**The Railroad Week in Review**
**September 2, 2004**
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**Peoria and Pekin Union Railway** (PPU) will join the ranks of fallen flag railroads at some point in 4Q04 as it becomes part of GWR's regional railroad network. A newly-formed GWR subsidiary, the Tazewell & Peoria Railroad (T&P), has signed a 20-year year agreement to lease the assets of the PPU. It's a good fit because the PPU system is contiguous with GWR's Illinois & Midland (I&M) Railroad based in Springfield, Illinois.

PPU operates about 20 route miles of track in Tazewell and Peoria counties and the customer base includes shippers of grain, steel and machinery products. In addition, PPU provides switching service for four Class Is -- CN/IC, NS, BNSF, UP – and all but BNSF are also its owners. It also touches four shortlines: RRA's Toledo, Peoria & Western, Railway Development Corp's Iowa Interstate, Pioneer Industrial, and of course the I&M.

GWR expects the new T&P to contribute approximately $10 mm in annual revenue and that the transaction will be immediately accretive to its earnings per share. The North American OR for 2Q04 was a respectable 81.4, so look for roughly $1.8 mm in operating income, most of which ought to flow directly to net income for about a nickel a share added by the end of 2005. This equates to about 70 cents in share price at Friday's 2005 PE of 14.

The lease also contains provisions for automatic five-year renewals. The lease payment may be adjusted based on certain factors, including inflation and customer shipment levels. The boards of directors of both GWI and PPU have approved the transaction, which is subject to regulatory approval as well as other closing conditions.

Also this week GWR bought the 7-mile Savannah Wharf branch from CSX and will run it as part of its Golden Isles (Rail Link) subsidiary, adding about 4,500 cars a year to the count. In addition to the rail line the transaction includes a 20-year lease of the related real estate along the rail line. Headquartered in Jacksonville, Florida, Rail Link serves 28 industrial sites in 11 states, operates 10 shortline railroads, and had FY 2003 sales of $30 mm, about 12% of GWR total NA revenue.

**RailAmerica** closed the Australia transaction Tuesday for a cash payment of US $204 mm (AUD $285 mm). With the net proceeds from the sale, RRA will pay off US $60 mm in Senior Debt and expects to use the balance to repay other long-term debt. Recall RRA originally purchased Freight Australia from the Victorian State Government in April 1999 for US $103 mm (AUD $163 million), so it looks like a pretty good deal.

On balance, it was a tough slog in Australia, especially during the year of the drought. It seems reasonable to say however that shareholders have been well-rewarded by the company's management of this investment and stewardship of the investors' money. I want to take a closer look at what kind of return they got and will report those results soon.

CEO Charles Swinburn says, "With the sale of Freight Australia now complete, we can concentrate on operating and growing our North American rail business. The proceeds from the sale will be used to pay down long-term debt, thus strengthening our balance sheet, significantly reducing our interest expense, and reaching our goal of a net debt-to-capital ratio of 50%." RRA stock closed Tues at $11.50, up 2.6% on the day.

RRA isn't wasting any time. Immediately following the Freight Australia closing RRA announced an offer to purchase for cash all of its outstanding $130 mm aggregate principal amount of 12 7/8% Senior Subordinated Notes due August 15, 2010. See press release (www.railamerica.com) for details. If all of the notes are tendered and purchased RRA will incur a nearly $20 mm premium charge plus $12 mm in non-cash charges of relating to the write-off of deferred loan costs and original issue discounts. The offer will expire at 5:00 p.m. on September 29, 2004, unless otherwise extended.

**CSX and Norfolk Southern** are finally able to take their respective parts of Conrail under their own wings. The press releases seem needlessly verbose but bottom line the lease structure mandated by the 1999 split is over. Recall Conrail remained as a holding company, leasing some lines ("NYC Lines) to CSX and the balance ("PRR Lines) to Norfolk Southern. They even went so far as to stencil NYC and PRR on transferred equipment that had carried the CR mark

And so it was on Monday that both successors announced the restructuring that allowed them to bring the leased properties into their core businesses, adding about $325 mm and $450 mm respectively to the debt loads of CSX and NS. The CSAO will remain jointly owned and operated and will retain about $320 of the original transaction debt. Reduction or elimination of the "Conrail Rents and Services" line on the income statement ought to offset any bump in depreciation and interest expense, so it'll be an eps wash starting with the 3Q04 statements.

**BNSF has opened its new** en-route fueling facility near Spokane. They can fuel up to ten locos simultaneously in about half an hour. Having to get in a queue in a major serving yard like Pasco or Seattle can take a lot longer, and few yards are able to take whole trains at once. What's more, the new facility can sand, water and lube the units while they're filling their 3500-gallon fuel tanks. At a 2Q04 hedged price of 97 cents a gallon a four-unit power set (typical for an intermodal hotshot) starts out with $13,000 worth of fuel. The faster you can feed these babies and get them on their way the less fuel wasted hanging about waiting for turns at the pump.

**Union Pacific** still gets hammered – and I think needlessly -- in the press. Monday's *Omaha World-Herald* latched onto some big aggregates shippers who were unhappy, quoting one fellow who wouldn't give his name as saying, "UP is trying to solve their problems on the backs of the aggregate industry." Others were more charitable acknowledging UP's efforts to right the railroad. A shipper forum meets Sep 7 in KC and all seven Class Is will be there.

What really gripes me is these aggregates guys will kill for a penny a hundred-weight and really beat up on the rails for dirt-cheap rates to move their dirt. Yet a box of rocks takes up as much room on the railroad as a carload of plastic pellets, costs as much to handle (more if it's in RR-owned cars), and moves at a lot less revenue per train-mile. And since so much if it is short-haul business, it gets in the way of the profitable high-density long-haul business. Not good.

None the less, UNP stock is inching its way up, breaking the $57 resistance that has been its nemesis for so long. In the process it also broke through the 50-day MA. Recall I posed the question (WIR 6/25) whether $56 might be a bottom for UNP. There's precedent. Back in March NSC dipped to its 200-day support level of $20, bounced off it, and kept going. NSC has appreciated by nearly 50% since then. Can UNP repeat?

As a group the rails continue to surge as BNI, CNI and NSC all hit new 52-week highs this week. The question is how long this can continue. Coming out of last year's traffic downturns the yoy comps are easy. But we're getting to the point where PEs are in the teens, high for this industry. As growth rates measured by yoy changes in eps slow, PEG ratios rise and stocks look more expensive. Looks to me like trailing stops and covered calls may be in order for the leaders. For UNP, however, 2005 may be the year of easy comps as the consensus looks for 40% earnings growth next year. Could be a fun ride.

**Governance** and full disclosure came to the fore in Tuesday's "Street Sleuth" column in the WSJ. The article cites a Goldman Sachs report ranking 14 technology companies and the implications seem to be that equity analysts could do well to look more at transparency in earnings reports – accountability to investors, as it were.

We've taken our fair share of pot-shots at rail companies whose quarterly reports were lacking in detail. The variance in reporting formats and completeness thereof are two reasons we started publishing the *Quarterly Review* to put all operating, commercial and financial results in the same format. The takeaway from the WSJ article is that a company that does not publish complete reports may see stock prices head rapidly south. *Week in Review* is watching.

**The Shellpot Bridge** in Wilmington DE is open for business. Out of service since 1994, this 242-foot swing-style drawbridge across the Christiana River was built by the PRR as part of a freight bypass around the Wilmington passenger station. The total span is 725 feet and its original timber framework was replaced by a concrete foundation in 1951. But as freight trains got longer and heavier, the bridge was deemed inadequate and ultimately closed by Conrail.

For the last ten years freight trains operating in Wilmington have had to run on Amtrak's Northeast Corridor (NEC) through the Wilmington station. Moreover, freight trains were restricted to the wee hours when no passenger trains are scheduled and access to the Port of Wilmington had to be from the south via Perryville, Maryland, where the NEC has only two tracks. The decision to rehab the bridge came out of the Conrail sale and work began in 2003.

With the Shellpot Bridge back in service, NS can access the Port from the north off the 4-track NEC with no hours-of-service restrictions. Port and Delmarva shippers will have better access to Norfolk Southern, both passenger and freight rail operations in Wilmington will be improved and there will no longer be a need to route freight or yard trains through the Wilmington Amtrak Station.

This $14 mm Delaware DOT-Norfolk Southern joint project is truly unique. DelDOT agreed to fund the cost of restoring the bridge in exchange for NS paying a per-use toll to use it. For the next 20 years an AEI-type reader will count cars crossing the bridge and will collect tolls accordingly.