THE RAILROAD WEEK IN REVIEW
OCTOBER 1, 2004

Wick Moorman has been tapped as President, Norfolk Southern, effective October 1. David Goode retains the CEO and Chairman mantle, as is customary. Ike Prilliman, vice chairman and chief marketing officer, SteveTobias, vice chairman and chief operating officer, and CFO Hank Wolf will report to Moorman. The appointment is timely. At 52 Moorman can run the company for at least ten years before hitting the mandatory retirement age of 65.

Like many of the NS senior management team, Wick's roots go back to the Southern, where he hired out as a student trainee in 1970. He's a graduate of Georgia Tech and Harvard Business School and has served in senior positions in transportation, personnel, labor relations, information technology and strategic planning, moving to the last-cited position in 2003.

As Wick moves up, others move up as well. I'm personally pleased to see these appointments. Congratulations are in order to:

- James A. Hixon, currently senior vice president legal and government affairs, was named executive vice president finance and public affairs, reporting to Wolf.
- Mark D. Manion, currently senior vice president transportation operations, was named executive vice president operations, reporting to Tobias. Mark understands shortlines and branch line operations and communicates well. We're still dining out on his shortline presentation of June 2003.
- Kathryn B. McQuade, currently senior vice president finance, was named executive vice president planning and chief information officer, reporting to Moorman. Kathryn, like Rathbone, Wolf and a certain newsletter writer, is a W&M grad, and brings that institution's tradition of independent thought to Strategic Planning – one of the more analytical groups in the business. Great move.
- John P. Rathbone, currently senior vice president administration, was named executive vice president administration, reporting to Moorman. John knows the NS culture and how to fit the various pieces together for best results. As the former controller, he knows finance and can explain the nuances without relying on financial jargon. Shortliners should get to know him better. Give him a call before your next trip to Norfolk.
- Donald W. Seale, currently senior vice president marketing services, was named executive vice president sales and marketing, reporting to Prilliman. One of my favorite marketing types, Don's an advocate of the carload business and a friend of the shortlines. His focus on revenue and asset yield is invaluable.
- James A. Squires, currently vice president law, was named senior vice president law, reporting to Wolf.

Meanwhile, NS stock continues to roll. Since May it's up 36% from $22 to $30. January 30 calls are now $1.65 bid and Tom Wadewitz of Bear Stearns has raised his 3Q04 estimate to $0.55 from $0.53. He also writes, and I think correctly, "The Trend Remains Your Friend in the Rail Space. We believe that the rails that have delivered strong EPS performance (and strong stock performance) in 2004 remain the stocks to own as we anticipate strong 3Q EPS performance and we see upside vs. current consensus expectations." NS is one of three; BNSF and CN are the others.

RailAmerica reduces its margin rate on its debt by 50 basis points as it restructures its $450 million senior credit facility as of September 30. They also closed out most of the outstanding $130 mm in 12 7/8% Senior Subordinated Notes due August 15, 2010 with the $124 mm in proceeds from the sale of Freight Australia. As Expected, (WIR 9/24/2004) RRA incurred about $20 mm in transaction expenses. The two deals will reduce annual interest expense by about $20 mm.

Also this week RRA decided to shed its E&N Railway on Vancouver Island in British Columbia, taking a pre-tax non-cash charge of $12-13 mm in 3Q04. The E&N was bought in 1998 from CP for $11 mm. CEO Charles Swinburn cites declining carloads over the past two years and says the E&N "is no longer viable." Sale date is in 1H05. Writes Jon Langenfeld for RW Baird, "Line disposal is a continuation of RRA's asset rationalization plan as it hones its focus on profitable, growth operations. This sale supports the much-improved focus of RRA."

Last time I looked E&N was running about 8,500 cars on its 181-mile system for a rather thin 47 cars per mile per year. Assuming a nominal $250 per car revenue and applying some other shortline benchmark ratios to the income statement I get an EBITDA in the neighborhood of $145,000 and an OR in the mid-90s. Clearly not what RRA is looking for. Or needs.

Greater transparency is still needed non-public shortline financial reporting. I recently completed a survey of shortlines in various parts of the country to see who's reporting what and how. Take operating expenses. Most report by traditional line item – comp & benefits, fuel, car hire, etc. The rest – and this includes some of the larger roads -- break out operating expenses as transportation, maintenance of way, equipment maintenance, and so on. The former group clearly shows where the money is going; the latter does not.

With comp and benefits, fuel, and car hire eating up half the operating budget it would be helpful to know how well all shortlines manage these items. Some observations: (1) The smaller the railroad, the greater percent of revenue represented by comp & benefits; (2) Fuel consumption varies directly with carloads per route mile and runs from four to 26 gallons per revenue carload handled (GTMs are meaningless in this environment); (3) Car hire is remarkably low, from one to eleven percent of revenues, and relief was less a factor than mix of privates and railroad-owned cars.

All-in, EBITDA is the preferred measure of operating profitability among shortlines. Among my sample the names that did the best job controlling compensation, fuel and car hire also had the best EBITDA-to-revenue ratio, ranging from 20-50%. Moreover, higher traffic densities mean lower expense per unit. But there's still something missing: capital expenditures, of which track is or ought to be the largest item.

As a rule shortlines must invest $4-5000 per route mile per year yet we're seeing numbers closer to half that. A railroad is a "wasting asset," meaning assets are consumed in the process of producing the service the business owner sells. Sometimes one can get away with letting track deteriorate to the minimum FRA class needed for the service, but rarely is it less than FRA class 2.

Buyers must weigh the impact of under-maintained track on pro forma free cash slows. And sellers must weigh the impact of bad track on the value of the railroad. Granted, one can increase apparent FCF by cutting capex, but the buyer will see it on the first due-diligence trip. On a typical transaction track quality can cause a spread of several $millions. So stinting on track drives good buyers away, reduces CAGR on the initial investment, and ultimately pushes operating ratios up. Not good.

Mike Smith, a shortliner who knows a thing or two about making good money with low-revenue short-haul moves has taken me to task on my aggregates commentary (WIR 9/2/2004). He writes, "I believe you should reconsider your comments in the 2 Sep 04 WIR concerning aggregate shippers. Aggregate guys will kill for a penny a CWT but that is the nature of a highly capitalized and competitive industry selling a low value product where transportation costs can represent 50%+ of the selling price. Grain shippers are similarly challenged except they will sell their mothers for a quarter-cent per bushel.

The aggregate business that UP handles in Texas (which has been restricted by UP) is characterized by large volume semi-unit train operations (90 car + trains broken up into 30 – 50 car blocks near destination), delivered to distribution yards capable of unloading all deliveries within 16 hours, and a scheduled high utilization of equipment (2+ loads/wk). To me, this defines a lower cost and efficient operation that exemplifies what railroads can do best. Aggregates are good business for railroads, whether they move on giants such as UP or shortlines such as Nittany & Bald Eagle."

Regarding cost of capital (WIR 9/17/2004) Kel McKavanagh, whom many of us got to know when he was running Conrail's shortline program, writes, "While earning the cost of capital is a sound objective, it is much easier said than done, especially when decreed for each business unit. Railroads, like public utilities, are a decreasing cost industry. Based on the 'envelope curve', costs per unit go down as volume increases.

"Railroads make money when they have a lot of volume. As the rail earnings reports come in, you will see cost per car drop by a larger percentage than the percentage increase in over-all transportation costs, etc. Conversely, revenue disappears much more quickly than costs. You lose all the revenue if you don't handle a car; however, you still have costs, assuming you are still in business.

"There is also the matter of allocating common or joint costs among the business units. Getting rid of traffic which doesn't earn the cost of capital in one unit may add to the cost of capital in another unit. I remember Paul Gorman, CEO of Penn Central for a period just before and after the bankruptcy, asking why rates couldn't be raised to the maximum level permitted by the ICC. He had retired as president of Western Electric and was used to selling telephones and other equipment to AT&T on a cost-plus basis.

Around 1995 Conrail attempted to raise rates on box car and other commodities that were perceived as not making a satisfactory contribution to overall earnings. After loss of business and some lower than anticipated financial results, Conrail went back to 'counting cars.' It's difficult to fine tune prices on a large scale basis. Charging what the traffic will bear is still the best solution, in my opinion. Of course, one of the railroads' problems nowadays is that they don't have enough people to figure out what these amounts are." Boy, ain't that the truth.

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