RAILROAD WEEK IN REVIEW
DECEMBER 7, 2007

"On December 1, 2007, IANR assigned the first of several yard jobs at Manly, Iowa at the former Rock Island Yard." – Dan Sabin, Iowa Northern

Tom Murray nails it in his December *Rail Stock Watch.* He writes, "There was little good news in November – in fact, little news of any kind – to support investor interest in rail stocks, and the overall market has likewise been in the doldrums as investors worry about how long it will take for the housing crisis to unwind. Given the lack of positive catalysts, it's not surprising that rail stocks were down roughly in line with the broader market for the month. The Dow Jones index of large-cap North American rail stocks declined 5.1%, or a bit more than the 4.4% drop in the S&P 500. Five of the big six North American railroads saw their share prices drop in a range from 0.7% (NSC) to 6.2% (CSX); the sixth, CNI, saw a 12.4% decline.

"The railroads all fared better during November than the four publicly-traded freight car builders, whose declines in share price for the month ranged from 17.0% (GBX) to 32.1% (ARII). There's increasing concern that the ethanol boom is running its course, at least for now, and neither coal nor intermodal is ready to take over as a source of new car orders." In fact, there are reports that brand-new ethanol tank cars are going directly to storage tracks from the production lines. The story is that though new ethanol factories are sprouting up all over, places to send the stuff are not.

Murray continues, "Strong pricing has been the foundation of rail stocks' revival since 2003, and for that reason, it is now their biggest risk factor. As UBS analyst Rick Paterson notes in a November 15 report, 'The chief fear on the rail stocks remains a rapid deceleration in pricing driven by economic weakness and greater truck competition. Our surveys show that while the economic expectations of transportation customers is indeed deteriorating, they still appear to be budgeting for rail price increases above inflation in 2008.' Anecdotal evidence suggests that some of the railroads are becoming less aggressive in taking price increases, but for better or worse we will have to wait for the next round of quarterly earnings releases to get any firm quantitative data on this crucial metric."

Bear Stearns' Fourth Quarter Update sees volumes improving against easier comps: as the current slow-down had its roots a year ago, ergo even small revenue-unit gains will look good in yoy comps. "The rails are benefiting from easy comps, strong grain harvests, continued solid chemicals vols, and solid export growth into the weak dollar. CNI is tracking most above our expectations while CSX is lagging by the widest margin." However, fuel costs are up 23% in the last two month as and about half again what they were a year ago. "While the rails are well-protected from fuel over the long term, they face near-term pressure when fuel prices are rising because most surcharges tend to lag rising prices by 2 months."

BSC further confirms that pricing is holding steady but again the RPU gains of a year ago will lessen the yoy deltas in Q4. The report concludes, "We are not changing our rail estimates at this point, with more than one-third of the qtr. remaining. However, we see the greatest potential risks for BNSF and UP who should see a relatively greater negative impact from higher fuel costs."

JasonSeidl of Credit Suisse sat down with the senior management team at GWR the other day for a bite of lunch and an update. His report: "We walked away feeling encouraged about the company's long term prospects. Indeed, management highlighted several potential growth opportunities and also noted that it remains firmly in the hunt for new acquisitions—both domestically and abroad.

"Though GWR does not have significant exposure to intermodal traffic, the short line is poised to benefit from the newly-constructed APM/Maersk container terminal in Portsmouth, VA. GWR owns 16 miles of track that directly serve the new facility and, more importantly, the lines will have dual access to NSC and eventually CSX. GWR will be the sole switching provider for the Eastern Class Is for all traffic coming through the terminal.

"The company also discussed its outlook on the acquisition market. Management has seen several 'interesting' prospects though the environment remains competitive. In general, domestic opportunities include rail lines of industrial companies, other regional railroads and natural resource development projects (i.e. ethanol plants).

"In the near term, pricing strength continues to outweigh weak volumes. Though the freight recession has shown no signs of improving, management indicated that core October volumes (excluding grain and haulage) actually increased sequentially from September, a welcome signal in an otherwise dismal environment. Also at the forefront is the Short Line Tax Credit renewal. The bill has widespread bipartisan support though the timing of the vote is uncertain. [Not bad considering the number of short lines in Charlie Rangell's district: Harlem]

"Depending on when and if the bill passes, EPS could be negatively impacted by an increase in the effective tax rate. All in all, though the tax credit and the aforementioned freight slump are near-term risks, we maintain our confidence in management's ability to grow the company and to generate stable cash flows over the longer term."

In the meantime, I've been having my own round of talks with GWR on the subject of the Meridian & Bigbee and the background, implications and positive outcomes of the bridge failure under the NASA train last spring. Look for that story in an upcoming issue of *TRAINS*.

Chop Hardenbergh has uncovered yet another Providence &Worcester opportunity in his December 3 *Atlantic Northeast Rails & Ports* letter. Connecticut DOT seeks funding for rail spurs to serve waterfront terminals in New Haven with the P&W in the forefront. But it's not a quick process. Chop writes, "Getting rail to the terminal operators will require another year because [the goal is to have] the rebuilding of Waterfront Street to coincide with the building of the spurs across it to the property lines of the operators.

"The original design specified six spurs in Waterfront Street. ConnDOT will fund the spurs across Waterfront to the property lines, [though] the General Assembly did approve the issuing of bonds to assist the operators, in a grant and loan program via the Department of Economic and Community Development," which required action by the state Bond Commission. The project is about $10 mm.

Larry Kaufman picked up on my regional airline/paper barrier analogy [WIR 11/30] and writes, "You did a fine job of equating the issue of a shortline air carriers to shortline railroads. If the Class Is are to sell their unwanted branch lines lock, stock and barrel, with no paper barriers or other restrictions on the new owner's ability to capture new business, the Class Is will demand a somewhat higher price for the property. As you so accurately point out earlier in the same piece, the paper barriers in effect allow the Class Is to sell off the lines at a 'discount' (my word, not yours) to what they might otherwise bring in the market.

"You may not be aware of it, but the Branch Line Management program reported to me at the old BN right after Staggers when I was VP-Public Affairs. We had filed a system map showing 4,000 miles that were candidates for abandonment. Talk about a firestorm in the Dakotas, Minnesota, Montana, Missouri, Nebraska, etc. You are absolutely right, and I say that coming at it from a different perspective.

“We didn’t want to abandon any lines that might have useful revenue or the prospect of generating it (this was in the days before ICC allowed leasing of lines). The lines we did get rid of just were not viable and even a tightly-run short line couldn't make most of them pay. If we could have gotten a higher price back then, I don’t think we would have worried about who the operator interlined with, just so we didn't have to absorb the losses any longer.

“The paper barriers today relate to the fact that many lines are being divested because the Class I doesn’t want to be burdened with the operation any longer, even though it is marginally profitable. That’s why, I think, the Class Is are concerned about ensuring that they retain the long haul; they know the traffic volume is there.”

Larry recalls, “When visiting with customer, civic and political officials of communities that were going to lose their rail service, our basic response to being told ‘If we lose our rail service, we’ll never get that GM assembly plant we’re working on.....’ was ‘Look, we're not in the line-abandoning business. We’re in the train-running business. That’s what we do, and what we like to do. Look at the data. By the time we tell the world we have to abandon a line we’ve already lost a lot of money.’ It was true, but that didn’t make any difference.” It was a case of use it or lose it.

He is, of course, spot on. There are still market managers who are reluctant to let go a losing line because of what *might* come down the road – a new auto assembly plant, a new ethanol mill. In the meantime, MOW gangs are spending $5,000 per mile per year (to use the shortline model) to keep the track up to FRA specs. That’s a quarter of a $million for a 50-mile branch. If all you’re getting is 1000 loads a year of aggregates and feed with a 1:1 revenue cost ratio, that’s $250 a car for track, before you even buy the fuel and filters or pay the per diem and the crew. But that’s all operating cost – if I’m the marketing guy all I care about is revenue. Ergo Larry’s experience perpetuates.

Iowa Northern’s Dan Sabin sends this note: “Not sure when the last Rock Island assigned yard job worked at Manly, Iowa, but on December 1, 2007, IANR assigned the first of several yard jobs at Manly, Iowa at the former Rock Island Yard. The new 6 day job will handle classification of traffic to and from UP and IC&E, industry switching at Manly Terminal [see my sidebar, August 2007 *TRAINS*, page 37], the local elevator, and several new industries planned for Manly.

“We expect traffic growth to require 24 hour per day, seven day per week switch service at Manly within two years. Today, the assigned engineer is son of Rock Island engineer Red Knudson, Marty Knudson, the conductor is Warren McAllister, son of Rock Island Company Doctor Dr. William McAllister.” I love it when a plan comes together. Congrats, IANR.

Next week: The *Follow the Money* series starts with an article on working capital for short lines.

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