THE RAILROAD WEEK IN REVIEW
JANUARY 4, 2008

"We and our shipper partners see the ANY playing a critical role in one of the world's largest construction projects." – CN's Hunter Harrison on the Athabasca & Northern acquisition

Canadian National continues its buying spree with the acquisition of the 202-mile Athabasca & Northern (ANY) in Alberta. It's a logical extension of CN's Alberta strategy as just two years ago CN bought RailAmerica's Alberta properties – the Mackenzie Northern (600 miles), the Lakeland & Waterways (118 miles) and the Central Western (21 miles). Then in Dec 2006 CN added the Savage Alberta (345 miles), the former Alberta RailNet of North America RailNet that went to Savage as part of the April 2005 breakup of the NA RailNet holdings.

ANY was the last independent short line in Alberta, one of the Cando Limited properties, and it was one of the least used with fewer than 5000 cars a year, falling well short of the 100 cars per mile per year ideal making proper track maintenance an iffy affair. However, it is the only rail link between Fort McMurray and the Athabascan Oil Sands region and the rest of the world via CN and CP in Edmonton. Moreover, until CN bought the LWR it was a two-line haul to Edmonton.

Now with this acquisition Fort McMurray is a single-line haul to/from anywhere on the CN system from Vancouver to Montreal to Chicago and New Orleans. Moreover, with the marketing agreements CN enjoys with KCS, Houston is that much closer. As CN's Chief Commercial Officer Jim Foote noted at a recent quarterly call, the diminished southbound lumber trade is being offset by growing oil-related commodities motive north.

The sale agreement calls for CN to pay Cando Ltd C$25 mm for the railroad. CN will invest an additional C$135 mm infrastructure upgrades premised on long-term traffic volume guarantees CN has negotiated with Succor Energy, OPTI Canada and NEXEN Inc. The CN press release says that the oil sands reserves in northern Alberta are second only to Saudi Arabia's, and the petroleum industry is expected to invest more than C$100 billion over the next decade in oil sands development, construction and infrastructure upgrading. No wonder Ft McMurray is looking more like a boomtown with the highest residential prices in Alberta.

Patriot Rail has made its third acquisition, the 34-mile Utah Central Railway, bringing total miles under control to 246 in three states. Based in Ogden, UCRY did about 8,500 carloads last year and interchanges with both UP and BNSF. Commodities shipped by UCRY include sugar, asphalt, lumber, plastic, steel, LP gas, fuel, grain and chemicals. Major customers include Scoular Company, Horizon Milling, SemMaterials, Metalwest, Brenntag Pacific, Inc., Kenco Group, Kellerstrass Oil Co., Amalgamated Sugar and Western Zirconium. UCRY also has a long-term lease to provide exclusive rail switching services at Business Depot Ogden, a large industrial park.

Also, Patriot has revived the original Butte Anaconda & Pacific Railway name, an apt move for its Rarus Railway. It conjures up visions of diminutive eight-wheel box cab electric locos, something I missed seeing altogether save for some locos dead in Butte in the early 1970s (they quit in 1967). The present Utah acquisition brings Patriot Rail some nice density, giving them about 130 cars per mile per year on the three properties.

RailAmerica is beefing up its Northeastern Region sales and marketing forces with the addition of two stalwarts with more than a half-century combined rail industry experience between 'em. Bill

Schroeder comes in as Director of Marketing & Sales for the Northeast Region with over 34 years of experience in the railroad industry. His resume includes stints with the Milwaukee Road, Union Pacific, Canadian National and most recently Genesee & Wyoming where he was SVP for marketing and sales.

Teaming up with Schroeder we have Douglas Low who becomes the marketing and sales guy for the NECR. Jack Dail will be a tough act to follow, however I'm sure that Doug with his 24 years in the business will do well, having worked for the GTW and CSX in various commodity marketing manager slots. In his new role, Low will be responsible for identifying and securing rail traffic from new and existing customers. His Class I experiences will be invaluable, I'm sure. Congrats to both and to RA's Senior Marketeer Charlie Patterson for finding these chaps and bringing them on.

This move comes at an excellent time because we are clearly entering a period where depressed volumes and a slowing rate of price increases is going to put pressure on short lines to find their own ways with commodity-OD pairs that are more secular than cyclical. Moreover, the regulatory and legislative climate in Washington maybe less forgiving than it has been in the past. In short, beware the government handout: it comes with a price.

Value Line ranks the rail industry 51st in earnings growth potential for 2008. Charles Schwab gives the Road & Rail Industry Group a D for growth potential. Now comes a note from JPM's rail analyst Tom Wadewitz downgrading NS to Neutral from Overweight "in light of continuing weakness in volumes and lacking visibility to timing for an upturn." Moreover, writes Tom, "NS has little legacy re-pricing to drive yield growth."

He develops his thesis further: "We are lowering our rating on NS to Neutral primarily because we believe that improvement in its volume growth trend is likely to be slow, and earnings growth is likely to be modest until the volume trend improves. In the long term, we believe that NS will realize strong growth in its intermodal business, and we continue to believe that its strategic approach to capacity investments in this business will eventually drive growth.

"We suspect that a weak truckload market and resulting TL competition, and on-going weakness in broader rail transport demand trends will result in another slow year of volumes for NS in 2008. Lacking the cost side opportunities (NS already runs a very efficient railroad) and the legacy contract re-pricing of other railroads (NS has only about 5-8% of its book left to re-price), we believe that NS's earnings story is more reliant on volume growth compared with the broader rail group." And that's particularly good for short lines that rely on handling allowances that can ebb and flow with volumes regardless of commodity pricing.

That said, NS was not alone in the downdraft. Week 52 AAR revenue-unit data shows a 6% volume drop though the Tuesday Christmas holiday was partly to blame. Actually none among the Big Six had any gains for the week, up though YTD (really a better picture anyway) only CP showed a positive number, up 3%, led by gains in chems (12%), intermodal (7%) and automotive (2%). As for the US, the AAR reported carloads off 3%, intermodal off 2% and ton-miles down a point, yet the year was the second busiest ever for freight rails.

Where we go from here is the big question. Byron Wein, Chief Investment Strategist for Pequot Capital has compiled his Ten Surprises List for 2008. He has issued this list of economic, financial market and political surprises every year since 1986 and is batting about 500 for his surprises becoming real.

First on the 2008 list: "In spite of Federal Reserve easing, and other policy measures, the United States economy suffers its first recession since 2001 as housing starts stay soft and banks are reluctant to lend to anyone where a whiff of risk is apparent. Federal funds drop below 3%. The unemployment rate moves definitively above 5% and consumer spending is lackluster."

If this Surprise becomes reality, we can expect short lines will take the big hit because as volumes fall so do revenues as there is – for handling roads, at least – little opportunity to raise rates on some commodities to offset losses in others. Weak lines like the ANY above either will be bought out by a bigger operation with the resources to fix the track to attract more business or will collapse of their own weight. The alternative is to find an equity stream not tied to debt covenants and ebitda multiples but rather to a strong business plan. Write if you're interested in backing away from the federal trough and foraging on your own.

I get a lot of calls asking what's going on with CSX and The Children's Fund (TCI) initiative. Here's the deal. TCI owns 8.3% of CSX common stock having paid an average price of $41.96 per share and amassing a holding worth $18.2 bn. TCI and 3G Capital have informed CSX of their intention to propose nominees for election to the board at the 2008 annual meeting. TCI had previously asked the board – among other things -- to separate the chairman and CEO roles, add new independent directors, align management compensation with shareholder interests, justify its capital-spending plan and provide a plan to improve operations.

Who exactly is TCI? It's an international activist investment firm making its first U.S. 13D filing. In 2005, TCI, with the help of Atticus Capital (owner of 1.9% of CSX), forced Deutsche Börse to drop its $2.5 bn offer to buy London Stock Exchange. TCI observed that in 2006, CSX shareholders rejected a proposal to separate the roles of chairman and CEO. Then in 2007 shareholders OK'd three other shareholder proposals of which the Board instituted only one. TCI seems to be betting that the board's failure to institute two of the proposals may well create more opposition at the next annual meeting.

Finally, BNSF made *Forbes* "Best-Managed Companies" list in the transportation category. "This $15.4 billion (sales) railroad is in the midst of a $2.75 billion building boom that includes three new train-to-truck transfer facilities and a second track between Chicago and Los Angeles. Third-quarter profits were up 8% on record sales of $3.9 billion. Even better: Warren Buffett upped his stake from 10% in April to 17.2% in October."

And short lines count. In the current BNSF Short Line Newsletter Mark Schmidt writes, "I would again encourage each of you to use the Short line Opportunity Capture System for the tracking and realization of new shortline business opportunities on our connecting shortlines. Log onto the BNSF homepage, click the arrow under 'register/log in,' input your user ID and password and click 'log in.' Once in the system, look for the Applications window on the right and select the 'Shortline Business Opportunity' link at the bottom." What could be easier?

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions are $550 per year. A publication of the Blanchard Company, © 2007. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned.