RAILROAD WEEK IN REVIEW
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"*We're focusing on process innovation and efficiency. We need to be fanatics over a locomotive not moving. For example, I have more than 8,000 locomotives moving freight 55 to 60% of the time. My challenge to the team: Why isn't that 90% of the time?"—Union Pacific CEO Jim Young*

Union Pacific's Jim Young is the subject of an Aug 15 *Smart Money* on-line interview, part of the magazine's on-going CEO Interview series. He's in good company, too – Charles Schwab, Harley Davidson's Jim Ziemer and AMD's Hector Ruiz. Some excerpts:

"UP is buying new locos, adding 5,000 new jobs, adding track and changing the way you move freight. We know Wall Street measures the productivity of such assets and we started to see those numbers changing in the fourth quarter of 2005. We are handling record volume more efficiently than before, but are a long way off from anyone declaring victory. My customers are starting to see it, though, and with better service, I can get higher prices. In many cases it's three steps forward, one back — but we have good momentum.

"In an environment where you are bumping up against capacity, the way you operate has to change. Historically, the marketing team would get some new orders, throw them over the cubicle and tell the operating guys to go handle it. That doesn't work today. My marketing guys' compensation is now based on the velocity of the trains — just as the operating team's has been.

"Historically, the railroads are among the nation's biggest corporate spenders, putting 18% of total revenue into capital investments and a lot of that has been on been on maintenance." Which is about right – we've been in shrink mode for so long it was more a question of which assets can we shrink the fastest rather than where do we need more capacity. Young again: "For the first time in many years, this industry is seeing capital expansion. The needs in the industry are significant; even with the record spending in the industry, I'm not certain you'll ever get to a point of excess capacity again."

The turn-around became evident in 2Q06: "Freight revenue was an all-time quarterly record at $3.9 bn, up 17% yoy, operating income reached $717 mm, up 53% yoy and the best ever seen on the UP. The operating ratio came down 4.3 points yoy to 81.7, the best seen in more than two years, as ops expense was held to an 11% gain even after a 33% increase in fuel on a burn that was up only 3%." (WIR 7/21/2006). And the best way to get a handle on what's happening out there is to go see it.

The UP shortline meeting starts with a train ride from Denver to Omaha on Saturday Sep 23, golf and a reception in Omaha Sep 24, and the usual presentations and breakout sessions Sep 25 and 26. Owing to prior commitments I'll have to pass. But if you've never seen the UP triple track between North Platte and Gibbon, this is the best way to do it. Imagine freight trains moving at the frequency of trains on the IRT's 7th Avenue line and you'd be close.

Providence & Worcester (AMEX: PWX) sales in 2Q06 increased 9.8% to $7.1 mm on an 8.7% volume increase. Merch carload RPU increased 8.2% to $652; intermodal, which is large volumes (15,499) for minuscule dollars per box ($56) was up 16.0%. Ops expense after capitalization and recovery from grants etc increased 9.6% to $8 mm and an OR of 94.7. First half sales came to $13.5 mm, up 13% yoy on a 5.6% volume increase. Ops expense after capex and recoverables increased 12.5% with an OR of 102.6, a 74-basis point improvement yoy.

Below the line PWX earned $277 mm, up 34% yoy, however, the quarters are so inconsistent that it's hard to tell where the value lies. The company lost $375,000 in 1Q06, made $844,000 in 4Q05 and $1.1 mm in 3Q05. Yahoo! © tells us the TTM EBITDA is $3.46 mm but given the losses most of that has to be depreciation, now running about $2.8 mm a year. If 2H06 looks anything like 1H06 we're looking at a FY 2006 EBITDA of about 62 cents a share. With PWX trading at $17 this week, that seems a tad rich.

Bear Stearns' Ed Wolf writes in "Summing up the Summertime: Positioning the Transports for a Slower Economy" that the shippers in his 2Q06 survey see rail rates rising on average 4.4% this year, 90 basis points over the 2005 experience. Survey responses indicate a sense that rail service in general is better than it was last year at this time and that service performance is most improved on CN, CP and CSX.

On other hand, BSC discovered that more than a quarter of the shippers surveyed expect service to deteriorate during peak season. At least that's an improvement over the 53% that expected worse service during the 2005 Peak Season. Still, shippers expect restrained capacity to continue though the rate of shifting business to truck from rail has fallen to 4% from 8% yoy. The western roads plus CN have been the most aggressive rate-raisers; CP and KSC the least.

"Class I rail traffic was up 2.0% in Week 32 following increases of 3.8% in Week 31 and 2.5% in Week 30" writes J P Morgan's Tom Wadewitz. Gainers include intermodal, coal and grain/farm while auto, building materials and industrial products drifted southward. Intermodal, coal, and grain/farm volumes grew 5.3%, 2.6%, and 4.7%, respectively. Train speeds were mixed in Week 32 with BNSF, UP, NS and CN slowing while CSX and CP improved – the latter up a whopping 11%.

Both BNSF and UP saw volume increases in the 5% range mostly on intermodal and coal. CSX was up nearly 4% again on coal and IM with a nudge from chems but an 11% drop in ag products. NS traffic was off half a point mainly on coal and auto though metals, chems and IM provided offsets. CN was off 3%, getting hammered on forest products, off 14%, IM was flat with ag up 10% and mets up 5%. CP was off 4% overall with coal down 22% and IM slipping 7%. Chems (+17%) and ag products (+15%) saved the day.

The August 8-10 ethanol conference sponsored jointly by the ASLRRA and the American Council on Ethanol (ACE) was well-attended and by all indications it was a very timely event. Todd Hunter, Director of Marketing for the Pennsylvania's North Shore Rail Group was kind enough to share the following excerpt from his report.

"The epicenter of the ethanol industry is Iowa and the railroad that currently has the most plants (as well as a distribution center under construction) is the Iowa Northern Railroad (10 active plants). However, plants have been announced for construction as far east as Coshocton, Ohio in 2007 on Ohio Central Railroad. Others are proposed for Upstate New York and another is projected for the Reading & Northern at Tremont using waste coal to power the plant. [There are two more slated for construction in GA, both on shortlines. – rhb]

"Regarding rail service to ethanol plants, the Class I railroads are taking somewhat different views of this traffic with both UP and BNSF demanding that they approve all ethanol plant designs before quoting rates, regardless of location. BNSF will only handle ethanol in 95-car unit trains. Union Pacific will take smaller trains of 75 cars. In the east, CSXT only wants unit trains and NS has not really made a public decision to date.

"Unit trains will command the best rates with single-car rates dependent on railroad management's view of such traffic. It may be likely that UP and NS will be the preferred carriers for smaller destinations while BNSF and CSXT are pricing to encourage more unit trains. CN and CP have not weighed in as of yet due to ever-changing political issues surrounding ethanol in Canada. However, several plants are proposed in Canada and one is active in Ontario. While corn may cross the border, due to government policies ethanol will probably not for the near future for political reasons."

Continuing the thread on railroad stock prices in retreat, Larry Kaufman writes, "If, as I believe, the railroad change has been and continues to be secular, what is wrong with the people who manage other people's money for a living? The analysts that I read -- mostly the ones you read and quote -- all see it the 'right' way. So the problem has to be with those who run institutional money, a young bunch who know only that railroads are cyclical and that whenever the economy turns south the railroads head south even faster.

"This view ignores the reality that for the foreseeable future coal will be the fuel of choice for the utility industry, which provides a good traffic base for the major railroads. Add in the re-pricing of legacy contracts as they come up for renewal, and you have a tremendous underpinning of earnings. Grain is in a similar situation. It has been good base-load traffic and now we get the movement of grain for ethanol production followed by the new business of moving ethanol from the Midwest to transload facilities near consumption points.

"Intermodal reflects globalization and international sourcing of components and tight supply chains are so embedded in the economy that it isn't likely to fall of much if at all, even if the economy softens significantly. That leaves traditional manifest business of chemicals, lumber, paper, metals, autos that remain sensitive to shifts in the economy.

"Fortunately, as the railroads have shifted largely to a *trainload* business [emphasis added; shortlines take note. – rhb], these commodities have less influence on their bottom lines. The reasonably assured traffic base allows the people running the Class 1s to plan their operations with far more precision than in the past. This, I believe, helps account for lower ORs and larger bottom line numbers. Of course, pricing leverage helps lower the OR, too."

The DM&E build-in project to access PRB coal got some favorable ink this week. A recent survey sampling 400 "likely voters" from across Minnesota found the project supported by a 7-to-1 margin with a +/- 4.9% margin of error. Improving safety was the most frequently mentioned reason for the favorable responses with farming benefits a close second. The increased production of ethanol alone could add up to 20 cents a bushel to the price of corn and other grains.

The survey also asked whether Minnesotans "favor or oppose DM&E Railroad's $2.4 bn federal loan application to help pay for its track upgrades." Two thirds said they were in favor. Moreover, it was 2:1 in favor of government funding for rail infrastructure improvement. As for the Mayo Clinic's objections, only one in eight agreed with the Clinic.

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