RAILROAD WEEK IN REVIEW
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"More than 40% of our business goes through a port and little of this has any direct connection to the US/Canadian economy." – Marcella Szel, SVP Marketing & Sales, Canadian Pacific

Canadian Pacific threw its sixth annual Investors Day fest on Oct 30 and it bears more mention than it got here last week (WIR 11/2/2007). The insights into what CP is doing and why were most revealing and I recommend that WIR readers log onto www.cpr.ca/investors and follow along.

I'm going to cut directly to Marcella's remarks as they have the most impact on the short lines that interchange directly with CP. To begin, CP (ex-DM&E, but more on that anon) has direct connections with some 60-plus shortlines. They in turn handled more than a quarter of a million revenue units or 11% of CP's total revenue units in calendar 2006. The table following the disclosure breaks out short line participation by commodity.

In the Investors Day Marketing presentation we learned that more than 40% of CP tonnage passes through a port and into the global economy while roughly 60% of all tonnage is not wholly dependent on the North American GDP. The three biggest commodity groups in this space are grain, sulfur/ferts and coal. Though these three comprise about 32% of CP tonnage they make up close to 40% of all tonnage passing over CP short lines.

A second CP trait that is useful for shortlines is the focus on the "strategic accounts" that contribute nearly 60% of CP's annual revenue stream. These accounts are characterized by long life, sector leadership and a growth orientation. As proof of this last, sales from this group are on track to generate an 11% CAGR for the five year period 2003-2007. It's also instructive to note that CP refers to "supply-chain partners," meaning not only beneficial owners but country elevators, steamship lines and ports. Together they have made infrastructure investments of more than C$4 bn to improve their rail access and usage.

Out on the railroad CP splits the non-intermodal business into trainload and carload, and shortlines have a role in each. The goals for both are to increase loads per car, reduce car hire expense, and to cut down on cars on line. The tools are asset velocity, consistency, using fewer customer-owned cars (as we saw with the NS eastern coal strategy) and insuring prompt customer release after loading or unloading. All are within the short lines' power, reduce shippers' rail-related expense beyond the freight rates and enhance the value of the railroad to the strategic accounts.

The last takeaway for shortlines has to do with managing a "pipeline of opportunities." CP targets a steady $100-mm pipeline of new business that will provide quality revenue growth at a reasonable price (ops cost) with a supply-chain stream that supports velocity and consistency. Recall that at the Vancouver 2005 Investors Day then-CEO Rob Ritchie and then-COO Fred Green made the point that CP will work with reliable customers and "price around" those that are not (WIR 12/9/2005). Fred told me during the break last week that the theme is still in place today as part of the strategic account discipline.

As for the DM&E, the STB ruled last week this will be a "significant transaction," meaning that the decision will be delayed another four months or so, from May 2008 into the Sep-Oct timeframe. Disappointing to be sure, but it in no way detracts from what is a brilliantly-scripted transaction. Recall they have an *option* on the PRB extension so if it isn't built there's no expense. What they do get for their US$1.5 bn is an end-to-end connection that they already know ("We owned this once," said Fred Green during the Q&A) and a $100 mm EBITDA stream they can double in Year One, meaning the effective multiple is more like 7.5x than the 15x at first glance. This is exactly what GWR did in the South Buffalo and Earl Durden transactions.

CP projects revenue and yield growth for 2008 in the 4-6% range, in line with what we've been hearing through this earnings season. CP intends to take out another C$25-30 mm in ops savings as it rolls out its Integrated Operating plan across more LOBs. Forward EPS growth is modest, again in the 8-10% range as ops expenses increase at a slower rate than ops income. Given the positive, forward-looking story, I'd say that Team CP is worth supporting as a short line connection, a supply-chain partner, and as an investor. (Disclosure: I own CP in my personal retirement account.)

The STB addressed the Paper Barriers question in its Oct 29 preliminary decision concluding that "the propriety of such interchange commitments [aka paper barriers] is best considered on an individual, case-by-case basis." This in response to the Western Coal Traffic League's Board request for "rules of general applicability" for interchange agreements that are part of any line sale or lease.

The Board demurred, writing that "we conclude that the lawfulness of the terms of interchange commitments is best considered on an individualized, case-by-case basis." The Decision then goes on to acknowledge that every situation is different and sets up new guidance for existing agreements and future agreements. As to the former, the Board sees no reason to reopen every paper barrier out there but it does propose a streamlined process whereby any shipper can get a look at any agreement he feels works against him.

As for the latter, the Board writes, "For future sales or leases that would include an interchange commitment, we propose to require the parties to the transaction to give notice of them when they seek Board authorization for the sale or lease… Obtaining this information should better equip the Board and affected parties to assess a particular agreement before the transaction can proceed." In other words, a private contract between short line and Class I as to a line sale or lease would then be subject to third party examination before the fact. Hardly encouraging.

Wall Street reaction was muted. Says Tom Wadetitz of JPM, "The STB ruling provides for greater upfront disclosure of the terms of future short line sales and also for a quicker discovery process if a shipper elects to dispute an existing Class I / short line interchange agreement. We don't think the increased disclosure will be a major barrier to future branch line sales but future interchange barriers might be lowered somewhat." That's putting it mildly. A senior Class I marketing exec told me last week all potential line sales and leases are on hold pending review of this decision.

Bear Stearns' Ed Wolfe writes, "Recall that paper barriers are contractual provisions included with a sale or lease of a rail line that restrict the ability of the acquiring shortline to interchange traffic with rail carriers other than the seller or lessor railroad. This restriction can lead to fewer competitive options and thus higher rates for shippers." It also leads to lower prices and more favorable lease terms than would be feasible if the seller/lessor were turning a franchise over to the competition. See also my shipper's lament fable (WIR 10/12/2007, "Turning now to CURE").

Larry Kaufman writes, "I read Brian Holtz' demurrer with interest. His 'every day is a new day' thesis reminds me of the old Southern Pacific. If ever there was a railroad where the operating department came in each morning rubbing their hands together and gleefully asking 'what's the crisis du jour?' SP was it. I would go so far as to say we grew a specific breed of crisis managers at SP. They rarely had the resources to plan ahead, and in any downturn it adhered to the old hold-for-tonnage mantra.

“If you ran the trains and the truckers took the last few revenue units off the back end of an intermodal train, for example, virtually all expenses continued but the revenue did not. Brian knows this, you know this, and I know this. Perhaps this is a subject worth exploring from the issue of long-term vs. short-term planning. At SP, we did not have either the resources or the cash flow to really engage in much long-term planning.”

“It was at SP where I first heard the term ‘hot car railroader.’ It was applied by a former SP operating/marketing official and in that instance was referring to Buck Hord, who later was VPO of the BNSF trackage rights lines. And the term was used admiringly in Hord’s case. Buck could make things happen that served the SP well and kept customers from fleeing more than they did. The problem was that Buck's fixes (and those of others, to be fair) never were permanent. The next day, it was another crisis that demanded attention.

“When Buck left BNSF, I was told by a friend there that Buck was extremely knowledgeable, but never could adapt to working in a disciplined environment after all those years on SP. I believe it. When companies are in survival mode, as SP was in the last few years of its existence, forward planning is a luxury that executives simply cannot afford, she says. Everything is focused on getting through one day at a time.” Thanks, Larry.

The New England Central has opened the newly-enlarged Bellows Falls tunnel for business. The tunnel dates at least from 1851 though some historians push it back to 1840 and has been successively widened and heightened as trains grew bigger. Chop Hardenbergh, who publishes the *Atlantic Northeast Rails & Ports* newsletter, reports that “it consists of seven layers of brick, and from two to four layers are crumbling as the mortar dries out and disappears. Above the tunnel lie water lines, sewer lines, electric transmission stands, and a major highway.”

As I recall at the tunnel’s north end is a short bridge over a canal that makes lowering the floor while allowing a decent approach a dicey proposition. Yet somehow they did manage to drop the floor – three feet according to some press accounts – to allow clearance for double-stacks and auto racks. Vermont’s Agency of Transportation estimates as many as 5,000 more freight cars a year on the NECR as a result, many of these to and from the expanded and enhanced intermodal and transloading facilities served by the Providence & Worcester, a connection for NECR in central Connecticut.

Brenda Taylor, long a member of the NS Short Line Marketing team, is changing positions within Norfolk Southern to become an Assistant Product Manager in the Agriculture and Consumer Products Team located in Roanoke. In an e-mail to her shortline friends, she writes, “You are a major source of strength for the Norfolk Southern network and thanks for your support over the years.” And thank YOU, Brenda, for putting up with all us shortliners over the years. You will do well in the ag group where short lines have always a major role. Best wishes and do stay in touch.

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Canadian Pacific Short Line Revenue Units by Commodity
Calendar year 2006
(units in thousands)

Commod	CP Units	% CP Units	SL Units	% SL units	SL % CP Units
Grain	383.0	14.6%	86.0	30.7%	3.3%
Sulfur, Ferts	178.0	6.8%	7.5	2.7%	0.3%
Forest Prods	135.0	5.2%	58.7	21.0%	2.2%
Industrial	316.0	12.1%	100.2	35.8%	3.8%
Automotive	165.0	6.3%	7.1	2.5%	0.3%
Total CL	1,177.0	45.0%	259.5	92.7%	9.9%
Coal	282.0	10.8%	17.7	6.3%	0.7%
Intermodal	1,159.0	44.3%	2.7	1.0%	0.1%
Rev Units	2,618.0	100.0%	279.9	100.0%	10.7%

Source: Canadian Pacific