RAILROAD WEEK IN REVIEW
DECEMBER 21, 2007

"Union Pacific has turned the corner in operations." – John Barnes, BB&T Capital Markets

Union Pacific stock drifted downgrade to the tune of nearly ten smackers Wed AM as the company guided the low-end Q4 earnings estimate down to $1.70 from $1.90 "primarily reflecting rapidly rising diesel fuel costs and the corresponding lag in fuel surcharge recoveries." Revenue units have been "softer than anticipated in recent weeks, which are largely related to recent weather events." FY 2007 earnings now look like they will be "in the range of $6.76 to $6.86 per diluted share," still up more than 14% over last year's $5.91 at the low end.

Morgan Stanley's Bill Greene calls it right, I think. Quoth he, "We would argue today's likely sell-off could give a nice entry point for those investors worried they may have missed the UP train. We believe that UP has more re-pricing of legacy contracts remaining, a better volume growth rate (UP is the only US rail actually growing 4Q volume), and an opportunity to improve cost per carload. We view today's news as primarily short-term one-off issues (weather) or related to the timing lag between when rising fuel surcharge revenue versus rising fuel costs. The long-term thesis is intact, in our view, and we remain Overweight the shares." Agreed; I remain long Union Pacific.

CSX may be facing an uphill fight for Board seats. On Wednesday The Children's Investment Fund Management (TCI) and 3G Capital Partners (3G) 13D with the SEC disclosing that they "and several individuals" have combined resources to become the beneficial owners of more than 8% of CSX. According to a press release these players also have sufficient "derivative securities" (read "options") to give them control of 11.8% of CSX shares.

The filing also says this group wants to name five directors at the 2008 Annual Meeting to "strengthen CSX's Board by adding strong independent directors with a shareholder orientation, a broad range of railroad and other relevant experience, and a firm commitment to improving CSX's operating performance and corporate governance." Railroaders in this Gang of Five include Gil Lamphere of IC fame and Tim O'Toole, late of Conrail and presently running The Tube in London.

The CSX Board of Directors is comprised of 11 individuals plus CSX President and CEO Michael Ward. None of the Directors comes from nor have any management experience in the railroad industry and five will have been on the board from 14 to 19 years when the next Annual Meeting comes around, probably next May. Ward himself has been on the Board since 2002, is senior to five Directors and has the same seniority as one Director.

CSX responded to the TCI/3G letter with a two-paragraph statement supporting the Board, citing the tripling of the stock price since 2004 and its superior shareholder returns. The statement concludes, "The Board also believes the company's outstanding record of financial, safety and operational improvements demonstrates unequivocally that CSX is a well run company."

I've been watching CSX and its predecessors since long before Michael Ward hired on (in 1977) beginning with the C&O coal trains rumbling past my W&M dormitory in Williamsburg, VA. Watching the various flags fall as CSX came into being – B&O, WM, Clinchfield, Seaboard Coast Line (itself the amalgam of the Atlantic Coast Line and the Seaboard Air Line), the L&N and others including the C&O itself -- I always had the feeing it was a perpetual work in progress.

Then came the Conrail transaction (disclosure: I consulted for NS on that one). They hired Ron Conway, Conrail's COO, to run CSX but, as another ex-Conrail exec remarked at the time, the CSX culture rejected Ron just as a human body might reject a transplant as a foreign body. There was a revolving door of good people coming and going until Michael Ward came along and began to get things settled down.

I'm not alone in saying that TCI and friends are about four years too late. Aside from improving stats, CSX is starting to *look* better. In Philadelphia I see pretty much the same trains in the same places at the same times every day. I'm *not* seeing as much of the everybody-do-his-own-thing diversity among terminal managers and divisional supers as used to be the case. Track looks better most places I've been of late and – small thing that it is – area police is much improved and the power now looks like it gets at least on occasional bath.

CSX is spending a lot on capacity because so much of its plant has its roots in Civil War railroading, when tracks were laid to the lay of the land and when multiple-track lines were a rarity. During the Bad Old Years pre-Staggers they ripped out most of the ACL double track Richmond-Jax and removed the SAL's Petersburg-Norlina Segment, two bits of infrastructure vandalism Michael Ward and his rejuvenated team are striving mightily to overcome.

Norfolk Southern meanwhile still has most of its ex-N&W multi-track main and where the Southern single-tracked its Alexandria-Charlotte line they still kept long runners at regular intervals. The Pennsylvania's four-track Broad Way may be down to two or three, but it's not down to one and the dispatching is crisp. Of course, Tony Ingram and Dave Brown had a lot to do with that and look where they are now.

RailAmerica is looking to close the ex-SP Siskiyou Subdivision on the California, Oregon & Pacific (CORP) between Montague CA and Medford, OR, 73 miles. This is a scary railroad with hairpin turns and tunnels with mainly overhead traffic on it. In a telephone interview, RA President John Giles told me he needs four units to get over that hill and around those curves. That can get expensive not only in avoidable cost but also in asset utilization.

In a letter to CORP customers, Giles writes, "We are in the railroad operating business, so any time we consider discontinuing service, it is painful for us. But we do not want to be in the business of losing money, so we are prepared to make some changes. The Siskiyou Line is difficult, expensive terrain for rail operations. Shifting most of the traffic to the Eugene interchange and reducing our days of service will help us reduce our costs."

Giles plans to reduce service over the sub to two round-trips a week starting Jan 15, working with customers to see if there can be sufficient revenue yield to keep running on a reduced schedule. He concludes, "If we are unable to secure the necessary economics to operate the subdivision, we will discontinue all service over the Siskiyou mountain pass on April 15, 2008." In other words, use it or lose it, which is the only way to go in the short line business where rail sidings are sometimes kept in place to just make the truckers think there is competition.

It's important to note that 15 years ago the SP shut down the line between Ashland (just below Medford) to Montague for the same reasons. Then on Jan 1, 1995, SP sold the line to RailTex as the CORP and by June the pass had been reopened. RailTex went to RailAmerica in 1999, which brings us to today and thus Giles' perfectly appropriate letter.

The Michigan Central commentary (WIR 12/14) drew some excellent reader feedback. Top of the heap is this note from Brian Holtz, a former shortliner now retired and free to use his extensive Class

I experience to comment on the passing scene. He writes, "I am pleased to see the STB is trying to do its job rather than rubber-stamping the industry it is supposed to regulate. Now it seems the Board has been listening to railroad customers' problems and complaints. Though I can sympathize with the frustration of both the NS and Watco, there is a positive message that may not be evident at first.

"Let's face it: the post-Staggers traditional branch line spin-offs are winding down. The low-hanging branch line fruit has been picked. The Class Is are no longer in financial trouble and no longer require protection from their customers. Government regulation is ready to return to its more traditional role of protecting the public, labor, smaller customers and to 'encourage commerce among the states,' as it says in the commerce clause of The Constitution.

"The good news is NS is a creative and financially successful Class I and Watco has shown its flexibility in dealing with the Class Is' differing requirements. I would hope that they would meet with the STB to discuss restructuring the deal to overcome the obstacles. If all parties want this to happen, I believe they can jointly come up with a way to make it happen. On one end of the spectrum is the sale and potential buy-back as was done on the Illinois Central Iowa lines, perhaps with a right of first refusal for NS. Another option may be some kind of open gateway program for shipments that do not go to NS long haul destinations.

"I'm confident the huge majority of trucks on I-94 carrying potential rail business are not headed to long-haul NS points. Some modification of the proposed structure is necessary to unlock more of the rail potential of these lines, especially as it relates to increasing short- and medium-haul business. Let's hope NS, Watco and the STB do not give up. They could be the leaders in ushering in a new era of improving Class I, short line, STB and customer-supported rail market share growth. The perfect storm of highway deterioration, congestion, driver shortage, fuel price increases, alternative fuel needs and the government finally developing a true transportation policy is coming. Will the railroads be ready?"

Elsewhere, the mail has ranged from suggesting the STB has become "too politicized" to criticizing the perceived application of 1980s thinking to 21st Century challenges. But I have to agree with writer Holtz that Norfolk's commercial creativity and financial strength combined with Watco's proven willingness to go the extra mile for its connecting Class Is will yet allow the Michigan Central flag to wave once again.

For a short lesson on how to kill railroad investment, one need look no further than upstate NY. My RR correspondents who are in a position to know say the state tax formula is based on replacement-cost new less depreciation, as if all that is there would have been built by the now-existing railroad (this includes four-track grade now occupied by a single track!). Hence, railroad r-o-w in NY is basically stripped bare. No structures, no bridges, no "sidings on spec" to industrial sites, so as to avoid taxes as much as possible. Short lines, moreover, still pay "special district" levies for water, sewer, fire district etc. These also can add up for an unsuspecting short line. It is a very perverse system, indeed, especially since states like Texas are much more realistic. It just depends on political climate, I guess.

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