THE RAILROAD WEEK IN REVIEW
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"While we are in a strong cash position today, we are also cognizant that our position relative to others [vis a vis acquisitions] may grow even stronger." – Jack Hellmann, President, G&W

Genesee & Wyoming's fourth quarter operating income increased eleven percent year-over-year or $14.6 million to $149.2 million thanks mainly to acquisitions ($26.3 million), offset by foreign-exchange losses of $7.2 million, a $3.5 million decline in third party fuel sales and a one million dollar decline in same-store sales (railroads open under the GWR banner for at least a year). During the earnings call Hellmann said most of the same-store decline was due to carload volume declines of nine percent in November and eleven percent in December.

Commodity groups suffering double-digit drops were metals and STCC 24 forest products while pulp and paper dropped nine percent. Grain in both Canada and Australia held up "reasonably well" as did salt, US utility coal and municipal solid waste, these last two major players in the "other commodities" line and representing new revenue streams on the Ohio Central. It is helpful that GWR keeps a 60-40 balance between "economically sensitive" commodities and those that are less so. Average revenue per revenue unit increased 6% ex-foreign exchange effects.

Operating income increased a respectable 35 percent, once again showing the leverage you get with a double-digit revenue gain and single digit expense gain, in this case a mere six percent. The operating ratio improved 367 basis points to 79.6. However, as in the revenue line above, there are many moving parts. Strip out gains on asset sales and acquisition-related expenses for both years and the adjusted operating income is $28.5million, up 27 percent, with an adjusted OR of 80.9. Non-freight revenues (switching operations, car hire and rental income, fuel sales to third parties and ancillary services) increased three percent to just under $54 million and dropped to 36 percent of revenues from 39 percent a year ago.

Full-year revenues gained 17 percent to $602 million and culminating continuous growth since 2004 at a CAGR north of 22 percent. Operating income jumped 20 percent to $116 million including $8 million in asset-sales gains and a four-year CAGR of 24 percent. Below the line, fourth quarter net income was $25 million aided in part by a retroactive impact of $7 million from the extension of the shortline tax credit; up 81 percent over least year. Earnings per share increased to seventy cents, up 79 percent. Full year net income grew 31 percent to $72 million and eps gained 41 percent to $1.99.

Looking ahead, Hellmann said they anticipate "strong volume deterioration in the first quarter, continued weakness in the second and the third quarters, and maybe a bit of an uptick in the fourth quarter." As to acquisitions, Hellmann offered this observation: "We continue to be focused on select opportunities and are being very patient in an environment of significantly reduced competition and extreme economic uncertainty. Second, we have significant capacity under our revolver and plan to increase availability over the course of 2009 as we generate strong free cash flow and pay down debt. While we are in a strong cash position today, we are also cognizant that our position relative to others may grow even stronger with the passage of time. So, we remain very patient."

The STB Wednesday evening reversed an earlier decision and decreed that BNSF has been overcharging an electric generating utility at Mona, Wyoming, just south of the Powder River Basin coal fields. The original dispute arose in 2004 between the carrier and the Western Fuels Association

(WFA) over the rates BNSF was charging to deliver eight million tons of coal annually to the facility. In 2006 the STB ruled against WFA.

Then in 2007 the STB changed the rules and gave WFA a second bite at the apple, and, as written in the present decision, "WFA has shown that its rates far exceed the level BNSF needs to charge to earn a reasonable return on the full replacement cost of the facilities used to serve WFA, because the Laramie River Station plant [at Moba] is located so close to the PRB. As such, it is now clear that BNSF has been forcing WFA to cross-subsidize other parts of BNSF's broader rail network that WFA does not use.

For its part, BNSF is understandably not amused. "The STB reversed its prior decision and has now ruled that those very same rates [those in place at the original 2006 decision] are unreasonable. It appears that the STB has awarded the shipper approximately $100 million in reparations and then capped rates for the next 16 years, for a total reported present value of $345 million. Despite ruling in BNSF's favor once, the STB substantially revised its large rate case rules, and then allowed the shipper to submit a reconfigured new case.

"BNSF believes that this case is a manipulation of the new rules and represents an outcome-oriented decision in favor of this shipper. If this ruling stands, it would be the largest award for any shipper in the history of coal rate litigation. We are currently reviewing the decision and intend to pursue all legal remedies."

The BNSF comment with respect to "an outcome-based decision" has merit. The press release accompanying the STB decision cites the Board's "commitment to delivering strong regulatory oversight over the freight rail market when necessary to protect captive shippers from monopoly pricing." Clearly, the Board has heard the complaint that it's too railroad-friendly and must come down hard to show it isn't.

This populist quote from Board Chairman Nottingham in the wrap says it all: "The ultimate beneficiaries of this decision are consumers in Colorado, Iowa, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Dakota, and Wyoming who are served by this captive electric utility plant. Those customers have been bearing the burden of these unreasonably high transportation rates in their monthly electric bills, a burden they should no longer be forced to bear."

Methinks the Chairman protesteth too much. It was the ICC a hundred years ago that recognized that sometimes one move has to subsidize another. As I wrote in *The Railroad, What it Is, What It Does* (Fifth Edition, Simmons Boardman, © 2008, with permission), "The ICC was formed largely because there was a growing sentiment that railroads were effectively monopolies and could charge whatever they wanted to charge and deliver whatever level of service they felt was appropriate. At issue were rate discrimination between large and small markets, short-haul vs. long-haul pricing, preferential treatment of large customers over small, and particularly the practice of giving free passes to politicians.

"To its credit, however, the ICC invented the *what the traffic will bear* concept, elucidated by one Judge Cooley, the first ICC Chairman: 'The public interest is best served when the rates are so apportioned as to encourage the largest practicable exchange of products between different sections of our country; this can only be done by making value an important consideration, and by placing upon the higher classes of freight some share of the burden that, on a relatively equal apportionment, if service alone were considered, would fall on those of less value.

“And, ‘Rates have been made on the principle of *what the traffic will bear* theory to prevent unjust discrimination between competing places and commodities. Cost of service fixes the minimum below which rates must not sink, just as *what the traffic will bear* fixes the maximum above which they must not rise.’ And so it was that the market value of the commodity was one of the earliest factors the ICC considered in determining ‘just and reasonable’ rates.” That’s why aggregates move at one revenue/cost multiple and chemicals move at a higher multiple - one has to subsidize the other.

If such were not the case, why should a taxpayer in Montana subsidize the New York City subway system or Amtrak.’s Northeast Corridor? Any why should this WFA power plant subsidize BNSF rates to other BNSF-served WFA facilities? Consider the possibility that BNSF rates to more distant WFA plants are lower thanks to the cross-subsidy from the nearer point. Maybe WFA ought to be careful what it asks for lest rates rise to the maximum allowable rate to all its generating stations.

New York’s Ed Wolfe writes in his note on this decision, “We spoke with two lawyers who do not view last night’s decision as a sea change in the overall rail pricing environment.” Well, I spoke with a lawyer and another analyst who agree that this might be the first olive out of the jar, so to speak, where self-perceived captive shippers of all stripes will climb on this one as precedent. The impact on short lines serving coal mines or coal-fired generating stations could be devastating.

Tony Hatch takes a more sanguine tone. “This will be perceived to be a big deal - another sign that Washington has turned against one of the few American industrial success stories of this century. A few farmers in the northern Midwest and thousands of lawyers in DC will celebrate while the possibility of a renewed intermodal infrastructure takes a hit. Perhaps this will galvanize shippers whose success brings low-cost goods to US consumers and is intermodal (thus rail) dependent (think UPS, Wal-Mart, etc) will realize the threat being put to them by a few well organized local interests and demonstrate their not inconsiderable political clout on behalf of the network.”

Some folks say this may take the steam out of the re-reg forces. I think not. If anything, it will only galvanize them. Members of Congress play to the mobs and do what looks good, even if when you dig down the item under discussion does more harm than good. (See Chuck Schumer’s concern about the negative employment effects on Wall Street caused by the Stimulus Bill’s Limitations on certain skilled immigrant labor.) As Lady Allen says in Jane Austen’s Northanger Abbey, “The government has lost all sense of reason.” Truly.

Pam Blakeney of Norfolk Southern has an offer no shortline railroad owner can refuse. She and her associates are running a Loss and Damage Primer in Atlanta Mar 23-25. The title she chose is certainly apt: “The Business behind the Business.” She writes, “This seminar will cover not only the prevention of lading loss but also understanding the claim process. My team and I are aware that not everyone handles lading loss but in those instances when a loss occurs we have found that the knowledge base is comprised of recall or old notes. Our intent is to level the playing field by starting with the foundational basics and building quickly on who, what, where, why, when, and how to handle lading loss and the prevention of loss.

“Colin Barrett, author and *Traffic World* contributor, will set the stage for the seminar. We will have a host of people and resources available for general and specific questions. Damage prevention vendors will be on hand to demonstrate methods and products that could be shared with customers to reduce the loss and damage. If your schedule will only allow for an overnight stay- please plan on Monday’s session with a late departure on Tuesday evening. We will be using two hotels- The W at Midtown and the Marriott Midtown on 14th Street.”

L&D is entirely preventable if shippers take precautions in loading material and railroads keep coupling speeds under control and practice safe train handling. Please remember that whatever is in that car is somebody's property, a part of an inventory supply chain that the beneficial owner needs to sell as is or a part of something else. As partners in supply chain management, we can't be perceived as being cavalier about L&D prevention. And after Pam's course, you ought to visit every traffic originator to be sure they practice safe loading. For further details, please call Pam at 404 658-2037 or e-mail pamela.blakeney@nscorp.com.

The "Market Watch" page in the *Barron's* Feb 16 Market Week Section, has an article titled "Anything but Normal" that makes reference to public-private-partnerships, or PPPs, something NS talks about a great deal in its corridor development projects (Crescent, Heartland, MidAmerica). The writer says the PPP concept "has proven difficult to execute and thus causes a high degree of skepticism." Granted, the PPP remarks are in the context of the banking system, however given the way local governments are cutting back due to tax receipt shortfalls, one has to wonder how long states like Virginia and Pennsylvania will continue to play this game.

NS issued a press release last week praising Pennsylvania Governor Ed Rendell on his commitment to his state's Rail Freight Program and we know that Rendell is looking to have as many programs in place as he can before the inevitable bills come due. Barron's again: "Main Street has taken to hunkering down and saving rather quickly." Whereas in the past monetary policy encouraged more borrowing, "that isn't the case this time and systemic de-leveraging will take years."

Elsewhere in the same issue, Michael Santoli and Vito Racanelli remind us that, given the market's fifty percent decline, "conservation of capital will remain an important investment requirement for a while." A solid balance sheet, low leverage and a sustainable franchise will attract new investors; a company that does not offer these qualities will not. Now put that in the context of GWR's most recent quarterly call. During the Q&A Jack Hellmann referred to "distressed situations" and low ebitda multiples. The days of paying eight to ten times cash flow (or more) may be over.

After a lapse of two weeks, it's time to conclude our three-part "How to do a RRIF Loan" screed (WIR 1/23/209), courtesy of Chris Rooney. This is where we get into the financial details of what to expect once the FRA has accepted your application for review. Since this is not a grant program, the FRA will do all the usual credit calculations to be sure you can repay the loan with interest. The interest rate will be whatever the Treasury is paying on bonds of the same maturity, now roughly three to four percent for the long bonds. Happily, the FRA can go out as far as 35 years for long-lived assets (track, e.g.) and match payments to the economic cash flow from the assets.

You can test your own credit score with a simple "cash flow coverage" ratio to asses your credit capacity based on historic and projected profit-and-loss data. The FRA wants to see a cash flow coverage ratio equal to or greater than one: the net cash flow from operations divided by fixed financial obligations including the RRIF payback and any equipment leases. Rooney has written a three-page guide to the process and has prepared a sample spreadsheet (available on request).