RAILROAD WEEK IN REVIEW
JANUARY 5, 2007

"It's all about how to make better operating decisions." – Henry Kravis on acquisitions in WSJ, 1/3/2007

A large part of making better operating decisions today is knowing what to expect tomorrow. So here is WIR's 2007 outlook cobbled together from a number of sources. It behooves shortline operators to pay particular attention, for two reasons. First, because the Fortress/RRA transaction is likely to be the first of a series and the winners in this game going forward are most likely to be the ones that execute best. Second, because increasing revenue at the same time ops expense is reduced is essential. Shortlines paid on FAK allowances will have the toughest row to hoe; ISS roads with the ability to negotiate divisions will fare a lot better.

Insider buying of stocks is generally a reliable sign that things are looking up. *Barron's* this week notes that materials and packaged foods saw heavy insider buying with names like Eagle Materials (EXP, formerly Centex Construction Prods), Huntsman (HUN) and ConAgra (CAG) being of particular interest to railroaders (disclosure: I own CAG). On the down side, Barron's also reports that cancellations of home orders are running at better than double the usual 15% rate for the publicly-traded home builders – DR Horton (DRI), KB Home (KBH) and Hovanian (HOV) chief among them.

Corn futures are now pushing $4.00 a bushel but if demand weakens and alternative fuels become more widely available the ride may be short-lived. Feed stocks, people food and export needs will always be there; I'm not betting my shortline's future on ethanol just yet, especially if it means going deeply in debt to do it. With private equity money looking for shortlines, ISS roads with lots of cash, low-debt, strong free cash flow and a stable customer base will bring the best prices.

And, speaking of ethanol, independent analyst Tony Hatch writes in a client note, "A recurring question is whether there is enough rail capacity for ethanol. As we all are aware, capacity remains tight in the continental railway system. But given the overall profitability of grain and grain products, and given that ethanol will be unit train business for the most part, I believe that capacity will be a minor issue.

"More to the point," continues Hatch, "Kevin Kaufman, BNSF's Ag Business Unit head, reverses the question – will the ethanol industry itself be ready for the growth? What he sees is a potential shortfall is the destination infrastructure, and who will pay for it given the reluctance so far on the part of the traditional energy companies." Which is another reason I think there is less to the ethanol shortline business than meets the eye. Economies of scale will dictate where producers produce; a hundred plants on 100 shortlines will not support that model.

On the broader transportation front, RW Baird's Jon Langenfeld writes, "We are expecting a tough near-term trading environment for transportation stocks given the weakening domestic trends into the seasonally soft 1Q. However, we believe long-term oriented growth investors should be opportunistic buyers of third-party logistics sector. It's still too early to make a call on asset-based truckers as deteriorating fundamentals are not yet reflected in the stocks, with downside risk of 15-20%."

Taking s slightly different tack, Bear Stearns' Ed Wolfe says in a recent note to clients that they are upgrading J B Hunt (JBHT) to Outperform because "we believe (1) its Intermodal and Dedicated units will continue to grow both revenue and EBIT offsetting some of its Truck units' current weakness; and (2) its high-end returns and free cash flow as well as more diverse operations are not reflected in its below-peer valuation. Wolfe sees two "gradual catalysts" behind JBHT's turnaround: "It's outperforming its pure truckload competitors during the downturn, and there's the potential for a strategic or financial buyer surfacing to unlock value. In the meantime we see limited downside from current levels."

More significant for WIR readers is Bears' belief that intermodal volumes will pick up soon, never mind the Q4 intermodal volume decreases in the AAR numbers. "We expect after about an 18-month hiatus to see increased transloading activity generally in the market, which should benefit JBHT. Also, Intermodal should show accelerated y-o-y OR improvement into easier comps as the BNI settlement has grandfathered. Thus during 2007 we expect Truck [over-the-road – rhb] to comprise about 29% of JBHT's total rev down from about 39% in 2000."

Of course, more IM cutting into OTR might be good news for shortlines' merch carload business. There's a lot of boxcar business on trucks because rates are low there's equipment to handle it. With more boxes going to IM, there's an equipment squeeze for OTR. This may be the opportune moment to win back merch biz that had been lost to truck on price/service issues.

Another shoe has dropped for the DM&E's expansion plans. Tom Wadewitz, JPM's rail analyst, reports that the 8th Circuit Court in Minnesota had upheld the STB ruling granting final approval to the planned 280-mile line extension into the PRB. Says Wadewitz, "We believe this decision is a meaningful step forward. In the first round the 8th Circuit ordered STB to address four issues and the STB's revised approval was appealed again by the groups opposing DM&E. While appeal to the full 8th Circuit or Supreme Court are possible, we believe these appeals are unlikely."

However, "Approval of the $2.3 bn RRIF loan request remains the key event which will largely determine whether or not DM&E's project goes forward. If DM&E receives approval of its loan within the next few months, we would expect DM&E to begin construction of the project in 2007. If the loan is approved, utility commitments to ship coal with DM&E may still be necessary in order to draw on the loan.

"Two key steps are necessary for an FRA decision on the DM&E loan request. First, the FRA must process all of the comments on its environmental assessment (issued August 06) and determine if further work is required. Second, and even more important, the credit council must vote on the analysis and decision proposal that will be put forth by FRA staff members. We believe completion of these two steps and a resulting decision on the loan request is possible by late March / early April."

US rail traffic hit 1.712 *trillion* ton-miles in 2006 through week 51 according to the AAR, beating the 52-week record of 1.696 trillion set in 2005. It was the ninth consecutive annual record for the industry. For the week ended Dec. 28, ton-mile volume was 34.8 billion, up 8.1% from the corresponding week in 2006. Carload volume was up 6.6% and intermodal units were up 5.5%. In Canada, carloads drifted down less than a percent and intermodal was up 7%.

Shortline revenue unit volumes through Week 50 (attached) increased 1.6% to 6.13 mm units. Coal won the carload honors at 760,000 units, up 7% yoy while petroleum & coke won the percentage gains sweep, up 13% yoy. Lumber and ores were the losers, down 9% and 6% respectively. For the week, coal, grain, mets and chems all hit 10,000 or more units; all but mets were up double-digits. Forest products and ores saw the largest percentage declines.

The Minnesota Regional Railroad Assn has tapped a new slate of officers effective Jan 1. Anacostia & Pacific President Peter Gilbertson has been elected president, succeeding Bill Drusch, Chairman of the Twin Cities & Western and Red River Valley & Western railroads. Other new officers include Lynn Anderson, Cedar American marketing SVP to First VP; Dan Rickel, President, Northern Lines Railway, to Second VP; and Andy Thompson, President, RRWV, to Secretary-Treasurer. All have been elected to a two-year term. John Apitz of Messerli & Kramer, P.A., a St. Paul law firm, continues to serve as Executive Director.

The Minnesota Regional Railroads Association was formed in 1987 and represents ten smaller railroads that operate about one-fourth of Minnesota's 4,500 route miles of track, plus two Class I carriers that are associated with the MRRA in support of its goals. MRRA carriers provide rail service to more than 160 communities and employee about 500 men and women in Minnesota.

The Iowa Interstate (IAIS) subsidiary of Pittsburgh's Railroad Development Corp has received STB approval to purchase the Lincoln & Southern Railroad ("L&S") from PolyOne Corporation in a decision issued December 22, 2006. The transaction closed on December 31. This was the third IAIS transaction in calendar 2006. Earlier in the year, IAIS purchased OmniTRAX's Great Western Railway at Council Bluffs, IA, and assumed operation of the Utica, IL to Henry, IL line segment previously operated by CSX.

IAIS President and CEO Dennis Miller told me that the purchase of the L&S is another step in solidifying the Iowa Interstate Railroad's long-term plans and strengthening its franchise. Moreover, "We have upgraded our main line from Council Bluffs to Utica, Illinois, over the past 2 years and this 31-mile section from Henry, IL, to Peoria will also be upgraded to handle 286,000-pound loads."

IAIS currently handles unit trains of coal to Cedar Rapids and unit trains of grain to Peoria via the L&S. The L&S, which serves as our access to Peoria, makes our customers competitive at a number of grain processing facilities owned by companies such as ADM, Aventine and Midwest Grain Processors. The L&S becomes IAIS' primary access to the Illinois River, which remains ice-free year-round, serving as an intermodal connection for grain and other products. The L&S currently has one on-line customer that ships sand to Chicago and other markets; Miller says they anticipate bringing additional customers to the L&S in the near future.

Small-cap value fund manager John Keeley sees L B Foster (FSTR; I started accumulating shares two weeks ago) as a buy. According to Market Watch, Keeley sees this as a capital expenditures play but the "real secret" is FSTR's 13.4% stake in the DM&E (see also page 22 in the 10-K). "If they get the permits to do this it's going to be a major event for the company," Keeley said. To follow the STB filings chain, do a search on FD 33407 at the STB website.

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RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 12/16/2006

Week Number: 50

Carloads Handled	Current Week			Year-To-Date		
	2006	2005	% Change	2006	2005	% Change
Coal	17,489	15,646	11.78%	756,637	706,183	7.14%
Grain	13,968	12,650	10.42%	631,900	601,838	5.00%
Farm & Food (Exc. Grain)	4,639	4,626	0.28%	218,099	209,900	3.91%
Ores	6,086	7,701	-20.97%	417,550	444,211	-6.00%
Stone, Clay, Aggregates	10,113	8,787	15.09%	509,625	489,355	4.14%
Lumber & Forest products	6,334	7,878	-19.60%	315,501	347,920	-9.32%
Paper products	7,766	8,828	-12.03%	358,916	371,104	-3.28%
Waste & Scrap materials	5,840	5,982	-2.37%	288,559	270,492	6.68%
Chemicals	16,115	14,125	14.09%	707,488	695,494	1.72%
Petroleum & Coke	5,171	5,395	-4.15%	284,006	251,052	13.13%
Metals & Products	10,017	10,409	-3.77%	558,683	517,898	7.88%
Motor vehicles & equip.	3,086	2,582	19.52%	109,736	111,774	-1.82%
Intermodal	13,885	16,998	-18.31%	819,453	865,842	-5.36%
All Other	2,812	3,275	-14.14%	154,692	150,932	2.49%
Total	**123,321**	**124,882**	**-1.25%**	**6,130,845**	**6,033,995**	**1.61%**