and the STB “will feel increased pressure and oversight from Congress over the next year or two.” There is concern that in the near-term the rails “may have taken too much rate too quickly” for some though longer-term the regulatory environment “will favor increased infrastructure investments and allow for the rails to earn a healthy margin” as “over time cooler heads prevail.”

I should hope so. UP’s Jim Young, in his Sep 14 letter to the STB re peak season preparedness, writes, “Union Pacific has made substantial investments in growth capital during the last few years because we were confident of our ability to improve our returns to justify these high levels. As we look ahead to 2008, our plans for investing in additional capacity are uncertain due to today’s regulatory and legislative climate. The Board’s recent proposal on the calculation of the industry’s cost of capital, its new regime for rate regulation, and the re-regulation legislation introduced in Congress, if adopted, will compel us to reconsider our future investment policies.

“The Board’s recent proposal for rate regulation will adversely affect our revenues to an undetermined degree. The STB’s action will lead to lower rates for some shippers, thereby depriving the railroad of the very capital we will need to invest in new capacity. Suppressing rates is the same as suppressing investment. This will be compounded by the Board’s new calculation of cost of capital, which we believe is mistaken, both technically and from a public policy perspective.

“Much more serious is the proposed legislation in Congress to re-regulate freight railroads, which would essentially establish federal price controls and shift railroads to a cost-plus rate regime that ignores the market and penalizes efficiency. If passed into law, these changes would undermine capital expansion and would make maintaining our network more difficult. This legislation would undo much of the progress our industry and company have made during the last twenty years.”

He concludes, “New capacity cannot be created without adequate revenue and returns. Either the private sector is able to earn a rate of return sufficient to fund new investment, or the government must pay the cost itself. If neither invests, the rail industry’s contribution to moving this country’s freight will diminish.” Peter DeFazio please take note; UP is the major connection for the CORP.

Last week I wrote that EP 646, the “Small Rate Case” Decision, could affect any shipper. A couple of readers wrote that they thought not, that only shippers of regulated commodities could file under this decision. Moreover, since the so-called “boxcar traffic” is largely exempt, short lines should ‘scape whipping, as Hamlet put it in his Act II charge to the Players. My correspondent suggests that “if the traffic is unregulated, whether by commodity exemption, car type such as boxcar, or because there is a contract for its carriage, there can be no rate challenge. In actuality, when all the various exemptions are tallied, something around 20% of all rail traffic is open to challenge at the STB.”

So to double-check I called Jamie Rennert, Chief of Staff for STB Commissioner Mulvey, and who had earlier provided an excellent overview of what the STB is doing and why at the Eastern Region ASLRRA meeting in Vermont (WIR 9/28). She confirms that EP 646 applies only to regulated commodities. And if anybody has a question as to what’s regulated or not can check Title 49 of the Code of Federal Regulations part 1039.

That’s not a scary as it sounds. Simply Google on “49CFR” and get a number of sources, particularly “1039.11, Miscellaneous Commodities Exemptions.” There inquisitive minds will learn that key short line STCCs like 20, 24, 26, 33 and so on are indeed exempt. However, cautions Rennert, any shipper can petition to have an exempt commodity removed from the list for a specific complaint and gave me some short line examples.

In other words, most short line commodities are exempt but make a shipper mad enough and he’ll go for an exemption, an action which will be costly not only for the short line but also for the Connecting Class I that set the rate in the first place. So be careful what you ask for.

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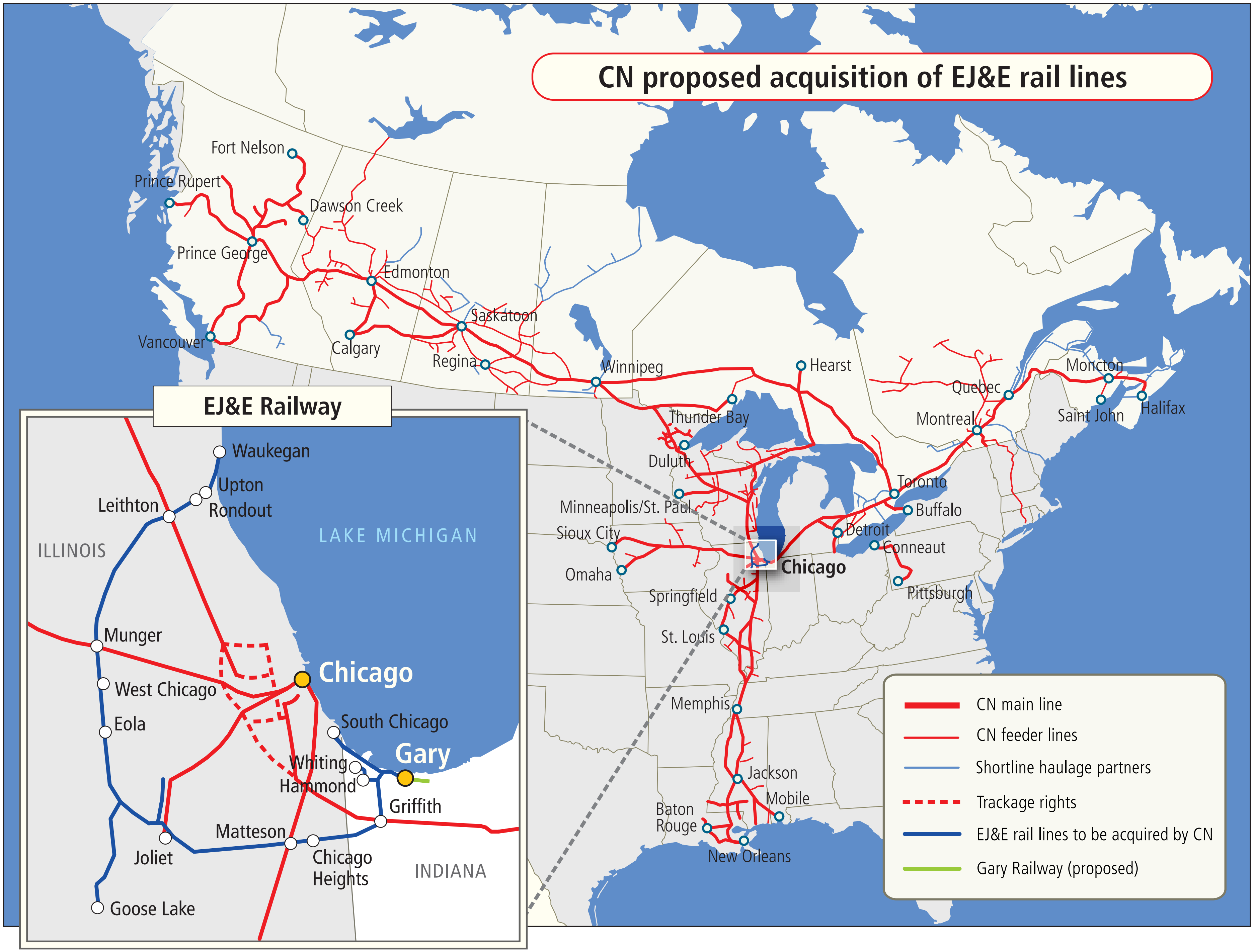

CN proposed acquisition of EJ&E rail lines
Fort Nelson
Prince Rupert
Dawson Creek
Prince George
Edmonton
Saskatoon
Vancouver
Calgary
Regina
Winnipeg
Hearst
Quebec
Moncton
Saint John
Halifax
Montreal
Thunder Bay
Duluth
Toronto
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Detroit
Conneaut
Omaha
Chicago
Pittsburgh
Springfield
St. Louis
Memphis
Jackson
Mobile
Baton Rouge
New Orleans
EJ&E Railway
Waukegan
Upton
Rondout
Leithton
ILLINOIS
LAKE MICHIGAN
Munger
West Chicago
Chicago
Eola
South Chicago
Gary
Whiting
Hammond
Griffith
Matteson
Joliet
Chicago Heights
INDIANA
Goose Lake
CN main line
CN feeder lines
Shortline haulage partners
Trackage rights
EJ&E rail lines to be acquired by CN
Gary Railway (proposed)


walworth
kenosha
WISCONSIN
ILLINOIS
mchenry
lake
ISO Quality
9001 System
QUALITY
COMMITMENT
SERVICE
SATISFACTION
EJ&E
J
RAILWAY
EJ&E Rwy QualityManagement System
Registered to ISO 9001:2000
One of the Transtar. Companies
Interchange points with connecting line haul railroads
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Waukegan
North Chicago
Rondout
Upton
Diamond Lake
Leithton
Gilmer
Lake Zurich
Barrington
kane
cook
Sutton
Spaulding
Munger
du page
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Warrenhurst
Eola
Frontenac
kendall
will
Normantown
Walker
Plainfield
Caton Farm
Joliet
Minooka
grundy
East Morris
Beven
Divine
Goose Lake
Frankfort
Brisbane
Matteson
Park Forest
Chicago Heights
Dyer
Hartsdale
Griffith
Van Loon
Goff
lake
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