# THE RAILROAD WEEK IN REVIEW

## MAY 2, 2008

*"The replacement cycle for the aging North American railcar fleet will be a consistent driver for railcar demand." – Steve Menzies, Trinity Rail Group*

**Tuesday's WSJ *New Highs and Lows*** list was particularly instructive for railroads, car builders and investors. Six coal mining companies, five rail industry players, two mining equipment companies and two steel-makers all hit news highs while three forest products companies hit new lows. Put that in the context of the quarter's earnings calls to date and one sees confirmation of the rail's pricing strength and the continuing forest products downturn.

Among the car builders, TRN took top honors with Q1 sales of $900 mm, up 9% yoy, and operating income up 16%. TRN took in orders for about 4100 new units, many of which represent extensions of current production lines for a variety of car types. Steady demand for auto racks, covered hoppers and OT coal hoppers offset softening of demand for tank cars, intermodal platforms and boxcars. During the call (credit seekingalpha.com for positing these transcripts) Trinity Rail Group President Steve Menzies noted that the number of orders for equipment to replace older, smaller, less efficient car replacements is "unique to this railcar cycle" and "the replacement cycle for the aging NA railcar fleet will be a consistent driver for railcar demand."

During the Q&A Menzies provided more color on the coal hopper story. Said he, "[We see] continued replacement of steel coal cars, certainly in the West, with lighter aluminum cars and there is some replacement of the first-generation of aluminum cars, which are a little smaller and a little heavier. I think the other dynamic we are seeing, in part driven by the weaker U.S. dollar, is the significant exporting of coal from the East and West Coast ports. That has created additional demand for coal cars." The latter ought to come as good news for coal-hauling short line connections of both CSX and NS given the outlook for export coal per their first quarter calls.

Meanwhile, *Railway Age Newswire* reports that Economic Planning Associates, noting a sagging, recessionary U.S. economy, has lowered its short term estimates for freight car construction but does expect a recovery beginning in 2010. "After a strong fourth-quarter surge in orders last year, demand for railcar equipment moderated in this year's opening quarter," EPA said. "Still, the 10,500 units ordered in the first quarter indicate that the railcar sector retains a degree of resiliency in the face of a rapidly deteriorating economy. Even with the evaporation of some prior orders from backlogs and with assemblies running at 14,200 cars and intermodal platforms in the first quarter, backlogs at the end of March amounted to 65,200 units, representing 4.6 quarters of deliveries at current production rates."

**Which leads into the present replacement** cost discussion. In a note to clients, Morgan Stanley rail analyst Bill Greene writes, "We view railroads as a solid long-term investment, even without a shift to a replacement cost model, and see substantial upside over the next 3-5 years [with] few regulatory risks for rails on the horizon. Last year's change in the cost of capital calculation had the potential to lower the regulatory bar on pricing regulation against rails. If a replacement cost framework for calculating rails' return on capital is adopted, it could add to the potential long-term upside we model by more correctly estimating the true reinvestment cost for the industry.

"The AAR has submitted a formal request to the STB to investigate whether a shift to replacement cost accounting is appropriate. The submission details the AAR's methodology for determining replacement cost by relying on numerous procedures already used in STB rate cases, which should reduce barriers to adoption. The STB has no obligation to move to a replacement cost framework, but we think the framework is superior to the current methodology of using book costs. However, a move to replacement cost would be a long-term positive.

Yet this is no panacea for rails for a number of reasons. First, rail pricing evolves slowly as contracts expire and second, SAC methodologies that factor in replacement cost limit rates on captive customers. Third, competitive market pricing is based on market conditions and the price of substitutes." With that, Greene rightly (I think) warns that "a greater umbrella for pricing could heighten congressional scrutiny."

JPM's Tom Wadewitz adds, "The issue of revenue adequacy matters because regulation of rates on captive traffic (~25% of rail revenue) could change significantly if the rail industry is ruled to be revenue adequate. Also, because revenue adequacy is a gauge of the industry's health, it may have an effect on the level of support for new railroad legislation (eg the Rail Competition Bill).

"The history of rail regulation by the ICC provides several examples where [they] indicated a choice of book value over replacement cost simply because calculating replacement cost would be too onerous and inaccurate. The AAR proposed method uses elements of the simplified stand-alone cost method and DCF frameworks both currently used by the STB. AAR's proposal appears to be sufficiently simple that it could be utilized."

A long-time WIR reader (and one of the more astute observers of the railway scene) suggests in an e-mail that "a lower regulatory bar based on misleading historical depreciation allowances is not inconsistent with the potential for monetary inflation (a/k/a dollar devaluation) to make the railroads, as investors in assets, big winners. Always and everywhere, the inflation gods steal from savers and smile upon borrowers.

"One of the Erie Railroad's 1905-1910 Harriman-sponsored grade reduction projects was for a low-grade "River Line" alternate to its main line in western NY. Originally projected to cost something like $4 million and take two years to build, the River Line ended up taking nearly $7 million and four years. In the meantime, the interest rates that Erie had to pay rose from something like 3-4% to 6%. This affected not only the discount rate but also the long-term rate of interest that would be paid, because the short term financing was carried on notes until bonds could be sold at favorable rates. As a result, the project was underwater.

"By the end of World War I inflation had boosted the nominal dollar value of the operating savings to such an extent (while the bonded debt remained the same), the River Line was clearly a winner. A study done during the 1938 bankruptcy recommended allowing a higher rate of interest to the Erie's River Line bonds than to others in the reorganization because of the value of the River Line's operating advantages. Undoubtedly, it was also due to the fact that these bonds possessed a first mortgage claim on the line.

"Confronting the Erie's lack of credit in 1905, Harriman set up these projects as independent companies. They were then leased to, and then in 1915 merged into, the Erie -- early examples of revenue bonds. The bonds were refinanced for twenty years at 3.25% in 1944, no doubt taking advantage of governmental credit allocation, and refinancing them for another five years was one of William White's first priorities in 1964. They finally were paid off (with great difficulty) in 1969. All in all, a parable of inflationary subsidy to railroad improvements." In other words, be careful what you ask for.

**Union Pacific stock will split 2:1** on May 28 for shareholders of record as of May 12. This action will not change the proportionate interest that a shareholder maintains in the company. The present $1.76 annual dividend will reduce to 88 cents or 22 cents per share per quarter, however the actual annual sum of dividend dollars going to each shareholder will remain as it has been.

Separately, the Board of Directors has authorized the repurchase of 20 million common shares (40 million shares post-split) by March 31, 2011. This new authorization is in addition to the 20 million share repurchase program initiated in January 2007. Estimates put the buyback accretion at about 31 cents a share in 2009. With current consensus estimates at $9.74 for the out-year, the combined effect of the split and buyback suggests $5.18 eps. If the split-adjusted 2008 consensus of $4.11 holds it looks like earnings will be up 26% yoy. (Disclosure: I am long UNP.)

**The RT&S Newswire reports** that Vermont rail system is again connecting with Pan Am Railways trains in Hoosick Falls, increasing train traffic to North Bennington, Vt., and Rutland, Vt., and then into New York. The goal is to loosen congestion at freight yards and make the freight option more attractive for local businesses. From an equipment utilization viewpoint, this is shorter route to/from CSX than via NECR and Palmer/Springfield or via Rutland/Whitehall-CP-CSX.

David Wulfson, president of Vermont Railway, said that workers recently finished repairing the tracks leading to the Hoosick gateway, and trains can now be diverted that way. The freight trains can still connect with the Pan Am lines in Bellows Falls, but sending some traffic through Hoosick will increase speed overall. "Some of the yards in different locations were getting congested and this just cuts down on handling and switching time," Wulfson said. "We decided to start using that gateway again."

Chop Hardenbergh writes in his *Atlantic Northeast Rails & Ports* letter for 5/5 that "In October 2007, when ST and VRS announced the forthcoming Gateway, officials said ST could move CSXT cars for VRS, which has six on-line large feed mills supplied by CSXT from the west. Moving the cars to Rotterdam Junction NY for interchange to CSXT bypasses Selkirk.

**Tidbits:** In its mad dash to replenish its balance sheet, **CIT Group** is shopping its railcar leasing business. GATX is said to be interested. (seekingalpha.com)… The **"food vs. fuel"** debate, until now largely an academic discourse, has begun to take root in the public policy arena, threatening to mire or perhaps even choke off ethanol expansion plans. (OPIS Letter)… E-mails the **DM&E** filed in Wyoming U.S. District Court show a conspiracy between landowners and consultants to stop a proposed expansion of DM&E's line. (Sioux Falls *Argus-Leader*)… GE is seeking a **buyer** for its rail services unit in a deal that could be worth about $4 bn (*Financial Times*)