RAILROAD WEEK IN REVIEW
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STB Rail Fuel Surcharges Decision, EP 661, Jan 26, 2007: "After considering all of the comments received, we conclude that computing rail fuel surcharges as a percentage of a base rate is an unreasonable practice, and we direct carriers to change this practice. We also conclude that the practice of 'double dipping,' i.e., applying to the same traffic both a fuel surcharge and a rate increase that is based on a cost index that includes a fuel cost component, such as the Railroad Cost Adjustment Factor (RCAF), is an unreasonable practice, and we direct carriers to change this practice as well.

"We will proceed with a proposal to impose mandatory reporting requirements for all Class I railroads regarding their fuel surcharges, in STB Ex Parte No. 661 (Sub-No. 1). We will not, however, prescribe the index to be used for measuring increases in fuel costs, nor will we partially revoke existing class exemptions to apply the measures set forth here to currently exempted traffic."

In other words, a fuel surcharge cannot be called a fuel surcharge unless it's linked directly to fuel costs, not something else, and the rails have 90 days to come up with something better. Concerning the decision, Bear Stearns' Ed Wolfe writes, "Our sense is that Friday's decision by the STB will cover a minority of rail volumes and even for those regulated, non-contractual volumes that the decision will impact, the rails will see little, if any, material financial impact from substituting one form of fuel surcharge for another."

Moreover, shipper response was muted. Bear Stearns sponsored a conference call discussion with attorney Lou Gitomer and NIT League President and CEO John Ficker. I listened in and the sense I got from Ficker was essentially his group will go along with FSCs as long as they link to fuel consumption (as does BNSF's mileage-based program). In fact, says Wolfe in his follow-up notes, "Both agreed that the ruling was likely neutral with some wins for shippers and some wins for the rails. Both also agreed with our original assessment that the financial impact should be limited."

"Further, each suggested the strong possibility that the rails could universally adopt a cost-based surcharge program for all of their traffic for the sake of simplicity. This would avoid having a cost-based surcharge on non-contractual and non-exempt business and a separate rate based surcharge for everything else. This would also preemptively avoid shipper complaints to the STB trying to eliminate commodity exemptions."

The decision leaves exempt traffic (mostly merch carloads moving on tariffs and intermodal) exempt: "The record developed in this proceeding offers no evidence that the marketplace has materially changed for any of the exempted categories of traffic since the findings were made to exempt that traffic from regulation. Without such evidence, we have no basis to re-impose regulation over traffic that has been exempted from regulation for almost two decades. Accordingly, we will not move forward with the proposal to apply these measures to exempted traffic."

As for shortlines, the Board writes that even though mileage-based fuel surcharges may work for Class Is, handling allowances "are based on negotiated agreements between the carriers involved and indeed such agreements often provide for a fixed per-car handling fee. Carriers may continue to agree to divide revenues on through movements in any reasonable manner." If on the other hand, the shortline opts to write its own FSC rules then "it must comport with the findings and requirements of this decision." You can't have it both ways, guys.

Bear's Wolfe wraps it thus: "Since the STB ruling only applies to non-contractual and non-exempt business, we estimate about only 20%-30% of total rail traffic is affected by the STB ruling. However, since BNI and NSC have already converted some of this business to a mileage-based fuel surcharge (BNI) and as part of the base rate (NSC), we estimate currently the decision will impact only about 15%-25% of total Class I rail volumes. CNI and CP are less impacted because the STB ruling will only affect their U.S. business (we believe U.S. originated only). As such, we would expect a relatively greater impact at UNP and CSX. Between the two, we see greater risk for CSX since it charges a similar surcharge rate to UNP currently but has a lower fuel intensity." On the other hand, Tom Wadewitz at JP Morgan sees "modestly greater risk for NSC."

Shortlines that are collecting FSCs as a percentage of the Class Is FSCs will most likely see some rate adjustment as the Class Is respond to EP 661. We know CSX shares FSC revenue with shortlines in the same percentage of the CSX base rate reflected I their junction settlement divisions. UNP has a similar arrangement, though NS was quite close-mouthed about their FSC sharing with shortlines during interviews I did in conjunction with a *Railway Age* article last year.

Sorting this out is a perfect role for the Shortline Caucus Groups that the ASLRRA and the various Class Is have established. It looks from here therefore that the impact on shortlines could be even less than on Class Is because so much of their traffic is exempt (merch carload like auto parts, general carload and some forest products). But because so many shortlines live on pretty tight margins being forewarned is being fore-armed and if there's a revenue shrink coming it's better known now than later.

Tony Hatch penned this piece that speaks volumes about what we've seen and what we're going to see. Quoth he, "The Scoreboard shows the rails winning. It has been a topsy-turvy earnings session for the rail group, with tough and persistent (and cynical) analyst questions hammering rails on price and market share issues. So far, however, the standings read three wins (BNI, UNP and CNI all beat expectations), two draws (CP and CSX matched) and only one loss by the closest (a penny) of margins, NSC, with one game (Kansas City Southern) yet to be played.

"It is interesting to note that with all these questions of secular versus cyclical changes in the industry, yield growth (mostly unaided or hurt by fuel surcharges + mix) "surprised" the Street Meanwhile, other related earnings were mixed, with some key customers/commodities reporting positive results and guidance (steel, P&G and Colgate), while UPS once again didn't like what it sees in its crystal ball.

"The past four business days brought three pieces of good to very good news to rail investors, helping to halt the beating that railroads have been taking since last Wednesday:

"1.*The STB fuel surcharge decision was a non-event.* It affects a small piece of the total, and some rails were already moving in that direction; it also lowers the heat on what had been (last summer) a major sore point between rails and their customers.

"2.*CP fought off awful weather to hit the upper end of earnings guidance* and reaffirm their '07 outlook (from the November analyst conference). The yields were strong (again) if the volume not so much (-3%). CP showed great cost control (as well as productivity gains in the $55 mm range from headcount reductions, the IOP and Co-Production with CN), and forecast more ($30-35 mm) to come this year (although head-count could go up modestly). What I liked to hear was the 4-6% revenue forecast, given the first month's weather, the softer economy, and the specific issues in CP's coal business. Clearly rate strength is at play here; I expect that rates bring about 4% in the past Q and will do so again in '07. CP demonstrated again that it is a fine operating railroad (its metrics improved across the board). What it needs to show us, perhaps in H207, is more growth, and I suspect that it will. [My sentiments exactly – rhb]

"3.*UP blew away numbers then gave investors a present*: UP beat the Street numbers for 4Q06 by 14% (and yoy by 62%) to prove that it too is back to normal operating levels and ready to participate in the "renaissance". Obviously, a big improvement was anticipated. But 600bp in the OR? Naturally there were questions on the call about guidance not being raised, and about price. UP said there would be no falloff in pricing this year (from +6% in '06!), and joined the industry's informal pledge to support their new-found pricing power over chasing short term volumes, in support of a 3%long term pricing power rate.

"In the earnings call, UP defended its big capex budget given the ROIC trend (the acceleration of the Sunset double-tracking sped up to three years or so, etc) and hinted that its FCF generation would still allow for a direct reward to shareholders, then yesterday bang! Zoom! UP announced a 17% dividend increase and a 20mm share repo program – letting shareholders have their cake (a rebuilt rail system with the capacity to handle the upcoming growth) and eat it too!" Thanks, Tony.

One additional Union Pacific note: Jim Young took the right hand seat as Chairman on Thursday as 47-year UP veteran Dick Davidson hangs up his markers. Thanks, Dick, for a remarkable ride.

Carbuilders Trinity (TRN) and Greenbrier (GBX) were in the news this week. Backlogs for the former reached a record high of about 35,850 units at the end of 2006. TRN says the current backlog is an increase of more than 90% from the 18,700 railcars reported at the end of 2005. During Q4 TRN received orders for 10,000 railcars and shipped 6,300. For the year, it received orders for more than 42,400 railcars and delivered more than 25,250 railcars.

I wrote in WIR 1/12/2007 that "GBX has had a wobble but there's nothing that can't be fixed." Not everybody believes it, I guess because the short position is way out of whack. Moreover, insiders and institutions are lining up for its shares, potentially creating a short-squeeze. Yes, the fundamentals show a debt/equity ratio of 260% to TRN's 80% and GBX experienced some production problems, however they are finally integrating their Meridian and Rail Car America acquisitions and expanding the product line.

Shares gapped up to $29 from $26 this week and are expected to drift back somewhat before rallying. The early Jan short position was nearly 2 mm shares out of 16 mm, 13%, compared to TRN's 7%. One buyer, Jeffrey Glendell of Tontine Partners, bought 1.9 mm shares just before Christmas and in the last few weeks senior management picked up another 33,000 shares. Average volume is 500,000 shares a day indicating it would take shorts four days to cover all their shares. But if they have to compete with GBX and the institutions for shares, it could get interesting for us mere mortals. I'm building a position in increments on the dips below $28.

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