THE RAILROAD WEEK IN REVIEW
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"Revenue ton-miles (RTMs), the true measure of railroad volumes, are growing, which indicates the railroads are generating more revenue with less equipment." Bill Greene, Morgan Stanley

Genesee & Wyoming reported 2Q08 operating income of $29.7 mm, up 39%, on sales of $152.7 mm, up 22%. Of the $27 mm revenue gain, revenue from acquisitions contributed a third. The balance was from same-railroad operations, posting a 10% gain on a 14% average same-store RPU hike (three points of this was due to foreign exchange rates between the US dollar and the Australian and Canadian dollar). During the call CEO Jack Hellman said they expected to average 7% for the balance of the year.

Commodity revenues ex-coal and IM increased 13% on a 1% gain in revenue units. The big bites were the STCC 24 side of forest products, off 4,000 units, and the M&B haulage, down another 4,000 units. Happily, gains in farm products and minerals & stone offset these losses. Coal car-counts dropped 2% as the recent flooding in the midwest delayed deliveries from UP and BNSF, though GWR expects to recover that in 2H08.

Non-freight sales (mainly the Rail Link switching and the small shortline franchise) grew 38% to 40% of total revenues, up from 36% in 2Q07. Three years ago "non-freight" was 31% of sales and much of the growth since then has come from small rail operations such as the Georgia Pacific rail group and the Earl Durden acquisition even as the port operations continue to build.

I also think that in this regard GWR has the right business model because "freight revenues"-- 60% of total sales -- come from their regional railroad networks that are mostly ISS roads not dependent on Class I handling allowances. The 14% RPU gain reflects that leverage. And in Australia there are similar operations where annual take-or-pay contracts are the norm as opposed to per car fees.

Ops expense rose 18% for an OR of 80.6, a 2.4 point improvement over 2Q07. Net income from continuing operations grew by just 3% though adjusted for discontinued (Mexico) operations reportable net income was $15.4 mm, up a whopping 53% yoy. EPS jumped 59% as diluted shares dropped 10% in the same period.

Elsewhere, GWR has signed an agreement to acquire the Ohio Central Railroad (OCR), a group of nine shortline railroads, for $219 mm in cash plus another $25 mm "upon satisfaction of certain conditions." The acquisition is subject to customary closing conditions and is contingent upon approval from the state of Ohio for the transfer of an operating agreement for one of the railroads. GWR expects to close the acquisition on October 1.

OCR operates some 445 route-miles of track and owns 64 locomotives. The railroads handle approximately 140,000 annual carloads, primarily in the coal, steel and solid waste industries. As it happens, the size and commodity mix closely mirrors the NY/PA region's Buffalo Pittsburgh which, according to gwrr.com, handles mainly "coal, petroleum, metals and forest products over 750 miles of mainline railroad."

Ohio Central has a traffic density most short lines would kill for -- more than 300 carloads per mile. I've known several members of the senior staff for years and they are all solid railroaders -- men who truly love trains, to borrow a phrase from Rush Loving. The fit with B&P is really hand-in-glove and

provides a reach from Columbus to Rochester and beyond if you count the Norfolk Southern "Empire Link" connecting NY state short lines.

During the Q&A on the call someone asked whether Ohio Central would be part of the NY/PA group or a stand-alone operation. While not answering the question directly, Hellman did concede the similarities between the two railroads would suggest they be "managed together." GWR expects OCR to generate approximately $70 mm of revenues and approximately $20 million of operating income in FY 2009. The OCR railroads will have annual capex of approximately $6 mm and annual depreciation and amortization expense of approximately $12 mm. Thus it appears GWR paid about 7.6 times forward ebitda ($219+$25 divided by $20+$12). Hellman said the acquisition ought to be immediately accretive to earnings per share and free cash flow.

An interesting footnote is that GWR's expanded debt facility leaves the firm with another $170 mm to finance future acquisitions. Given the speed with which they moved in on and closed on the MMID, the CAGY, and now OCR, the active short line player ought to be looking for tuck-ins at all levels -- as long as they can meet or exceed the Rule of 100.

The Livonia, Avon & Lakeville Railroad Corp of Lakeville, NY has reorganized as the result of a shareholder meeting July 31, 2008. Brackett Clark, the LAL's principal shareholder, was named Chairman, Gene Blabey (a member of the Board of Directors of the Arkansas & Missouri short line and of the ASLRRA) took the President and CEO slot. Larry DeYoung, former Conrail exec and NS consultant, was tapped EVP, Chief Operating Officer and Treasurer.

At the WNYP affiliate, Blabey becomes Chairman and CEO while Carl Belke becomes President. Carl's an excellent choice for this slot. His resume includes the presidency of the D&H and running a 1700-mile division of the Rock Island. Belke has also served stints with GWR and the P&W, so he is well-versed in the northeastern short line and regional railroad scene. DeYoung steps in as VP Govt Affairs, a logical choice given his Conrail experience and knowledge of the local political scene.

Continuing the scrap steel thread from last week, The Institute of Scrap Recycling Industries (ISRI) has asked the AAR to reconsider the proposed rule change that might shrink gondola cars' effective scrap capacity by 8 to 10 percent. Scrap metal shippers shouldn't be penalized for accidents caused by construction and demolition residue falling from open-top freight cars onto the track, ISRI said.

Continues ISRI, "Scrap materials are processed into consistent specification-grade commodities that are carefully loaded and packed so they do not shift while in transit to their final destination." Maybe so. But putting 140 tons in a 30-ton car meant for 110 tons is really tantamount to theft of service if you're paying by the carload. It's the same thing as loading four cars worth of stuff into three and getting the equivalent of one free carload.

Of course, some *do* play by the rules. This from a friend operating a west coast short line: "We have a large scrap customer on line that receives inbound loads for export overseas. They have us weigh all loads in and out simply because they don't trust someone else's scale weights. And at scrap prices north of $400/ton there is a lot at stake. I can honestly say that we have not come across any cars that are grossly overloaded as reported, although I think the 18" rule is a good one to keep the material in the cars, but as you note it is not always followed strictly and we often receive cars with material hanging over the sides."

Which brings up an insightful note from Larry Kaufman. He picks up on a theme of ***entitlement*** running through the scrap piece and others in last week's *Review*. He writes, "Entitlement is one of

the biggest problems railroads face. Roger Nelson's note on the effect of the Interstate Highway System on the railroads in the latest WIR is quite accurate. Now, we have a trucking industry that seems to think it is entitled to have all the right-of-way it needs and that shall be provided by the public. They'll pay something for it, but certainly not anything that comes close to covering [the cost of the damage they inflict on] the highways.

"Entitlement: Scrap shippers are entitled to load as much as they want in each car, contributing to car wear and tear as well as safety of the system. Entitlement: Captive shippers are entitled to rates that suit them whether the railroad providing the service covers its fully allocated costs or not. Take a look at the Dupont *vs.* CSX small shipments rate decision. The STB goes through a locution to establish that CSX had market dominance. Even some shipper lawyers with whom I am friendly agree that this one probably will not withstand the CSX challenge in the Circuit Court for the DC Circuit.

"DuPont threatened CSX with switching to truck, then argued before the Board that that was only negotiating rhetoric. The STB agreed that CSX had market dominance because alternative truck service was far too expensive for DuPont. I can't find the clauses in Staggers that say a shipper is entitled to rail service that is less expensive than the alternative and that if a shipper chooses rail in that situation, the shipper becomes captive. The worst thing about this attitude of entitlement is that in almost every case the entitled shipper denies to its own customers the same kind of entitlement."

Then there's the NIMBY brand of entitlement. Looking at the noise over the CN's plans for the J, Larry writes, "We who consulted for NS back in '97 [Larry and I were two of a gang of lots – rhb] recall the firestorm in Cleveland over a significant increase in traffic through the southeast side resulting from the breakup of Conrail. And let's not forget BNSF and SCIG, UP and ICTF expansion, UP and Picacho Peak in Arizona, NS and its intermodal terminal near Roanoke. Because railroads in recent history have tended to be shrinking operations, these kinds of changes were not relevant. Today, with expansion the way of the future, they are. You get the idea." That I do. Thanks, Larry.

Let me close this week's endeavor with a comment on the recent earnings season. Though revenue unit counts may have been off, revenue ton-miles were not, and in many cases the RTM percentage of GTMs was up, meaning fewer empty ton-miles. Morgan Stanley's Bill Greene picked up the same thing. "Revenue ton-miles (RTMs), the true measure of railroad volumes, are growing, which is not only supportive of rail pricing, but indicates the railroads are generating more revenue with less equipment.

"It's also worth noting that RTMs have not fallen on a full-year basis during the past three freight recessions (including 2007/08), which highlights the diversity of the rail portfolio and supports our view that rails will prove defensive in this downturn. The discrepancy [between revenue unit counts and RTMS] comes from the railroads' focus on asset utilization and yield management efforts (longer-hauls tend to be more profitable). The result has been consistent growth in RTMS per carload over the past several years as the railroads put more tons in each car and increase lengths of haul."

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