THE RAILROAD WEEK IN REVIEW
JULY 1, 2005

Railroad yield growth looks "solid" for the rest of 2005 according to a note from Ed Wolfe and Greg Ryan at Bear Stearns (BSC). The letter cites some softening in other modes' pricing practices whereas the rails look to boost both rates and fuel surcharge applications still further. The dozen shippers BSC surveyed last week indicate "demand appears somewhat mixed in the metals, chemicals and autos segments, although we believe grain volumes could bounce back in 2H."

The daily update at schwab.com notes the Chicago Purchasing Manager's Index came in a bit weaker in June at 53.6, down from 54.1 in May; analysts were expecting a reading of 54.0. Despite the mild reduction, the index remains above 50.0, indicating continued expansion in the manufacturing sector.

Readers can glean an indication of the leading industrial sectors by watching prices, volumes and trends in the Exchange Traded Funds (ETFs; see www.amex.com if you're not familiar with them). I follow ETFs for materials (AMEX: XLB), Utilities (XLU), Energy (XLE) and Consumer Discretionary (XLY) as many of the companies whose stocks reside in these ETFs are big rail users (automotive, coal, building materials, etc.). Also, the Industrials ETF XLI), a broad basket that cuts across lots of industries from conglomerates to Fed Ex is helpful at times.

Over the past three months XLU and XLE led the pack, up 10% or so, while XLY tracked the Dow and XLB lagged. The AAR's Week 22 total YTD carload commodity and intermodal volumes were up 3.5% YTD with intermodal (XLY) up 6.4%, coal (XLU, XLE) up 3.2% and materials (XLB) – mainly chems and forest products -- flat to down. The four-week trends are total volume +0.6%, intermodal +3.8%, coal -3.6%, and materials still flat, indicating a slowing of volume growth.

What I suspect is that the "mixed demand" that BSC found combined with the softening of revenue unit volumes and slackening consumer demand as indicated by the ETF stock price trends may point to two things. First, lower rail volumes as the low-yield commodities fall out the bottom. Second, improved yields on the better-rated commodities.

By my reckoning 60% of shortlines generate most of their revenue from low-rated commodities. As that business dries up, so will they unless they can partner up with other shortlines with better-yielding customer bases. In this sideways stock market there's a lot of money looking for a home and that's one reason behind price-sales multiples north of two or even three in recent transactions.

So, if you're a shortline operator looking to expand, go find somebody with a high OR and a low-rated commodity base that you can grow with the resources available from your present properties. And if you're a shortline operator stuck with a waning, low-rated commodity base, go find a buyer who can lower the effective EBITDA of your operation and pay you a premium to do so.

The Biden hazmat bill (WIR 6/24) prompted this note from John Cockle of California's Richmond Pacific Railroad: "Another interesting WIR. Your quote in the Biden piece about short line threats from the legislative branch certainly rings true for California.

"The California Short Line Railroad Association, along with UP and BNSF, is actively fighting the progression of several onerous bills through California. Everything from air quality restrictions (AB1101 and SB459), to regulation on rubber-tired rail-yard equipment (AB888), to additional fees and restrictions on hazmat tank cars (SB419), and a BLE/Teamsters laundry list of gripes - parking of hazmat unattended outside of terminals, new RCL job notifications, lack of accurate whistle posts, and shoving hazmat across grade crossings unattended (AB962).

"These are but a few of the bad bills we are working against. Fortunately, we also have several bills that we can support from a safety standpoint: AB158 which establishes an industry task force to study recent trends in California railroad accidents, and AB1067 which imposes stiffer penalties for drivers who run through grade crossing protection and provides more funding for grade separation projects. If you are interested you can check out http://www.cslra.org/ for more information."

There are three contradictory legislative threads that are particularly annoying. First of course is hazmats. It's OK to leave hazmat cars unattended for a week at a time in an unsavory neighborhood but it's not OK to run them through town. It's not OK to blow for crossings in some towns but the railroad is the bad guy when somebody gets hit. Add to this the resistance you get as a shortline operator when you try to close a highway grade crossing.

One state that's trying to do something about this last is North Carolina. The Spring 2005 issue of *RAIL* magazine, published quarterly by the Community Transportation Association of America, credits NC with closing its 100th crossing. In the ten years since the program began crossing incidents have been cut in half and fatalities by 75%.

NC DOT's Paul Worley says that increased public involvement has contributed significantly to the success of the program. It has "strengthened our crossing closing program because it gives people an opportunity to learn more, to get involved, and be sure the project serves them properly."

With more than 4,350 public at-grade crossings in NC the work may have just begun, but it's more progress than I've seen in other states that sorely need to do something about too many crossings with too many accidents. Worley again: "The first 100 closures – that's the low-hanging fruit." And shortlines can take the lead in limiting their own exposure by taking Worley's advice. "Communicate, let people know what you're up to and why. Offer win-win solutions and be consistent."

Want to know what it costs to build new railroad track? City officials in Victoryville CA are plunking down $26 mm for a 2-1/2 mile BNSF rail spur to convert Southern California Logistics Airport into a major inland port. And that's just the first phase. The game plan is to receive cargo from the Pacific Rim for transshipment to the US interior and beyond.

The mayor is touting 60 mm square feet of commercial space that will generate 30,000 new jobs over six years. Happily, it doesn't appear they had to displace any home owners because the site is the former George Air Force Base, closed in 1992.

FWIW, I seem to recall figures in the neighborhood of $2.5 mm a mile to build new track in the shortline environment. With a spread of ten times, one number has got to be wrong. Anybody?

Back when CSX and NS were dickering over the spoils of Conrail, the shape of future services was of crowning interest to many shortlines. Not the least was Pennsylvania's North Shore Rail Group, having just been on the cusp of striking an agreement with Conrail permitting limited CP interchange at Sunbury, PA, a point CP reached when it bought the ex-PRR line to Scranton. However, when the Conrail dust settled and NS became the North Shore's primary access to the outside world, there were those who thought said access ought to be improved as a result of the merger. Never mind the STB guidance has always been "do no harm." And therein lies the tale.

Finally, after four years of negotiations, the Harrisburg (PA) *Patriot News* was able to report that the parties have reached an agreement that permits most CP-origin cars to be interchanged directly with North Shore shortlines (there are five) that can be served directly from Sunbury. Continues the paper, "The agreement is significant because it includes the Joint Rail Authority (JRA) of the Susquehanna Economic Development Association Council of Governments (SDACOG, see www.sedacog.org) as a third-party beneficiary," said Jeff Stover, executive director of the authority.

"That recognition gives the authority standing should it change operators, he said. The authority owns 185 miles of track over which these five railroads operate." The JRA also told the paper that in the 20 years since it first started buying lines from Conrail revenue units increased to nearly 34,000 in 2004 from 1400 loads in 1984. Industries along the JRA-owned lines now employ some 8,000 souls, double the employment base when the shortline's doors were first opened.

The CSX branchline rationalization program continues. The Grand Rapids *Press* reports the 127-mile Ludington sub to that burg and to Manistee, running north out of Grand Rapids, is expected to go to a new operator, Marquette Rail Corporation, a partnership of Progressive Rail Corp of Minneapolis, Lake States Rail, Farm Rail Systems (Farm Rail, Finger Lakes) and TransSolutions, Inc. By itself, Lake States has just won the bidding for Mt Morris to Dean on the former Pere Marquette Flint Branch.

Over on the Lake Michigan side RRA's Michigan Shore Railroad will lease the West Olive to Freemont branch. I'm told by a friend who just returned from a trip up there to visit family that both lines are in fairly decent repair but the traffic base appears thin. Knowing the Progressive Rail and Farm Rail players as I do, CSX has made an excellent selection for the Ludington Sub. And RRA is a natural for the Freemont line given their history and presence in the state. Congratulations and best wishes to all.

Rail stocks' tech signs continue to improve. By Friday there were only three listed as *Avoid* – BNI, CP, NSC – thanks mainly to negative spreads between long and short EMAs. NSC is a particular concern as it has tested resistance at $30 three times in two months and still stuck in a $31-32 range. CNI, KSU and RRA have advanced to *Neutral from Avoid* thanks again to positive changes in the spreads between short- and long-term moving averages.

Ten days ago *Long* GWR touched $30, a level not seen since Nov, before falling back to $27.20; look for support around $26.50. CSX and FLA remain the only *Buy* rail names on the tech scene for now (I own both) but look for others to join them in the next few weeks.

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