RAILROAD WEEK IN REVIEW
FEBRUARY 23, 2007

"It's all about business opportunities for short lines." Clarence Gooden, CSX

More than 250 individuals representing some 100 short lines descended on Jacksonville last week for the 18th Annual CSX short line meeting. The meeting's theme was "Capacity, Service, Growth," which was quite fitting given that 2006 marked the fifth consecutive year of same-store volume growth with 60% of CSX' 230 short line connections hitting that mark. Short lines handled some 926,000 carloads worth more than $1.3 bn , 13% of the record $9.6 bn total 2006 revenue CSX reported in its Jan 22 earnings release (WIR 1/26/2006).

Some highlights as they relate to the theme:

Capacity: Alan Blumenfeld, SVP Service Design, said their goal is to reduce the gaps between actual service to the customer and the "ideal design" that matches customer service requirements to the operational resources required to meet those requirements. He cited the move to 90-car grain unit trains that now serve 27 origins on ten short lines. Conrail President Ron Batory showed how their successful GPS program for monitoring loco use and fuel consumption could be applied to the short line environment. And Steve Potter, AVP for Car Management, highlighted some of their concerns re car life and replacement, citing short line examples of finding new life for old cars.

Service. Going beyond the usual business of moving cars to and from customer locations, three presenters in particular showed how short lines and CSX can combine resources to bring new value to the rail transportation product. Kathy Wilson, AVP for Load Engineering and Design Services, gave specific examples of how her team can help short line customers move more goods with less L&D exposure, a real headache when loading boxcars with bricks or dimensional lumber.

Mitch Hobbs, Director of Product Development, Service Start-up and Integration, said their group specializes in helping not only customers new to using rail transportation but also seasoned customers looking for rail shipment options new to them. What struck me was the amount of seeming minutia that must be addressed for both: the service plan and industry track condition (origin *and* destination) and even credit. Hobbs noted their 30-item checklist has proven so successful it's being adapted to other Class Is' use.

Steve Potter rounded out the group with his observations in how the mix of car ages and remaining service life can affect rail service offerings. More than 13,000 cars will fall out of the CSX fleet within five years, 15% of today's fleet. For example, it can cost $50,000 to bring a HBO coal hopper back to life and a new one costs $75,000. What will the market be for steel coal cars in five years? Can the cost of either option be justified? Here again, the short line's intimate knowledge of its customers LT needs can be critical in the fix-old, buy-new or scrap decision. (Note how Potter's remarks span service and capacity. There isn't room here to draw all the parallel links but they were plentiful indeed.)

Growth. EVP and Chief Commercial Officer Clarence Gooden chaired a panel of the CSX commodity group heads and it was delightful to be able to link their remarks to the commodity carload info from the Jan 22 Earnings Call. Gooden set the stage saying that it's all about finding new revenue opportunities for the short line-CSX relationship, aligning stakeholder strategies (growth) with customer satisfaction (service) and how to play the upcoming changes in transportation (capacity).

Suffice to say the short lines are positioned to continue adding revenue and volume across the merch carload groups. In chemicals plastics produces more revenue than any other CSX line of business with short lines sharing in 22% of revenues on one percent of carloads. Ag group unit trains have reduced cycle times to 15 days from 40 days adding capacity, improving service and increasing revenue produced per asset unit. Short lines touch 30% of all volume in the combined forest products, metals and aggregates groups, with growth rates exceeding the CSX organic growth rate.

The various presenters invited greater short line participation in the creation of new transload facilities and invited joint CSX sales calls on short line customers. It was pointed out that having the short line rep and the CSX rep in the same room at the same time means the story only gets told once and everybody hears the same thing. Too often IMHO the short line has a much greater visibility with the customer and the occasional Class I call only serves to muddy the waters.

Charles McSwain, AVP for Regional Development, said short lines can add new customer locations at lower expense than CSX can because they don't need a 10,000-foot runner off the main to accommodate local switching moves. In fact, 29% of all new industrial development success stories are on CSX short lines or regionals and 15% of all the small to midsize industries reached by CSX are through short line connections.

Following the formal presentations CSX once again set up individual meetings between short line reps and their CSX counterparts in all disciplines. According to the registration packet materials, some 92 short liners representing 47 companies met with 78 CSX reps in nearly 200 individual breakout sessions. This says that 36% of short liners attending had breakout sessions and they accounted for nearly half of the short line names represented at the meeting.

The only negative is that local option still reigns on some parts of the CSX system. It's hard to use an ISA scorecard (WIR 2/9, 16/2007) when the local blows by without making the scheduled interchange or makes it at the wrong location. There also remains a need to sort out what are "competitive" rates where short lines are concerned. Though the CSX Junction Settlement system insures that short line charges don't come out of the market manager's pocket (WIR 2/9/2007), some short liners say they are losing share because "competitive" rates are too high.

The Bottom Line: The CSX message is clearly one of inviting greater short line participation in all interline traffic and senior management is passing out the tools to encourage collaboration at all levels. Now it's up to both parties to measure everything, benchmark against established BMPs, and keep pushing the goalposts farther out.

Florida East Coast Railroad, a division of Florida East Coast Industries (NYSE: FLA) reported a 4Q06 operating income of $17.3 mm on revenues of $63.6 mm, both up 7%. For the full year ops income was up 23% to $78.5 on revs of $264 mm, up 11% yoy. These numbers include hurricane-related insurance recoveries and expenses.

Revenue per unit increased 2% to $496 in the Q and 8% to $494 for the year reflecting improved pricing, fuel surcharges of $5.5 mm vs. 4.9 mm in 4Q05, partially offset by decreased carload volume, and the fact that the railroad operated at limited service levels during the 2005 Hurricane Wilma onslaught and aftermath.

Total carload revenues were down 2.4% to $31.8 mm yoy as vols slid 6.3% with double-digit declines in construction materials, auto (transplant gains only partially offset domestic losses), forest products and "other." Intermodal and drayage sales were up 9% (the 14th consecutive up quarter) reflecting improved pricing and higher volumes thanks to increased local business from the motor carrier, international and retail segments.

Looking ahead for FY 2007, FEC Railway sees continued weakness in residential housing construction and domestic vehicle shipments during the first half of 2007, with modest recovery in the second half of the year, not unlike what we've heard elsewhere on the earnings calls. Revenue is expected to range between $265 and $280 million, flat to up 6% over 2006, with ops income at $74 mm plus or minus $2mm, implying a best-case OR of 73 vs. this year's 72.3 ex-hurricane costs. Capex (not given for 2006) will be $42-47 mm or worst case 16.8% of revenues.

Bear Sterns Ed Wolfe hosted sessions with CP Pres. & CEO Fred Green and Ass't VP of IR, Janet Weiss. In his notes, Wolfe mirrors the sentiments voiced previously in WIR that the Green Team has brought "increased urgency and focus, almost obsession, with dynamic cost and productivity enhancements in all facets of the railroad."

Wolfe continues, "The recent productivity/cost improvements have resulted primarily from balancing the railroad's vols, increasing velocity, reducing head count, improving safety and more efficiently maintaining yards and trains. Each improvement has led to further opportunity for improvement. Management has an increasing pipeline of new productivity ideas, and we believe there remains more to come beyond 07." These remarks show that the outlook presented during the most recent round of earnings calls remains intact.

As of Tuesday the CN strike in Canada remained in effect and even gained staying power from the Canadian government. The Canadian Industrial Relations Board (CIRB) ruled Monday that the strike is in fact a legal one, leaving 1000 non-agreement personnel to do the work of the 2300 T&E types that have taken a hike. JP Morgan's Tom Wadewitz writes that UTU International's "removal" of four individuals from leadership roles in the union's Canadian division "may provide a catalyst for progress in the negotiation."

Wall Street seems pretty much agreed that any diminishment of CNI stock price as a result of this action will only make the stock that more attractive. At $45 the 5-year YPEG is 0.83 and the intrinsic value based on the $C1.6 bn FCF before divs and repos is right at $C106 ($US90), meaning one can buy CNI for 50 US cents on the US dollar. The only other roads in that bargain basement are NS (60 cents) and BNI (78 cents).

Car Supply tidbits: FreightCar America (RAIL) has delivered the first car of a 1,200 unit order for its newly-designed BethGon ® coal car to NS. The cars, being built in leased facilities at the NS East End shops in Roanoke, offer both higher capacity and more years of service. Though RAIL has particular expertise in coal-carrying railcars, they also design and build flat cars, mill gons, intermodal cars, coil steel cars and aluminum vehicle carriers. The stock closed Friday at $53.25, still stuck in the trading range of $50-56 where it's been since last June.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and short lines with less than $12 mm annual revenues $125. Corporate subscriptions $500 per year. A publication of the Blanchard Company, © 2006. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned here.