THE RAILROAD WEEK IN REVIEW
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"I am not ready to declare reinvestment in these lower turn/year car types is DOA." – Mark Schmidt, BNSF Short Lines

The equipment reinvestment thread (WIR 4/4/2008) continues with some highly informative and constructive feedback from Mark Schmidt of BNSF. He writes, "One of the conclusions that you drew from the presentations was that not all commodity OD pairs will support reinvestment in new cars going forward and that shortlines need to harvest those businesses while they can. Based on history, it is hard to argue with that conclusion especially looking at turns per year by car type. However, being the eternal optimist that I am and based on the presentations made throughout the analysts' meeting, I am not ready to declare reinvestment in these lower turn/year car types is DOA.

"That is not to say that those [commodity O-D pairs] moving in those car types will necessarily look the same as they currently do, but instead must under go some major reinvention. The reasons for my optimism are several [and are] based on a number of statements made in the March 6 Financial Analysts' presentations."

Schmidt writes that they are using the AIM process to work with a number of short lines on initiatives from simply handling more carloads to turning aggregates trains better to supporting a refinery expansion. Two side benefits are to reduce the time cars are not moving and to make it worthwhile for customers to add storage space rather than using boxcars for storage. Says Schmidt, "Greater density per geographic area can lower costs, improve service, and grow the business.

His wrap: "I think there is significant reason to be optimistic. The optimism lies not in the present model but instead in reinvention via AIM, Best Way, Technology, Marketing focus and Engineering reliability. Shortlines of necessity are a part." Thanks, Mark.

The CSX/TCI battle took another twist early this week as TCI accused the chairman and the board of insider trading in a 62-page federal court filing. TCI alleges that the directors took steps "to enrich themselves" using information not available to the trading public. CSX responded in a press release saying the claims were "without merit" and that "TCI has filed counterclaims in an attempt to distract shareholders from the Company's previously filed lawsuit against TCI, 3G Capital Partners and certain of their affiliates."

Barron's puts it thus: "That fight over the future of CSX has gotten a little more vicious, though it hasn't done anything to derail the stock's rally. The hedge fund quarreling with CSX management returned fire in the court battle over management of the railroad. The Children's Investment Fund, the British hedge fund that essentially introduced U.S.-style investor activism across the pond, said in a court filing that the company's chairman and members of the board have been benefiting themselves at the expense of shareholders. The company rejoined that the charges are without merit. Children's wants to add five of its own members to the board; the company, it probably goes without saying, doesn't want that. Despite the squabble, the operating performance has been solid."

The fact of the matter is that under the present leadership CSX per-share prices have tripled over the last three years, providing better returns than the rest of the railroad industry and 89 percent of all S&P companies. Thus, says investerms.com, "Any changes may be a hard sell to average

shareholders who do not understand the additional value that can be unlocked through independence."

Moreover, as UBS Rail Analyst Rick Paterson wrote so succinctly, "What we care about is the stock. Let's start with the bottom line and work back: CSX's EPS is surging due to i) strong pricing; and ii) improving operations. Pricing is an industry-wide phenomenon and we have no concerns pricing will be weaker than it otherwise would have been whatever the outcome of this battle. Whether ops management is left alone to continue doing what it's been doing becomes the only open question. We see nothing here that causes us concern ahead of 6/25 meeting, at which point we will reassess."

First Call calls for 74 cents this quarter and 89 cents in Q2, yoy increases of 48% and 25% respectively. The consensus for the year is $3.44, a healthy 27% yoy gain. At midweek's $56 the stock is trading at 16.3 times forward earnings, toward the high end for the rails, though with the estimated 5-year growth rate of 17.4% it implies a PEG ratio of 0.94, barely less than fair value.

(On a DCF basis, CSX is worth $56-58 confirming that at this week's price CSX is approaching fair value. Using the same model, NS' fair value is $66-$70, meaning that at today's $55 you're buying NS for as little as 79 cents on the dollar, even though NS' estimated 5-year growth rate is 15x. Starting with the 2007 eps of $3.73 vs. CSX' $2.70 makes all the difference.)

So how is CSX doing YTD? Through Week 13 (Mar 29) CSX total vols were off 2.7% with double-digit weakness with the usual suspects -- forest products, building materials and automotive. If 4Q07 results are any guide, total revenue units were off 2.7% yoy in that quarter as well and weaknesses were as expected.

Yet system RPU gained 10% on pricing and mix while ops expense increased only 3% leveraging a 26% operating income gain and a 260 BP drop in OR. This put CSX a point ahead of BNSF and three points ahead of UP, lagging only the Canadians and NS in operating ratio. Going back to 4Q05 CSX had an OR of 81.3 putting it 5th among the Big Six Class Is, exceeded only by UP's 85.3.

Clarence Gooden, CSX' Chief Commercial Officer said in the Q4 call the outlook is best for chems, ferts, coal/coke/iron ore, ag products and metals. First quarter roughs look like he hit it about right. Knowing Tony Ingram and Dave Brown's penchant for wringing out excess operating costs while at NS, I can say it's a safe bet they will continue to do the same at CSX. They are first out of the earnings box April 15. Given the heat from TCI, this is a crucial quarter and I have my fingers crossed for my friends in Jax.

Is the bloom coming off the ethanol rose? Possibly. As you know, I follow the industry through the Oil Price Info Services (OPISP) newsletter and they're pretty good about telling us who's in and who's out. In the past week or so, three more ethanol ventures bit the dust. On 4/4, financially troubled Kansas-based Ethanex Energy filed for bankruptcy protection. Next British-owned Renova Energy said it is struggling to raise the funds it needs to restart and finish construction work on the Idaho ethanol facility that it halted late last year. And Pacific Ethanol (PEIX) has eliminated the proposed Calipatria Calif plant from the expected build-out and it taking on still more debt. First Call has a 4.0 rating on PEIX (1.0 buy, 5.0 sell) with the average estimates for this quarter and the next as well as for this year and next all in the red.

This puts me in mind of he chap who said last fall (I think it was at the BNSF Short Line meeting) that ethanol plants fall into three groups: producing, under construction, and planned but construction not begun. The producing will keep producing, the plants under construction will get built, but the others will probably never get built. OPIS seems to support that view. As CSX pointed out (WIR

4/4/2008), many ethanol plants are on short lines. The message to short lines then is not to count your ethanol plants until somebody actually starts moving earth and putting up metal.

The STB Common Carrier hearings will run for two days – Thursday and Friday April 24 and 25. Thus far freight railroads scheduled to appear are BNSF, UP, CSX, NS and KCS plus the AAR. There are five presenters for "grain shippers and agricultural interests," eight chemical shippers, four coal or utilities presenters, four short line companies (RailAmerica, Chicago South Shore, CNJ Rail Corp, Progressive Rail) and the ASLRRA.

At issue are the "common carrier obligations of railroads" in Ex Parte 677. In its filing, the STB notes that the "common carrier obligation refers to the statutory obligation of the railroads to provide transportation or service on reasonable request." The present hearing arises out of more and more inquiries about what a railroad must do to meet its obligations.

Thus "the hearing will focus on various topics related to the extent of the common carrier obligation" such as service limitations resulting from a capacity-constrained environment. Of special interest of capital-constrained short lines, the STB wants to hear about "cost and safety issues related to the transportation of hazardous materials, especially toxic inhalation hazards" and "carrier-imposed requirements for infrastructure investments by shippers."

On the shipper side, the Board wants to hear about "the impact of volume requirements or incentives and economically-motivated service reductions and metering of the demand for service. As for possible service end games, the STB invites comment on the proper use of rail embargoes, what drives requests for abandonment authorization, and to whom the common carrier obligation applies. The hearing will also address the role of the Board's Office of Compliance and Consumer Assistance in ensuring that carriers meet their common carrier obligation.

It's a little surprising not more short line operators large and small have not elected to participate. The FRA is quite specific about the class of track required for hazmat moves so does a short line's common carrier obligation require it to get its track up to snuff for hazmats? Then there's the insurance requirement. Another Graniteville could put a small carrier out of business so is the shipper willing to pay a high enough rate to offset the cost of betting the farm on every hazmat move? Or what about the shipper using railroad-owned boxcars for storage thus taking up valuable assets that could very well be used to bring on new customers?

Add to these concerns the business of "small rate cases" that can take certain low-rated moves below the connecting Class I's equipment reinvestment threshold, limiting short lines' participation in those lanes. Then there's the HR 2125 re-reg bill that could limit the class Is' capex capability. And so on. This is a real can of worms that can do serious damage to the short line industry if not handled right. I sure hope Rich Timmons and Ed Hamberger have all their advocacy guns locked and loaded. And that short lines will focus on, to use P&W's Frank Rogers' term, "reinventing themselves."

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