THE RAILROAD WEEK IN REVIEW
NOVEMBER 19, 2004

The Canadian Class Ones have structured three new network initiatives that will improve railway transit times and asset utilization in British Columbia, Alberta and Ontario. First is a slot-sharing arrangement on CN between Edmonton and Kamloops (the press release says Coho, BC, but it's not on any of my system or RAC maps; it's near Kamploops and that'll do). CP gets to move eight bulk trains a week this way, essentially along the hypotenuse of a right triangle formed by Edmonton, Calgary and Kamloops.

Trains run though with CP power and CN crews over the 550-mile route. CN's Kamloops yard runs north-south and it's here the mainline heads west toward Vancouver along the north bank of the Fraser River. CP comes at Kamloops from the east and remains on the south bank to Vancouver. The present arrangement complements the already-established directional running trackage that sees all westbound trains of both railways move through the Fraser Valley on CN's line while all eastbound trains move on CPR's line.

The second is setting up directional running over about 100 miles of parallel CP and CN track in Ontario between Waterfall, near Sudbury, and Parry Sound on the Toronto-Sudbury segments. Third is a haulage arrangement, also in Ontario, with CN freight moving about 300 miles over CP track between Thunder Bay and Franz, a point on the former Algoma Central. The connection with the CN main is 50 miles north at Oba. Thus CN can downgrade the 200-mile Thunder Bay-Longlac segment to the track classification appropriate for the remaining local service.

Check your maps and you'll see these deals make a lot of sense and reduce redundant mains. Just pray they don't tear anything up. Think of all the choke points today where parallel mains of once-competing railroads are gone forever. But they sure would be nice to have today.

These announcements follow directly on the heels of last week's NS-CP-CN arrangement improving rail service between Eastern Canada and the US Northeast. The short form is that starting today CN-NS business crosses the border at Rouses point, NY and comes down the D&H rather than going around the horn via Buffalo. NS and CN benefit by cutting 300 miles and two days transit time for 20,000 loads a year. CP benefits because it adds revenue to the D&H at very little cost.

The ops plan is for CP to provide haulage for CN-NS traffic for the eastern US south to Saratoga Springs, from thence moving in NS trains running on trackage rights to the NS Buffalo line at Sunbury, PA. The agreement moves railroading onto the 21st Century by getting everybody past "protecting the franchise" and adding value for customers. CN customers in Quebec and the Maritimes get quicker access to important consuming markets in the Eastern United States. Ditto for NS customers doing business in that part of Canada. And CP gets a shot at seeing the D&H finally push the OR south of 100. Nice going, guys and gals.

Oscar Munoz, CSX Chief Financial Officer, told the assembled multitudes at the recent Smith Barney Transportation Conference that the company is "on track to deliver the best returns in five years." Through September CSX operating income was $749 mm; the previous best was $714 mm in 2000. That year closed with operating income of $995 and the average Q4 operating income 2000 through 2003 was $267 mm. Ought to be a piece of cake.

The street revenue estimate is $2.05 bn against 4Q03's $1.9 bn on a rail operating ratio of 87.2. The OR for the quarter just ended was 87.1, down 70 BP from the second quarter. Ergo, assuming the OR holds at 87 or even improves one might conclude CSX has better than even chances for a record year. Best of all, the added cash flow might help pay down some debt. The CSX debt-to-cap ratio as of 9/30/04 was 51%, highest of the Class 1s. Paying down a $billion would take that number to the 48% range against a peer average of 45%. Pay down $2 bn and hit 44%, but that's another story.

Jason Seidl of Avondale Partners opened his coverage of RailAmerica this week with a Market Outperform rating and a 12-month price target of $14.00, indicating a 14.7x multiple on the current 2005 estimate of $0.95. He writes, "We believe the company should benefit from 1) strong demand for rail transportation 2) recent tax adjustments favoring short line railroads 3) an improved balance sheet; and 4) recent additions and potential acquisitions."

Can't argue with any of that, especially the accretive aspects of recent acquisitions in the Midwest. It was clear from my meetings with RRA management (WIR 10/22/2004) that they are going to be much more picky about lines they go after and this is much to their credit. However, much depends on pricing, and here shortlines are at a district disadvantage. Most shortlines are paid on a flat-fee per-car allowance that typically does not rise with Class 1 pricing. Yet RRA for the first nine months posted RPU up 5% in the merchandise sector, representing 84% of RRA's operating revenue.

But at what cost is revenue added? The top 50% of RRA properties generate 80% of operating revenue with an OR right at 80 (pre-2004 acquisitions). The other half run at an OR of 97 – incremental expense over incremental revenue. If any shortline can shed X% of miles and only lose .25X% of revenue by shrinking the railroad then there's too much railroad. And what one typically finds in line segment analysis is the percent of expense runs twice the percent of revs gained running these line segments. 'Nuff said.

Regional Railroad and shortline holding company comps for 3Q04 appear on the last page. Please note we're only comparing *above the line* data – that which relates to the core railroad operation. Excluded are non-operating income items, equity earnings in affiliates, discontinued operations and the like. As ever the WIR focus is and will remain to be what happens between railroad operating revenue and railroad operating income. Note also the sums of the commodity percentages don't always add up to 100. How far short depends on how much "other revenue" exists. Inquiring minds may want to see the Third Quarter Review, due out soon and available at www.rblanchard.com .

I've added yoy change in operating income and accretive OR, or the ratio of the change in operating expense to the change in revenue. If it's less than the railroad OR then new business is coming in at less cost than what was there before, a good sign. If it's more then expenses are rising faster than revenues and it bears closer scrutiny. For example, FEC got hammered by four successive hurricanes and there were no non-Florida operations to mitigate the effect. RRA's number is before a one-time write-down charge but includes significant jumps in fuel, casualties & insurance and joint facilities.

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Small Class I and Shortline Holding Company Commodity Carload Comps

Quarter ending 9/30/2004

Revenue and income in $millions

North American Rail Operations Only

Metric	FEC	KCS	GNWR	RRA
Railroad revs (1)	$46.3	$163.0	$77.2	$100.0
YOY Pct. Change	3.5%	11.6%	25.6%	11.2%
Carload revs (2)	$24.6	$111.6	$44.9	$75.6
Pct carload	53.1%	68.5%	58.1%	84.0%
Pct Intermodal	45.0%	9.7%	0.8%	1.1%
Pct Coal	0.0%	14.0%	15.1%	8.1%
Mdse Carloads (000)	42.0	128.7	109.3	200.2
Rev/CL	$585	$867	$410	$378
Rev/IM CL equiv	$515	$310	$579	$175
IMCLE/avg CL rev	88%	36%	141%	46%
Operating Income (3)	$7.8	$19.0	$13.2	$17.6
YOY Pct. Change	13.2%	8.4%	22.5%	22.1%
RR Operating Ratio (3)	83.1%	84.8%	82.9%	82.4%
Accretive OR (4)	288.9%	62.2%	74.6%	147.5%
Price/gallon of fuel	$1.19	$1.19	$1.37	$1.40

(1) Excludes Mexico

(2) Excludes coal, intermodal, bridge traffic, GWR Railink Switch ops.

(3) NA Rail Ops only, before extraordinary items

(4) YOY change in revenue divided by yoy change in ops expense before one-time charges