RAILROAD WEEK IN REVIEW

AUGUST 11, 2006

"We therefore admonish carriers to re-examine their method of calculating fuel surcharges". -- STB in Ex Parte 661, August 3, 2006

Kansas City Southern operating income in the second quarter of 2006 was $77.5 mm vs. a GAAP loss of $8.3 mm in 2Q06. The latter included one-time charges relating to profit sharing and the TFM acquisition, without which the ops income would have been $43.1 mm for a yoy increase of 90%. The OR was 81.2, down sequentially three points from 1Q06 and nine points yoy ex-items.

Revenues increased 8.4% on a combination of pricing, FSC and mix. Merch carloads were off 8.1% yoy, intermodal was off 5.9% yoy (the only IM decrease out there) though coal saved the day, up 19%. Pricing held as average RPU went up double-digits in the chems, ag and mineral, paper and forest products commodity groups propelling a 16.4% hike in merch RPU.

Below the line, net income available to common shareholders was $19.2 mm or $0.24 a share vs. a 2Q05 loss of $27.3 mm or $0.33 a share yoy including one-time charges. Absent these the 2Q05 net was $1.0 mm or a penny a share. Clearly, the combining of TFM and KCS organic statements is having the desired effect. The Street perceives better than expected operating results in Mex that more than offset the RR malaise common to all north of the border. Based on this report and on what we've heard in the past, it would not surprise me to see Mex ORs in the 70s and KCS in the low 80s.

Looking ahead, CEO Mike Haverty says he expects financial performance to continue to improve throughout the second half of 2006 thanks to "strong revenue growth reflecting continued focus on yield management and the value-recognition of KCS' long haul freight transportation services. In addition, the ongoing integration of shared services for U.S. and Mexico operations will provide additional cost saving opportunities for the consolidated system."

Florida East Coast 2Q06 railroad operating income grew yoy by 26.5% to $20.2 mm on revs of $70.0 mm, up 18.8%, and holding ops exp to a 16.0% gain. The $11 mm yoy revenue increase included $6.3 mm – 57% -- in FSC while 2Q05 revs included $ $2.6 in FSC. Carload revs in 2Q increased $4.7 mm with rate/mix accounting for $2.6 mm and mix the rest. As usual, construction aggregates brought in $31% of total revenue on 28% of volume to IM's 44% of revs and 59% of volume. FEC continues to be the lowest-cost supplier among US roads with an OR of 71.2, beating out second-place NSC by 50 BP.

The 2006 outlook calls for continued strength in both the national and Florida economies. FECR revenue estimates have been raised to a range of $265-$275 mm, up as much as 16% yoy. Operating income ought to be $75 mm plus or minus for an implied OR of 72.2. Capex will be right around $50 mm and includes four new locos plus 11 more miles of run-around track to support additional volume while still maintaining RR fluidity.

The railroad is, of course, part of Florida East Coast Industries (NYSE: FECI), contributing 66% of total revenues, 56% of operating expense, and 109% of operating income as the Realty side of the lost $1.6 mm in Q2. Happily, Railway drives the business and share prices are down only 10% since May. CSX and NSC by comparison are down 20% and 28% respectively.

Fuel surcharges are again in the spotlight at the STB. That august agency is now seeking public comment on several measures it proposes to adopt regarding railroad FSC practices. The proposals follow the STB's May 11, 2006 public hearing concerning the manner in which fuel surcharges are calculated and charged by railroads, and the extensive testimony submitted to the agency by the rail industry, the public, and railroad customers regarding those practices.

Specifically, the STB is proposing that specific commodity OD pair fuel surcharges be based on calculations more closely linked to the actual increased fuel costs attributable each move. In addition, the STB would prohibit railroads from "double dipping" by charging for the same fuel-cost increases for the same shipment both through a fuel surcharge and through application of a rate escalator based on an index such as the RCAF without first subtracting any fuel-cost component from that index. See also STB Decision *Ex Parte* 661, "Rail Fuel Surcharges."

Actually, it's not surprising it's come down to this. The fuel surcharge component of yoy quarterly revenue gains is now running a third to a half of the total increase. High-rated commodities (chems, e.g.) travel at a higher multiple than low-rated commodities (aggregates and wood chips) and so generate more revenue – and thus FSC dollars -- per ton-mile.

But 100 tons of chems weighs the same as 100 tons of chips, and the loco doesn't care what it's pulling. It'll burn the same amount of fuel per GTM whether chems or chips. In the text of the Decision, the STB writes, "Because differences in base rates are not pegged primarily to differing fuel costs, we do not believe that it is a reasonable practice for railroads to compute fuel surcharges as a percentage of existing rates." In this regard, at least, the STB got it right and the RRs had it coming.

Shortline tidbits. **Iowa Interstate** has purchased the Great Western Railway of Iowa from OmniTRAX to increase its presence in Council Bluffs. The long term plan will be to rehabilitate the newly acquired railroad and incorporate the yards and operations into one facility….Watco has agreed to purchase the **Minnesota, Dakota & Western** (MD&W) from Boise Cascade. The sale of the railway will include MD&W's portion of the International Bridge, a rail and toll bridge that links the communities of International Falls, MN and Fort Frances, Ontario, Canada. Abitibi Consolidated will continue to own the Canadian portion of the bridge. Closing is expected at the end of this month. This is a particularly good fit because Boise Cascade and Watco already do business in Louisiana.

Maryland Midland Railway has tapped David Bordner as President and CEO, succeeding Paul Denton, who retired June 30. John Rudman, Director of Business Development will add the title of Director of Marketing, succeeding Barbara Denton retired on July 10, after serving Maryland Midland for eight years…**Wheeling & Lake Erie** is taking delivery of 150 multi-purpose triple hopper cars from FreightCar America (NASDQ: RAIL) -- the first *new* cars the 840-mile regional has ever purchased. W&LE will use the steel cars for coal, aggregates, limestone and taconite pellets.

Concerning **2Q06 railroad results**, Tom Wadewtiz of JPM observes, "We had mixed results where there were high expectations. The major rails reported 2Q EPS showing meaningfully less upside versus Consensus expectations than we have seen for most of the past two and a half years. However, we note that positive pricing and demand trends remain in place and believe that the risk/reward profile for the railroads is attractive over the next 6 - 12 months.

Janney Montgomery Scott looked at **Wabec** and concluded that even though the "the fundamental picture has not changed, a year's worth of price appreciation in the stock has evaporated. Wabtec continues to improve its internal cost structure, as evidenced by dramatic gross margin improvement. While the top line has stagnated against a tough comp in the second quarter, order backlog in excess of $1 bn paints a brighter outlook for future sales." They note the strong balance sheet, the $50 mm share repurchase and WAB's developing acquisition strategy. "Looking toward a long-term secular play on the rail cycle, both freight and transit, we reiterate our BUY rating on Wabtec." [Note particularly the reference to a long-term *secular* play in rails.

Over at Credit Suisse, long-time shortline observer Jason Seidl had this to say about **RRA**: "Although RailAmerica's 2Q earnings certainly leave much to be desired, we note several key indicators of sustained progress that brighten our favorable view on the company. Specifically, RRA has announced the following: 1) Consolidation of dispatching and support functions in the next 12 months; 2) Construction of a Honda plant in Indiana in 2008 that will be served by RRA; 3) A lower tax rate going forward on Canadian volumes (20-25% of freight revenues); 4) A long-awaited sharing of fuel surcharge revenue by BNSF; 5) Sustained debt pay-down, resulting in the company's best balance sheet fundamentals ever; 6) A planned sale or lease within the next year of burdensome sections of the company's money-losing Ohio Line and perhaps some other unprofitable properties. While RRA certainly has a long way to go before achieving its operational potential, looking past the noise of 2Q results yields a great deal of promise."

Jason also writes that "**GWR** falls short of expectations as Q2 earnings from continuing operations ex-items came in at 5 cents below the consensus view and lowered its FY06 EPS guidance from a range of $1.43-$1.50 to a new range of $1.38-$1.43. Operations at GWR proved softer than expected in the quarter as weaker volumes (+14% vs. exp. +20%), lower carload yields (+5% vs. exp. +8%), sustained impacts from line damages in Mexico, and outages at a coal customer resulted in weaker-than expected revenues of $113.6m (vs. exp. $119.9m). Cost pressures associated with higher diesel fuel prices in Australia, increased transportation costs, and higher labor & benefits expense consequently resulted in a weaker-than-expected adjusted O.R. of 82.3%, 230 basis points worse than we had modeled."

Writing in Bear Stearns' *Friday Freight* for August 4, Ed Wolf cites a pair of **interviews with coal receivers**. One shipper notes that "while the current coal supply in the West is likely meeting burn requirements, the rails are currently unable to meet replenishment needs. Coal capacity remains very tight and our contact believes this is a rail issue and not a mine issue." Another coal receiver "believes the DM&E rail expansion will eventually get built and add some needed capacity, he does not expect the utilities to guarantee business in advance of the actual build-out." And therein lies one big reason the FRA may wind up bank-rolling the project.

Tony Hatch **sums up the whole mood** in his amusing and insightful *Chicken Little, Cassandra, UPS and Other Prophets of Doom: A 2Q06 Review*. He asks, "What do you make of a stock market that looks a gift horse in the mouth (in the guise of yet another successful railroad earnings quarter) and promptly shoots it?" He answers, "Cynics are ruling the day, as the rails matched or exceeded strong earnings expectations and suffered the worst share drops in years, leaving forward P/E ratios at 13X and seemingly taking nothing into account of the secular changes in light of cyclical fears."

Tony concludes by asking, "If this indeed a secular event, a *railroad renaissance*, then is this indeed a once-in-an-investor's-lifetime opportunity? Or is it the end of a stronger than normal cyclical run? I know what side I am placing my chips on." [Mine too – rhb]

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Small Class I and Shortline Holding Company Commodity Carload Comps

Quarter ending 6/30/2006

Revenue and income in $millions

Metric	FEC	KCS	GWR	RRA
Railroad revs	$70.0	$413.1	$113.5	$116.8
YOY Pct. Change	18.8%	8.4%	22.5%	13.0%
Carload revs	$37.9	$325.3	$67.5	$86.0
Pct carload	54.1%	78.7%	59.4%	83.2%
Pct Intermodal	43.6%	8.0%	0.4%	1.0%
Pct Coal	0.0%	8.0%	13.2%	8.9%
Mdse Carloads (000)	57.8	282.5	158.6	214.2
Rev/CL	$655.0	$1,151.4	$425.6	$401.5
Operating Expense	$49.8	$335.6	$739.1	$332.5
Operating Income	$20.2	$77.5	$16.3	$8.7
YOY Pct. Change	26.5%	na	26.8%	-41.6%
RR Operating Ratio	71.2%	81.2%	85.6%	92.6%