RAILROAD WEEK IN REVIEW
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"This transaction presents opportunities to enhance the efficiency of both FECR and the RailAmerica Railroads, by applying the 'best practices' of each in the other railroads' operations." – STB Decision FD 35031

In its decision accepting Fortress' application for control of Florida East Coast Railroad (FECR), the STB writes: "The transaction presents opportunities to enhance the efficiency of both FECR and the RailAmerica Railroads, by applying the 'best practices' of each in the other railroads' operations. According to applicants, in 2006 FECR's operating ratio was 70.6%, making it one of the most efficient railroads in the US.

"Applicants state that a significant reason for FECR's performance is its focus on asset utilization and, in particular, implementation of operating strategies that optimize locomotive turns, increase average train speed, reduce dwell time, and produce reliable scheduled train service. Applicants would seek opportunities to implement FECR's 'best practices' on the RailAmerica Railroads, and would likewise explore the possibility of further improving FECR's operations by adopting 'best practices' currently employed by RailAmerica. Applicants state that this would contribute to greater efficiency in the operations of all of the rail carriers in the Fortress family."

One can only applaud this kind of language. WIR has always taken the position that "best practices" have to be shared around the industry because doing so is a great way to move the collective ball forward. FECR's managers are serious businessmen whose interest is the railroad; Fortress appears to be assembling the same strengths at RRA. The old joke about the problem with railroads is they're run by railroaders isn't funny any more; if nothing else, the business approach goes to the comments about "cultural fit" in WIR 7/13/2007.

Is CP in Play? Before the open Wednesday morning the *Globe and Mail* ran a story saying a private equity consortium led by Brookfield Asset Management was in the process of making a takeover offer for Canadian Pacific. According to the paper, "Brookfield, in partnership with Goldman Sachs and the Caisse de dépôt et placement du Québec, had expressed interest in a possible acquisition bid in April, but those advances were rebuffed. Instead, the board of the Calgary-based railway operator authorized a massive buyback of up to 10% of its stock that some observers interpreted as an attempt to thwart a takeover." It now appears Brookfield et al may not have taken the buy-back seriously and was pushing ahead anyway.

CP stock closed at about US$74 Tuesday, indicating a market cap of $12 bn. According to the paper P-E players would invariably add debt "to help finance the purchase and generate returns," ponying up maybe $15 bn, implying a stock price in the low $90s. And so it was that at the open Wednesday CP gapped up immediately to $84 on the NYSE on *huge* volume. Then there were some signs of selling and at 9:48 the Big Board NYSE halted trading in CP. At this point CP was approaching the $90 mark, up 21%, from Tuesday's $74 close on unusually high volumes.

I watched the whole thing on minute-to-minute charts until the trading halt came. Prices did in fact come off their highs when trading resumed at noon at $86. Moreover, since UP had been mentioned as one possible alternative to the Brookfield gang, its stock spiked to $129.26 from the previous close of $123.90 before drifting back in early trading. As for CP, there was a raft of downgrades for

CP before Thursday's open. The arguments were that at the higher price CP had either approached or exceeded its fair value and by that day's close CP was back to $83 and change.

My take is that the world is not ready for further consolidation among Class Is. During the UP call Thursday somebody asked Jim Young a rather oblique question about such transactions in the rail industry and Young quickly replied that the number of "tax, property and reversionary issues" are such that "we don't believe consolidation makes sense in our industry." And if that's not enough, a note from UBS observes that "Shippers are likely to take issue with this as they have already expressed their view that the Class I Rails currently possess too much pricing power." And JPM's Tom Wadewitz wrote, "We believe a rail LBO would face meaningful hurdles, but a buyout is possible and the visibility provided by the Brookfield /CP news may limit downside for the group."

Lastly, CN shares were up 5% on the news. As blogger *FP Trading Desk* put it on seekingalpha.com, "CN Rail investors are presumably driving up the stock thinking that the company will be next on the block, should the Brookfield-led bid for CP Rail go through. However, they may want to consider the fact that unlike CP, CN is subject to a 15% ownership restriction for any one owner under the CN Commercialization Act, which would make it difficult for potential bidders to get a deal done."

CSX opened the Q2 earnings season on Tuesday with some very good news for short lines[1]. Total revenues hit $2.5 bn, a quarterly record and up 5% yoy, of which merch loads (ex-coal, IM and auto) brought in $1.3 mm, also a record and up 5% yoy. The ag products and phos & ferts commodity groups posted double-digit revenue gains, the former helped by eastern ethanol; the latter by an 18% RPU gain due to mix as longer-hauls replaced short-haul, lower rated business in Florida's Bone Valley. Coal sales were up 8% thanks in part to strong exports helped by the weaker dollar while IM revs dipped 4% as international trade fell and was partially offset by new short-haul domestic lanes.

Volumes were off across the board with the biggest hits in forest products (both STCCs) and "food and consumer," which at CSX includes residential building products from wallboard to roofing granules. Ag got high on ethanol, up 7% and chems saw no change in yoy loads. Still, same-store sales (same commodity O-D pairs in the same car type) were up 7% and they account for 75% of CSX Business base, said Clarence Gooden, EVP Sales and Marketing.

Merch RPUs increased 9% over 2Q06 and Gooden said they will probably continue to go up at a run-rate in the six-seven percent range. Asked during the Q&A whether CSX might take a breather on rate hikes to lure back some of the revenue-unit loss, Gooden answered with a flat NO, which IMHO is the right answer. Low-yielding traffic takes up space and reduces sales per revenue-producing unit from cars to locos to track space. During the ops portion of the presentation COO Tony Ingram said they're taking advantage of the lower volumes to put more tons of payload per car and more cars per train start, reducing train-starts as well as loco and car cycle times.

Operating expenses (less the $126 mm insurance recovery credit a year ago) grew 1.3%, further demonstrating CSX' commitment to keeping the lid on costs. Comp and benefits were held to +4%, fuel was unchanged and equipment rents dropped 17% on lower freight car volume and better cycle times. CSX increased GTMs/gallon 2% to 824/gallon even as price per gallon increased 3% to $2 from $1.95. Net income adjusted for the above-the-line expense credits increased a respectable 22% to $0.71 from $0.58 and beating the Street's $0.65 guess by 10%. Nice job.

[1] CSX pays short lines on junction settlement basis that provides greater flexibility in sharing the upside than does the more typical FAK fixed allowance.

Union Pacific posted $4 bn in revenue with merch carloadings including auto at $2.4 bn, 59% of the total, and up 3% yoy. Ag and chems were the top performers, up 7% and 8% respectively. Coal revenues rose 4% while intermodal posted a modest 3% revenue gain. Traffic volumes lagged, however, with total 2Q revenue units down 3% yoy. Only chems gained, up 2%, and industrial products was the big looser, down 10%. The whole merch group slid 5% in volume yoy while coal slipped 3% and intermodal was unchanged.

Within the IP group, lumber and stone were down double-digits however, said EVP Marketing and Sales Jack Koraleski, though anticipated 2H gains in rock, steel and non-metallic minerals ought to offset the housing-related building products softness. That said, UP's proprietary Customer Satisfaction Index scored an 80, up 20 points in three years and a strong indicator that UP's efforts to attain greater serviced reliability are working.

Operating income gained a respectable 10% as ops expense crept up but 2% with fuel expense actually declining 3% even though the price of a gallon of gas rose 1% to $2.17. The lighter load in terms of revenue units translated into a 3% decrease in MGTM and a 4% decrease in fuel burn. During the call COO Dennis Duffy said they are using the slow period to turn back some 100 less-efficient leased units. He also said certain 'tactical tools" were making the terminals work better. The OR shed 120 BP to 80.5, lowest for a second quarter in four years.

Investors must be pretty happy, too. Union Pacific (NYSE: UNP) closed the quarter at $115.15, up 24% since the 2Q06 close of $94.96. Moreover, near the close on Thursday UNP was trading at $125, a 52-week high. This makes UNP the most expensive of the rail stocks in sheer dollars but there is a school of thought that stocks trading above par ($100) tend to have better upside potential than lower-price goods. My Intrinsic Value tool shows UNP worth close to $150 a ticket based on today's earnings, the projected earnings growth rate and the stock's volatility. UNP earned $1.65 this quarter, up 15% yoy against a Street estimate of $1.63.

Looking ahead, UP sees the third quarter a repeat of the second with revenue growth in the 5% range mainly on price as volumes are expected to be little changed from 3Q06. The OR will go below 80 for the first time in a long time and better operating results will enhance ROIC, an area where UP has not fared as well as some others. They think they'll tack another 15% on EPS to $1.78 which would out the current $6.81 FY consensus within striking range. And that four out of five revenue dollars comes from the carload sector ought to be good news for short lines.

At both UP and CSX there is one sign in particular that tells me the railroads are not running as well as they could. That's the Amtrak Monthly Performance measure sheet and for May it was grim. Every long distance train running primarily on these two roads suffered delay minutes well in excess of those built into the schedules. More late arrivals.

What this seems to say is that the "scheduled railroad" isn't working. Used to be operators would create string charts of "paths" showing when every train passed every station and where all the meets were. A train missing its path had to wait till there was a vacant one and then fit in. Amtrak trains have published schedules and paths and one would hazard to guess that on a scheduled freight railroads every other train would have an assigned path as well. Unless they're running as extras.

Which brings up the One Big Question that no Class I road – with the possible exception of CN – has answered to my satisfaction: Of all the core (non-local) train starts, what percentage is assigned a schedule path and how are priorities assigned? Sometimes it looks like the merch and intermodal trains get the paths and everybody else runs extra. And yet it also looks like a grain or coal train running extra gets priority over the scheduled merch (and Amtrak) trains. I wish I knew for sure.

Got a nice note from Chris Burger on the span-of control thread (WIR 7/23/2007, page 3). He writes, “I agree that decentralization of dispatching is a good thing but I’m not sure ‘span of control’ is relevant. First of all, let’s realize that dispatching is -- by definition, centralization of control and consolidation of dispatching offices and operating divisions has been going on for a hundred or more years. After all, the work load or ‘span of control’ of an individual dispatching desk or dispatcher isn’t related to where it’s located and changing the work load doesn’t require relocation.

“Motivation, day to day working relationships, communications and the like are a different -- and as important or more, matter however. For that reason, what is relevant, as I see it, is the organizational relationship between the dispatching organization and the other operating management in the field. In a centralized organization, the point where these functions come under joint responsibility is likely to be a ‘HQ type’ officer. When it's decentralized, this responsibility is in the field and much lower on the organization chart -- where it belongs.

“Most operating managers will tell you that the person with the most influence on how the day -- or, from a personal standpoint, how the night goes, is the DS. I think most field managers on railroads where dispatching is centralized feel the operation would benefit if they had the responsibility. Many do not think it’s proper to be held responsible for the operation without authority for a vital input. CSX has already moved some dispatchers from Jacksonville to field locations such as Indianapolis and I’m hearing the dispatchers involved like it better too.

“Maybe back when things were centralized, it was realized that there’d be trade offs between the savings and dispatching quality but with the pressures on cost and traffic levels at the time they were acceptable. Today, we need to boost capacity and one way to do so is to improve dispatching. This should be a step in the right direction.” Thanks, Chris.

RailTrends 2007, *Progressive Railroading* magazine’s annual conference on railroad leasing and finance, will take place October 3-4, 2007 at the Hotel Pennsylvania in New York City. Speakers include Charles Nottingham, STB Chairman, Jim Foote, EVP and Chief Marketing Officer at CN, DME President and CEO Kevin Scheiffer, and Kathryn McQuade, EVP and COO at Canadian Pacific. Nottingham's keynote address will be on Wednesday Oct. 3 at 0930. Foote presents on Wednesday at 1330. Sheiffer presents at 0815 Thursday followed by McQuade at 1015.

There will also be two panel discussions, one with AAR’s Ed Hamberger, Rich Timmons of the ASLRRA and RSI’s Tom Simpson, the other with analysts Tony Hatch, Jason Seidl (Credit Suisse) and Tom Wadewitz (JPM). Other *RailTrends 2007* highlights include presentations by Matt Guasco from the Port of Los Angeles, Toby Kolstad of Rail Theory Forecasts and Terry McDermott, director of agricultural sales, Intermodal and Automotive, Ferromex; and Dan Avramovich, executive vice-president sales and marketing, Kansas City Southern.

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