THE RAILROAD WEEK IN REVIEW
JUNE 27, 2008

"It will be impossible to justify growth capex if this bill [HR 2125] is passed." – Chris Hohn, TCI

All eyes were on Jacksonville and New Orleans Wednesday as CSX shareholders gathered to consider the arguments for and against seating new board members. It was amusing to watch the cascading of press releases and reports during the day: "Activist finds say they're won seats on the Board" (3:35); "CSX says it's too close to call" (3:48); "Contention. Name-calling. Partisan accusations." (3:55); "TCI and 3G announce four of its nominees elected (5:07); "CSX adjourns meeting without vote on Board members" (5:27); "Funds claim victory in close board vote" (7:27).

On CNBC Thursday afternoon, TCI's Snehil Amin said their preliminary assessment of the vote puts TCI candidates Chris Hohn, Gil Lamphere, Peter O'Toole and Alex Behring on the Board. Asked about the day's market drop and volatility in general, Amin said, "Being long-term investors we can withstand the volatility so we're not going to change our investment approach." He added that CSX' fundamentals are strong enough to stand up to short-term market turmoil. Amin estimated there is a "productivity opportunity of about $2.2 bn that could quadruple earnings in five years."

There are no plans to change the present CSX management team: "We're adding highly qualified people who know railroads" to help identify the specific places to improve yields. "We're confident that once everybody is in the same room we can work with one vision." I must say that's encouraging, especially given the tenor of the arguments on both sides through these proceedings. Michael, Clarence, Tony and Oscar are some of the best brains in the business. TCI needs their institutional knowledge to deliver.

There are serious strategic implications to the outcome. According to the court proceedings, TCI principal Chris Hohn last August called the proposed rail re-regulation legislation "a death threat to the industry…it will be impossible to justify growth capex if this bill is passed." Then on October TCI sent an open letter to CSX that among other things "requested that the CSX Board freeze growth investment" pending outcome of the proposed legislation.

Yet one of the biggest challenges facing CSX is that the plant had not kept pace with growth and contributed to CSX' high operating ratio relative to the other class Is, something TCI points out in its early announcements. Actually, it's more a question of CSX predecessor roads and when they were built and how. Much of CSX is in the Deep South where predecessors of the L&N, Atlantic Coast Line, Seaboard Air Line and myriad short lines sprang up during and shortly after the Civil War. These locally financed operations were laid to the lay of the land -- no superior engineering such as Cornelius Vanderbilt put into the New York Central from Albany to Buffalo and beyond.

For an example of what CSX inherited, turn to page 34 of the Feb 2008 *TRAINS* and read about the passing siding at Haywood, Ga. Now a 20,000 foot "super siding" where you can have non-stop meets, just two years ago it was a 6,000-foot runner with 15-mph turnouts, a 15 mph track speed, and a vertical alignment three feet below the main. The original line was laid out in 1887 as the Waycross Airline between its namesake city and Sessoms, GA, 48 miles to the north.

That's the sort of stuff CSX faces, and it's taking take serious capex dollars to fix them. This isn't about double tracking the transcon or buying your way through Chicago. It's about getting your railroad finally out of the 19th Century and into the 21st. Therefore, to the extent that there remain these major fixer-uppers out there, the railroad slows down.

The merch carload trains are the ones that take it in the shorts -- they are the ones to go in the hole or get set out to clear the path for the intermodal jobs and unit trains. CSX has said that roughly one merch car out of five touches a short line, so as capex lags so does merch train performance making the short lines' customers less competitive with their truck and intermodal served competitors.

Addressing these congestion points has helped CSX improve velocity, on time arrivals and departures, decrease loco and crew setbacks, improve the revenue-cost ratio on a lot of the merch traffic and take points out of the OR. Thus I take umbrage at any suggestion that CSX is spending too much money on capex.

With respect to the potential damage the re-reg bill presents, Tony Hatch writes, "With the exception of the Mutually-Assured Destruction component of HR-2125 there is no individual element of concern in Washington, save for a changing and increasing wind that collectively bodes ill. On the other hand, the growing Green movement and (more importantly) the need for affordable infrastructure and cheap transportation should counter the MAD-ness building in DC."

On the flip side, one should look at Ohio as an example of a government that acts in a rational manner. Tony says they have passed a "$100 mm/three year Rail Development Fund and are actively pursuing opportunities to spend on infrastructure. Ohio joins Virginia and Indiana in my personal 'They Get It' category." To which I have to add Pennsylvania, Maine and the Province of Quebec.

HR 2125 or not, the rails have to add capacity. There are two traditional ways to do it: lay down double tracks a la the BNSF transcon or buy parallel routes a la CN's purchase of the DMIR (or – 50 years ago -- the N&W purchase of the Virginian). There is yet another way emerging, one that is less concerned with "protecting the franchise" and more on maximizing returns on core routes.

Short lines that were created when the rails were in downsize mode may have new roles as alternate routes for the merch carload traffic as the core routes fill up with intermodal and priority unit trains. Recall the Burlington Northern shedding the old Northern Pacific main, a route now under the auspices of Montana Rail Link, is doing yeoman service as a BNSF alternate to its ex-GN route across the northern tier. UP has given the ex-T&P main between El Paso and Fort Worth new life as a core intermodal route linking up with the KCS/NS Meridian Speedway, itself a 1986 IC cast-off to the now-defunct Mid South railroad, which KCS bought out in 1994.

Happily, more and more state DOTs are beginning to realize the invaluable assets they have in their short lines. They're making grant money available in the $billions nationwide to preserve and protect these corridors. My sense is that the KCS-Midsouth kind of transaction will be more commonplace (see also CP and DME/ICE) and that joint ventures and private equity will play significant roles.

Shares of car builders and track suppliers were all down sharply during Thursday's 300-point sell-off at the NYSE. The least hurt was FSTR, down just 4% at 3 PM. Worst off was KOP, down more than 8% during the closing hour. None of this was on any particular news -- it was that oil was up so the rails were down ergo their suppliers got dragged along.

It's not that prices are wildly ahead of the curve, either. With the exception of WAB, every one is changing hands at 10-25 times earnings. Economic Planning Associates, a service that tracks this sort of thing, reports that as of eight weeks ago builders had sufficient orders on the books to keep them busy for another year.

On the other hand, carload volumes related to consumer discretionary items from housing to automotive are not expected to rally any time soon. The holy trinity of grain, coal and chems ought to be up enough to give us a flat year. And since much of these three move in leased equipment, and since cars in unit train service turn twice as fast as cars in single-car merch trains, shippers can more more freight in fewer cars, ergo they will wear out faster but there will be fewer to replace as fleet sizes dwindles.

This bodes ill for the single-car shipper and bodes well for replacing small-volume carload services with a more efficient intermodal service. And, if the railroads are smart, they will be less concerned with protecting carload franchises and will pay more attention to keeping customers with a broad range of service offerings. With one sales person calling on them. Bring the short lines in as intermodal intermediaries and let them get paid for selling IM loads as well.

Short line carloads as reported by RMI's RailConnect Index are down 8% for the week ending June 14. The four biggest volume commodities among the 331 roads reporting were coal, grain, aggregates and chems. Coal was off 29%, more than 4,000 units, grain dipped 7% (nearly 1000 units), while aggs slipped 5% or 1,000 units. Chems were up 1%, plus 140 units. YTD, chems leads, up 9.4%, followed by grain (9.2%) and coal (5.6%); aggs were off a point. See RMI chart following the disclosure.

Rick Paterson (UBS) writes, "Class I carloads in the US continued to drop (-4.4%) in week 24, as weakness in autos (-18%), coal (-8.3%), building materials (-6.2%), and paper & forest (-5.3%) more than offset strength in metals (9.8%), ag (4.1%), and chemicals (1.1%). Intermodal fell 4.8%. In Canada, carloads plunged 7.7% and intermodal decelerated (1.7%). Weakness was led by autos (-22%), building materials (-18%), ag (-16%), chemicals (-11%), paper & forest (-3.5%), and coal (-0.3%), while metals (7.3%) was the sole gainer." No surprises there.

The Fed left interest rates on hold as expected. A note from High Frequency Economics in Valhalla NY posits that "auto sales are plummeting in truly alarming fashion" and the Fed expects housing, credit and energy prices to "weigh on economic growth". HFE adds, "Whenever the economy is weak the Fed can be relied upon to expect better times just around the corner.

"On the inflation front, commodity prices and higher expectations are cited again, but the important new element is the bald statement that "the upside risks to inflation and inflation expectations have increased." All of which underlines still further that the rails will weather this storm in commodities that keep people fed and comfortable at home. Grain, coal, chems (for all those grocery items in the middle aisles) and aggregates for commercial construction (including apartments for those who suddenly realized they could not afford the McMansions on no money down).

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RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 6/14/2008

Week Number: 24

Carloads Handled	Current Week			Year-To-Date		
	2008	2007	% Change	2008	2007	% Change
Coal	11,118	15,697	-29.17%	354,544	335,648	5.63%
Grain	13,095	14,068	-6.92%	346,698	317,630	9.15%
Farm & Food (Exc. Grain)	4,987	4,527	10.16%	127,269	115,698	10.00%
Ores	3,234	2,673	20.99%	73,835	62,399	18.33%
Stone, Clay, Aggregates	12,434	13,033	-4.60%	255,711	257,929	-0.86%
Lumber & Forest products	5,522	6,372	-13.34%	118,159	149,829	-21.14%
Paper products	7,894	8,083	-2.34%	186,474	202,929	-8.11%
Waste & Scrap materials	6,985	6,804	2.66%	157,103	151,173	3.92%
Chemicals	16,531	16,392	0.85%	414,240	403,053	2.78%
Petroleum & Coke	6,248	5,209	19.95%	144,608	132,167	9.41%
Metals & Products	11,222	11,209	0.12%	287,613	265,766	8.22%
Motor vehicles & equip.	2,414	2,239	7.82%	48,738	48,304	0.90%
Intermodal	11,366	16,836	-32.49%	310,887	351,384	-11.52%
All Other	2,941	3,515	-16.33%	72,517	74,765	-3.01%
Total	**115,991**	**126,657**	**-8.42%**	**2,898,396**	**2,868,674**	**1.04%**