

Rail Industry Overview and Trends

A Report to CSCMP 2006

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Four Key Rail Trends

I Intermodal: Dramatic increases ...Surging growth in Asian economies leads to higher US rail volume with lower rail profits per unit

- Capacity is a key issue

II Rail Economics: Costs And Rates

- Their use in negotiations and regulatory settings

III Rail Regulation and Competition

- ❑ Fuel Surcharges
- ❑ Legislative and Regulatory Initiatives

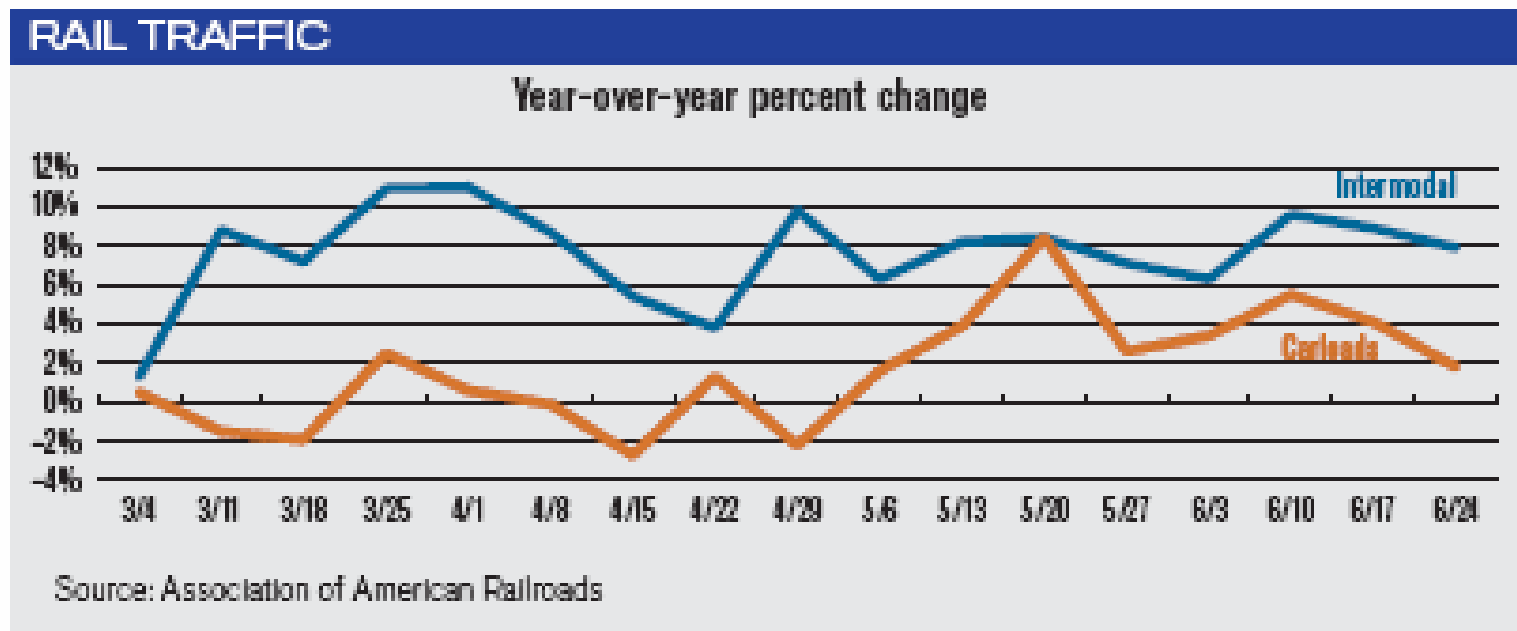
IV. Mergers And Strategic Alliances ...mergers may be coming and strategic alliances have already arrived

I. Macro Rail Industry Overview

- ❑ Increasing importance of Intermodal
- ❑ Relatively weaker profit position of Intermodal rail industry wide; BNSF appears to be an exception
- ❑ Strategic Alliances of Rail and Truck
 - ❑ Schneider allies with BNSF and with CSX in Intermodal
 - ❑ JB Hunt first quarter revenue was 41 % Intermodal
- ❑ Intermodal now 23% of Rail Revenue, more than Coal
- ❑ Relative cost advantage of rail over truck increases as fuel cost rises

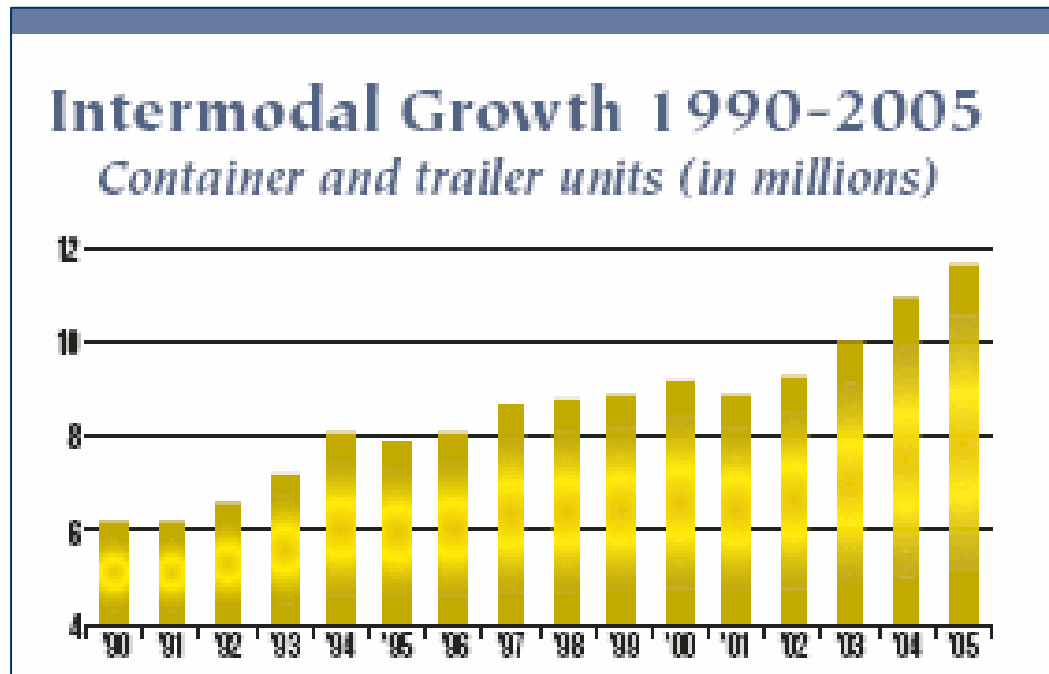
Recent Trend: Increasing importance of Intermodal

Jan 06 to Aug 06: Intermodal up 6.4% and Carloads up 1.5%



Railroads Pursued Intermodal Cost Subsidy by Federal Government - A response to Revenue Constraints on Intermodal.

Long Term Trend: Increasing importance of Intermodal



Source: AAR, Traffic World

- ❑ Intermodal growth can absorb railroad capacity and cut into carload service

The Highway Network: Approaching and Exceeding Capacity.

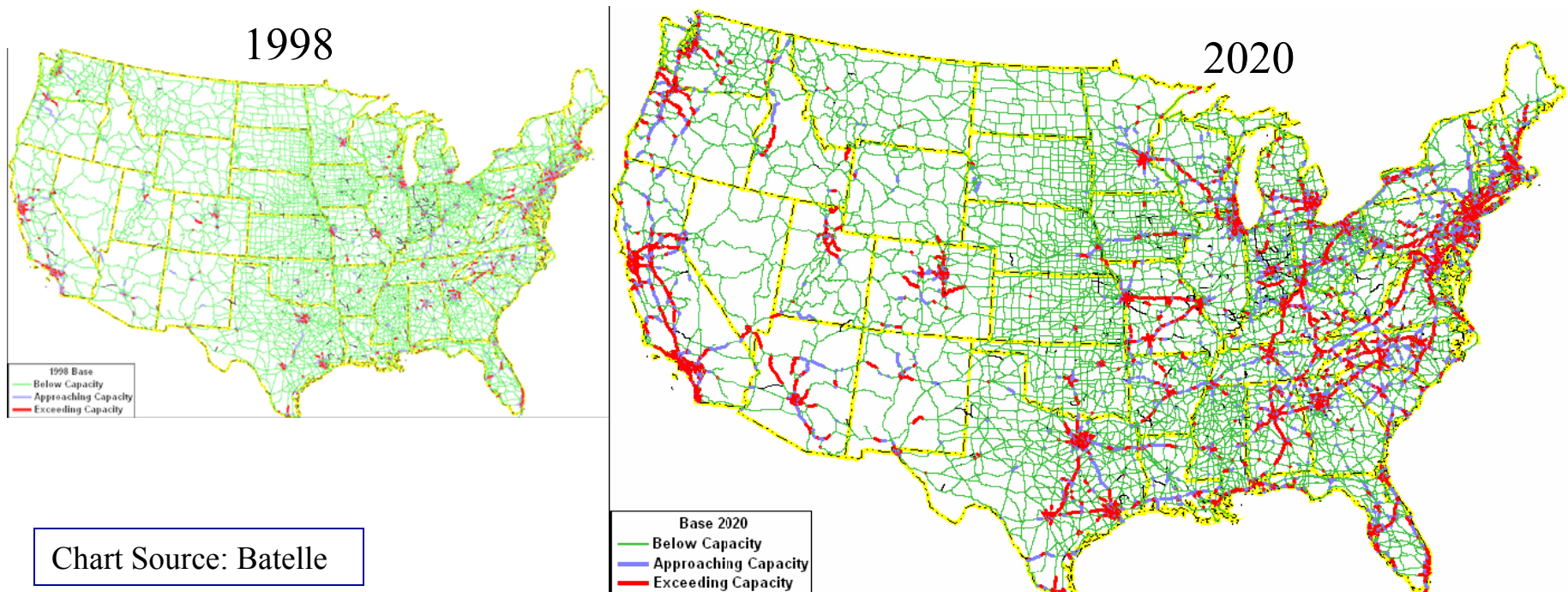


Chart Source: Batelle

- Highways over-capacity are shown in red for 1998 and forecast 2020
- Highways approaching capacity shown in blue for 1998 and forecast 2020

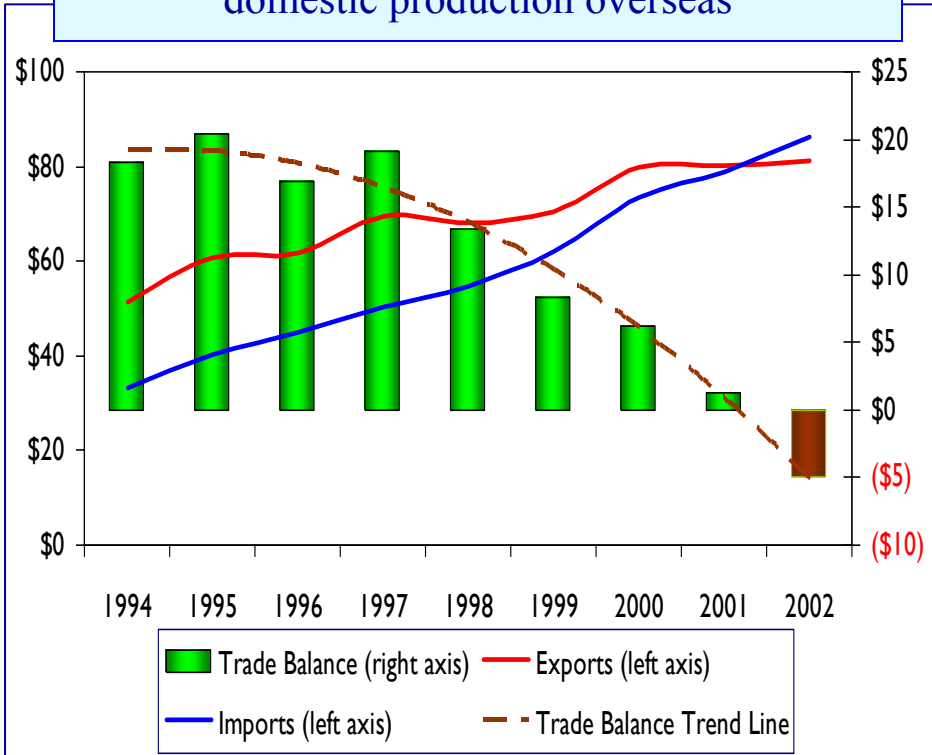
Factors Affecting Railroad Capacity In The Future: Import/Export And Intermodal

- ❑ Increasing use of back haul to reduce cost and increase capacity
 - ❑ Tropicana back hauling other products to FL
- ❑ Projected growth in Intermodal is both welcome and a concern to Railroads
 - ❑ Volume levels up and profit levels down

Long Term Shifts In Production Have A Major Impact On Domestic Transportation

- ❑ **Mexico is the second largest US trade partner and has growing importance in trade with Asia**
- ❑ **Continued Impact On Freight Flows Of Long Term Shifts In Domestic Industrial Production**
- ❑ **US Trade Deficit with China was \$202 Billion in 2005**
- ❑ **US Trade Balance Was Running At Annual Deficit Of \$763 Billion As Of April 2006**
 - ❑ **6.4% Higher Than The Record \$717 Billion US Trade Deficit In 2005**

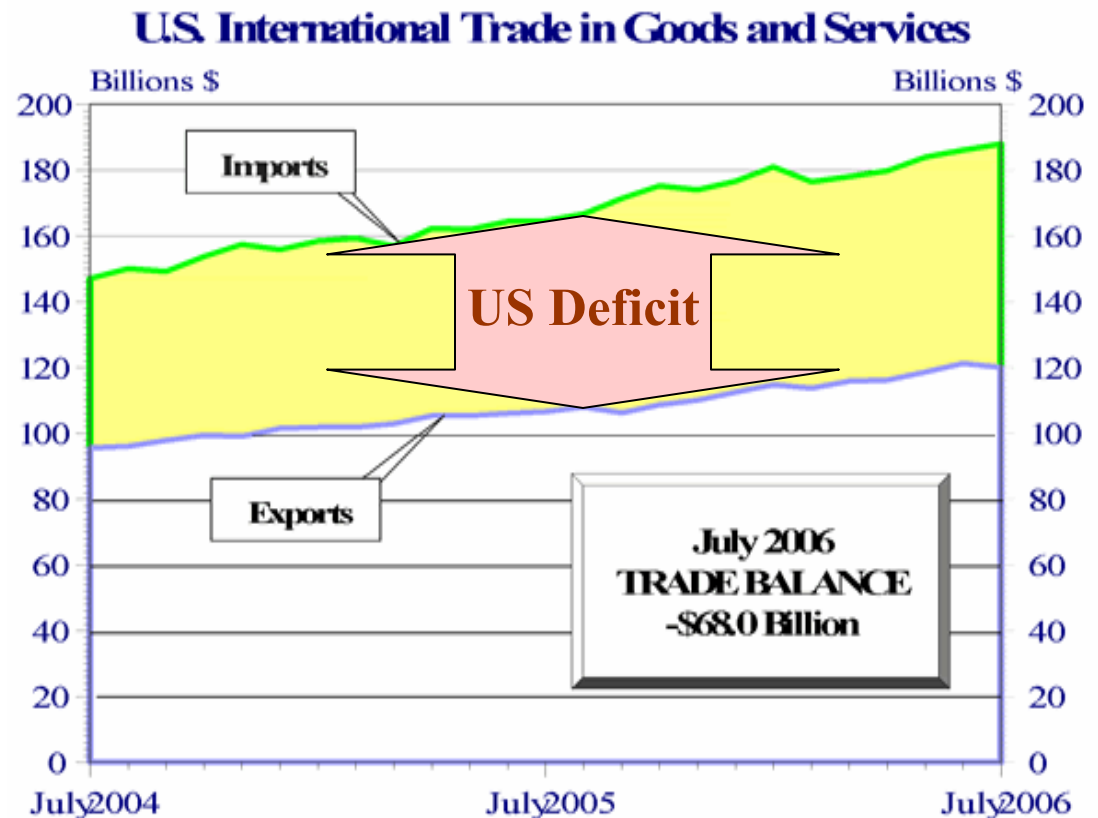
Chemical Business: persistent shifts of domestic production overseas



Source: US Department of Commerce

Long Term Shifts In Production Have A Major Impact On Intermodal Volumes and Port Congestion

- ❑ **Continued Impact On Freight Flows Of Long Term Shifts In Domestic Industrial Production**
- ❑ **US trade showed a deficit with China of \$19.6 billion in July 2006; 12 months at this level would yield a US deficit of \$240 billion; 20% above the US deficit in 2005**
- ❑ **Monthly US deficit worldwide was \$68.0 billion in July 2006**

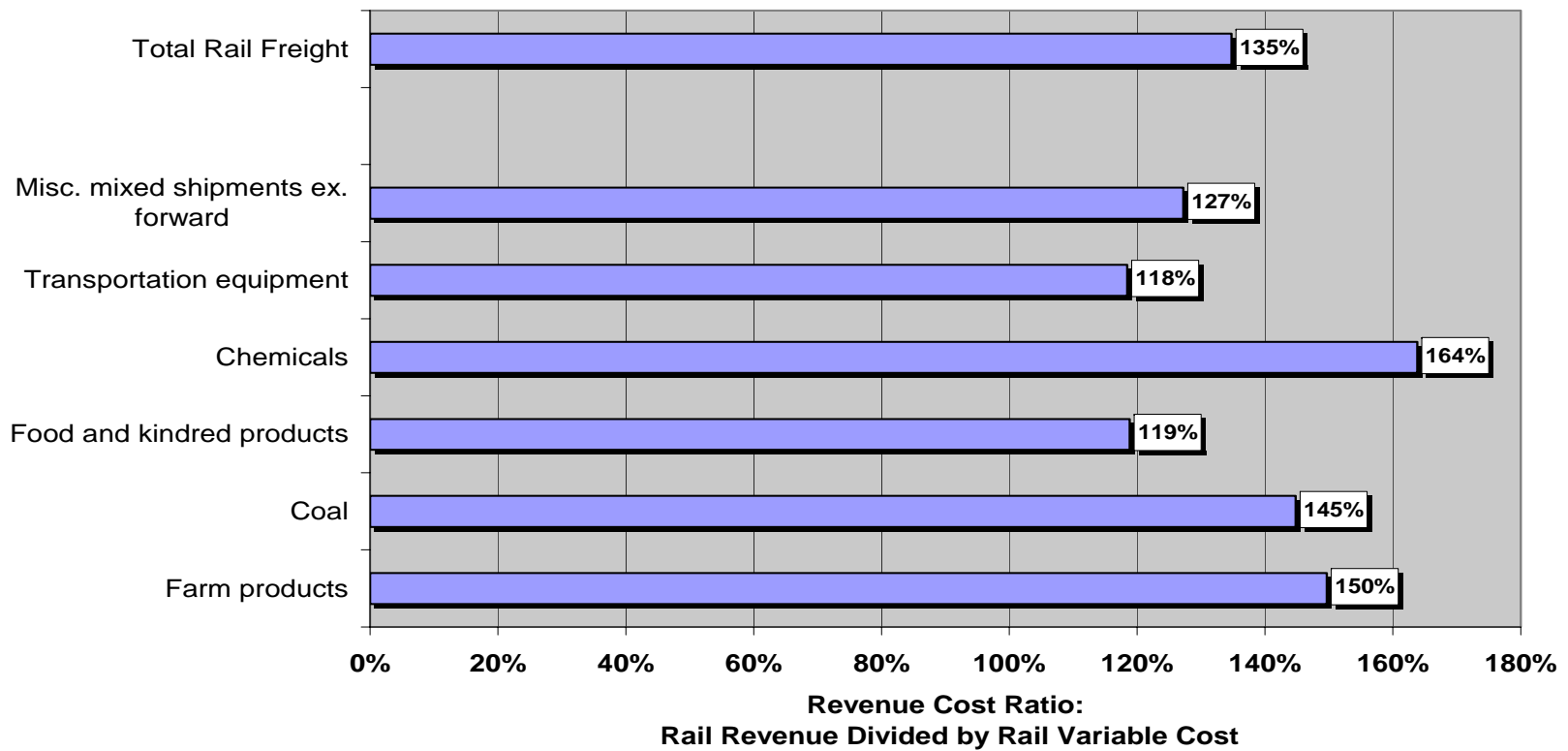


II. Rail Economics: Costs And Rates

- ❑ Commodity Comparison
 - ❑ Compare rail rates to other rail shipments of the same commodity
- ❑ Year over Year comparison
 - ❑ Compare year over year change in rail rate
- ❑ Rail Profitability; Revenue Cost Ratios (“RCR”)
 - ❑ RCR is Revenue divided by variable cost
 - ❑ RCR estimates the profit the railroad realizes from each rate.
 - ❑ RCR is used for regulatory purposes at the Surface Transportation Board (“STB”)

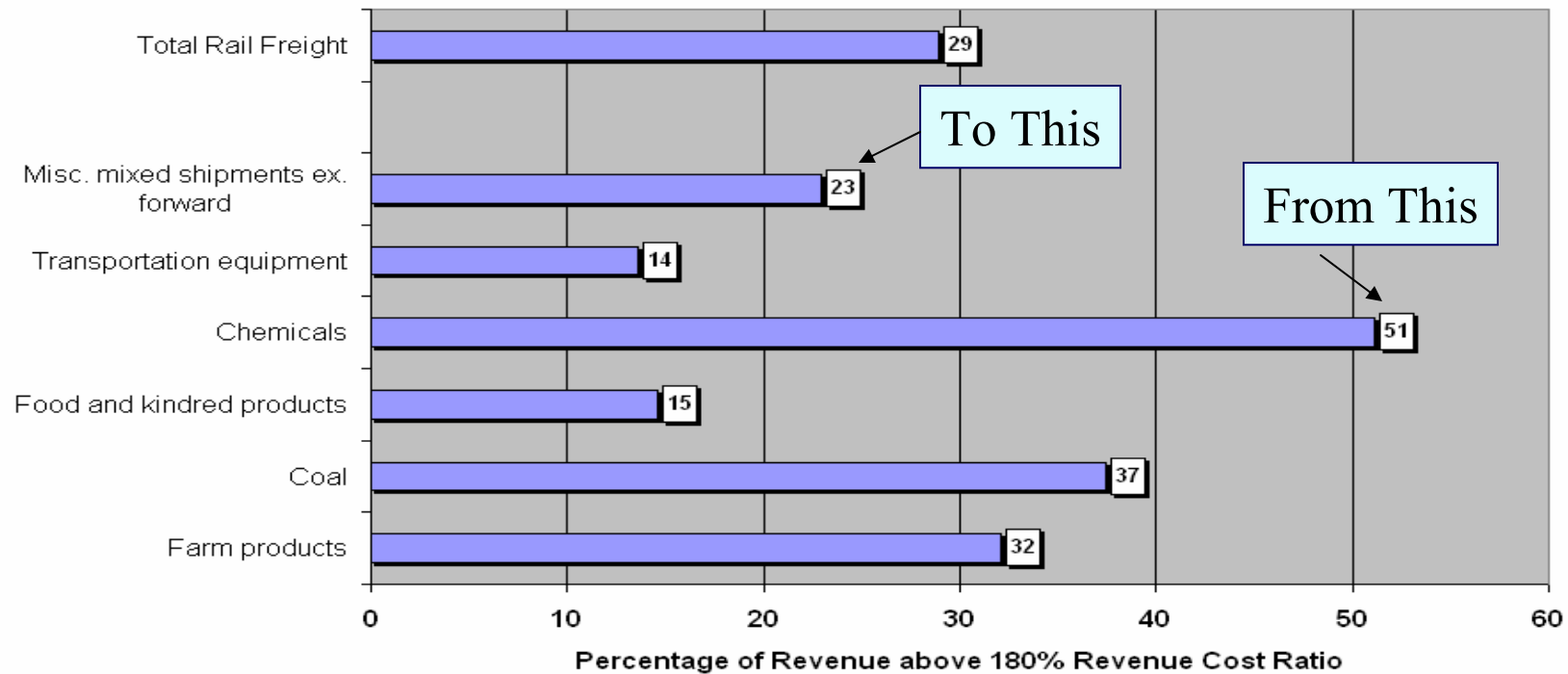
The Profitability of US Rail Shipments Varies Widely as measured by Rail Revenue divided by Rail Cost (RCR)

Revenue Cost Ratios: Commodities with \$2 Billion or More in Revenue
Source: STB; 2004 Waybill Sample



Converting Chemical Shipments From Domestic Rail Carload to Intermodal Import Can Lead to Dramatic Changes in Rail Rates

**Percentage of Revenue above 180% Revenue Cost Ratio:
Commodities with \$2 Billion or More in Revenue**
Source: STB; 2004 Waybill Sample

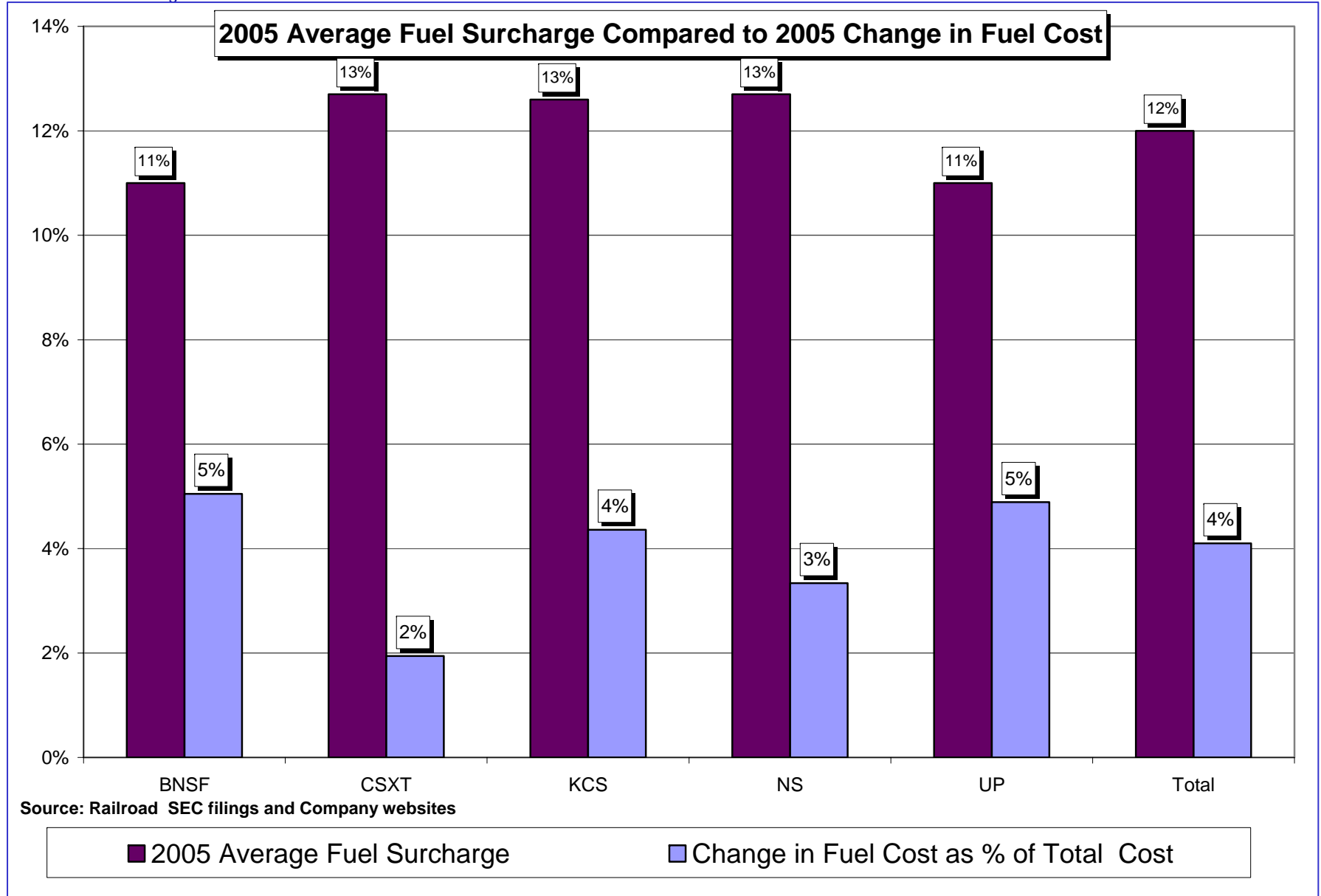


- Revenue Cost Ratio is railroad revenue as a percentage of railroad cost.
- Misc. Mixed is Primarily Intermodal

III. Rail Regulation and Competition

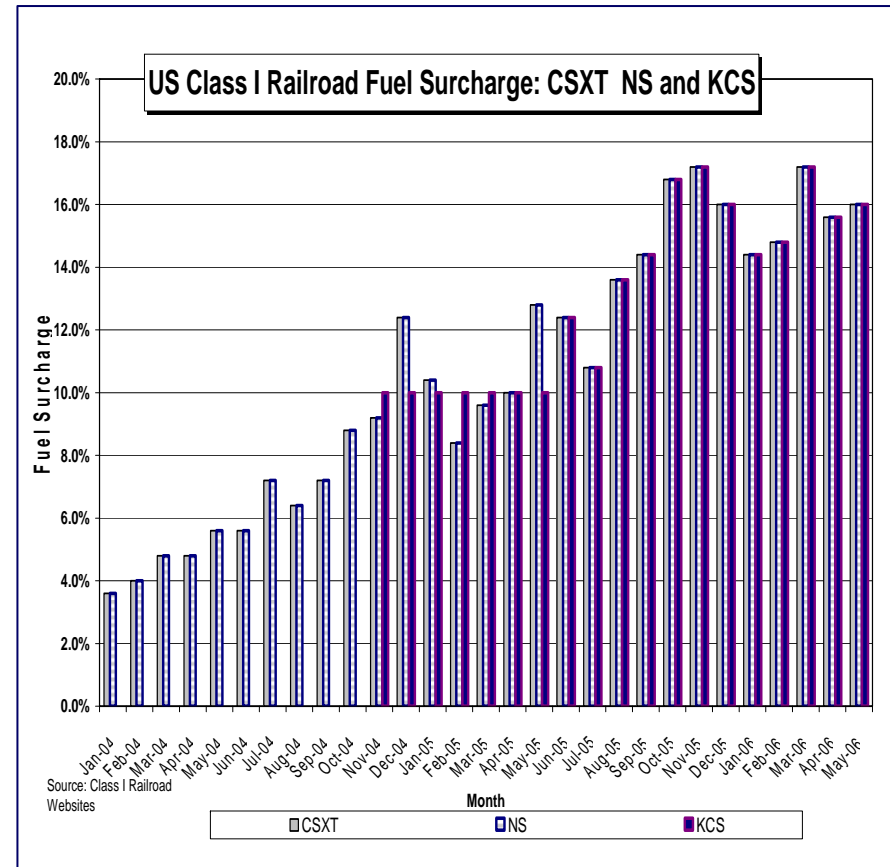
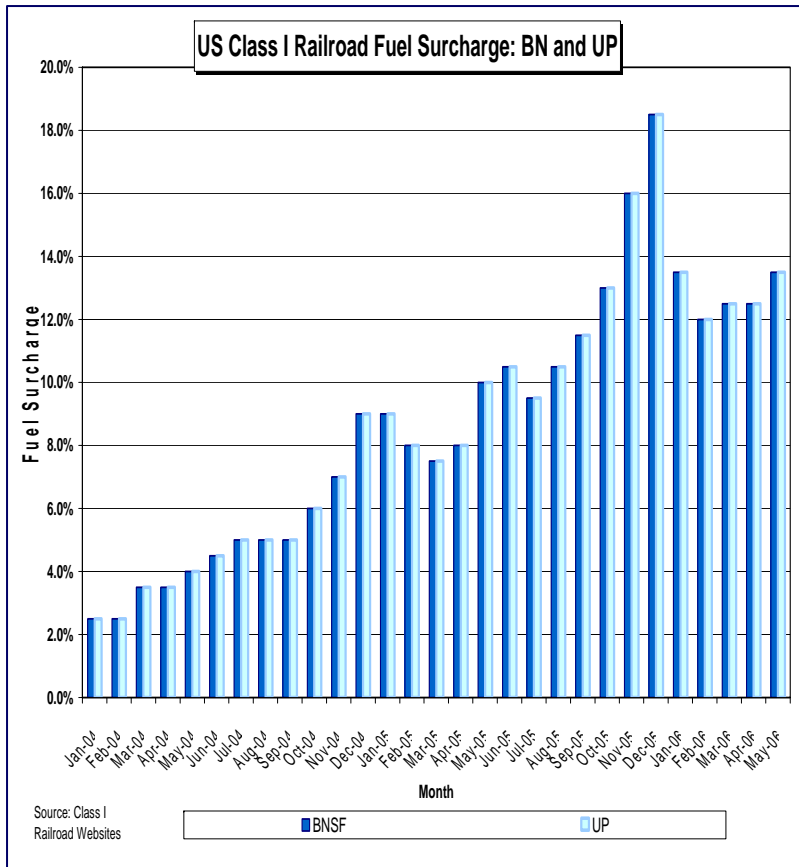
- ❑ Initiatives At Surface Transportation Board (STB)
 - ❑ Two major STB initiatives will impact Shippers
 - ❑ Fuel Surcharge –
 - ❑ Railroads Reporting Fuel Revenue and Cost to STB
 - ❑ Fuel Surcharge linked to Fuel Cost
 - ❑ Small Shipment Rate Case – A Rulemaking to redefine procedures
 - ❑ Reflects a more proactive approach

Economic and Management Consultants



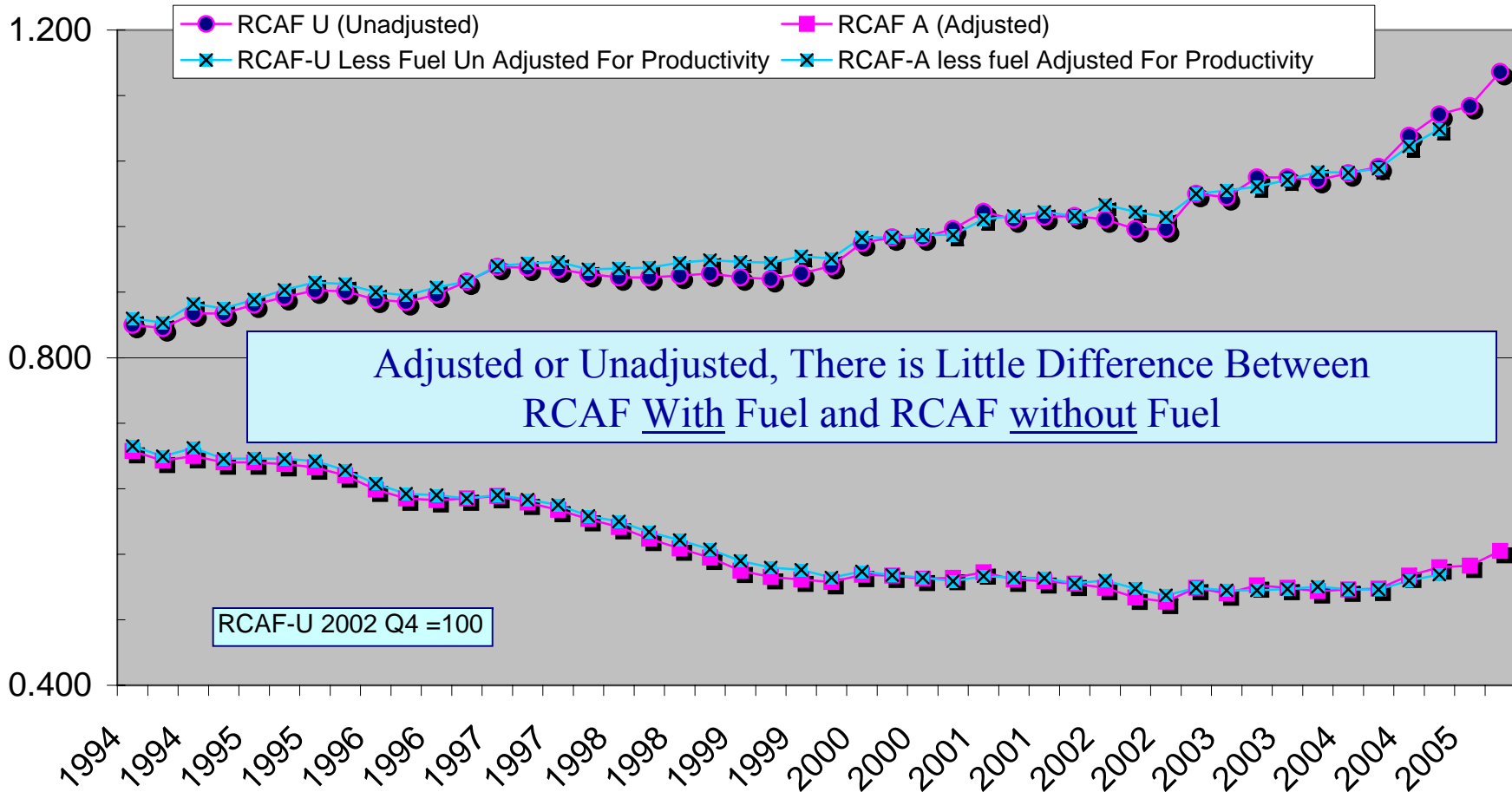
Fuel surcharges claimed by the BNSF and the UP are virtually identical.
Fuel surcharges claimed by KCS, NS and CSXT are also virtually identical.

In contrast with this uniformity, fuel cost as a percent of operating cost differs widely



Source: Railroad SEC filings and Company websites

**Rail Costs as measured by RCAF are very similar with and without fuel
RCAF-A is Rail Cost Adjusted for Productivity
Costs and Productivity and Fuel all as Measured by Rail Industry**

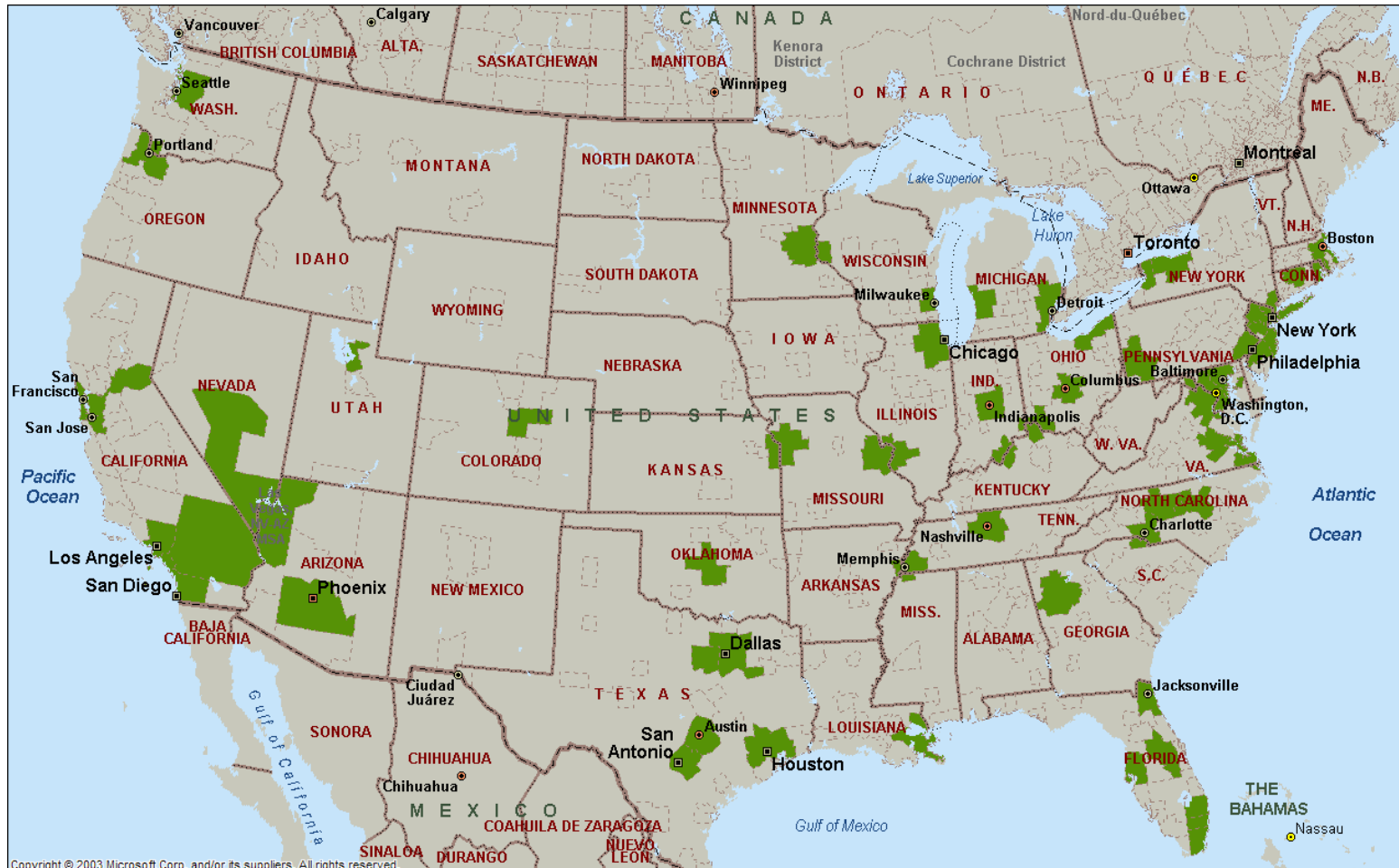


RCAF-U is Rail Cost Adjustment Factor Without Reflecting Productivity Gains

Railroad Financial Performance

- ❑ **Union Pacific, the largest US railroad**
 - ❑ *70 percent growth in 2005 net income to \$1.03 billion,*
 - ❑ **Revenue jumped 11 percent to \$13.6 billion.**
- ❑ **Burlington Northern Santa Fe, second-largest US railroad,**
 - ❑ *93 percent growth in 2005 net income to \$1.5 billion,*
 - ❑ **Revenue of \$13 billion, up 19 percent, for 2005.**
- ❑ **CSX, the third largest US railroad**
 - ❑ *237 percent growth in 2005 net income to \$1.2 billion*
 - ❑ **Revenue increased 7 percent to \$8.6 billion.**
- ❑ **Norfolk Southern, the fourth largest US railroad**
 - ❑ *39 percent growth in 2005 net income to \$1.3 billion*
 - ❑ **Revenue rose 17 percent to \$8.5 billion.**

IV. Mergers and Strategic Alliances Major US Ports And Metropolitan Areas With Populations Greater Than 1 Million People



IV. Mergers And Strategic Alliances

- ❑ Rail service via Mexican Ports is a Response to US West Coast port congestion
- ❑ The Mexican ports and the “Meridian Speedway” Joint Line links to NS and targets service to East Coast population centers and rapidly growing Intermodal freight
- ❑ This could foreshadow major shifts in rail flows



- Ports of Los Angeles and Long Beach handle:
- 70% of cargo moving between Asia and the US
- 40% of total ocean cargo shipped to US every year from the world.

KCS Estimates



Most Observers See Virtually no Network Redundancy left in the Rail System

- ❑ Segments of many mainlines at capacity
- ❑ Operating issues in some terminals
- ❑ Recurring shortage of crews due to retention and training challenges
- ❑ Need to acquire and refit locomotives
- ❑ The Railroad Metrics tell the Story

Rail Mergers: Lessons for the future

Continued high demand

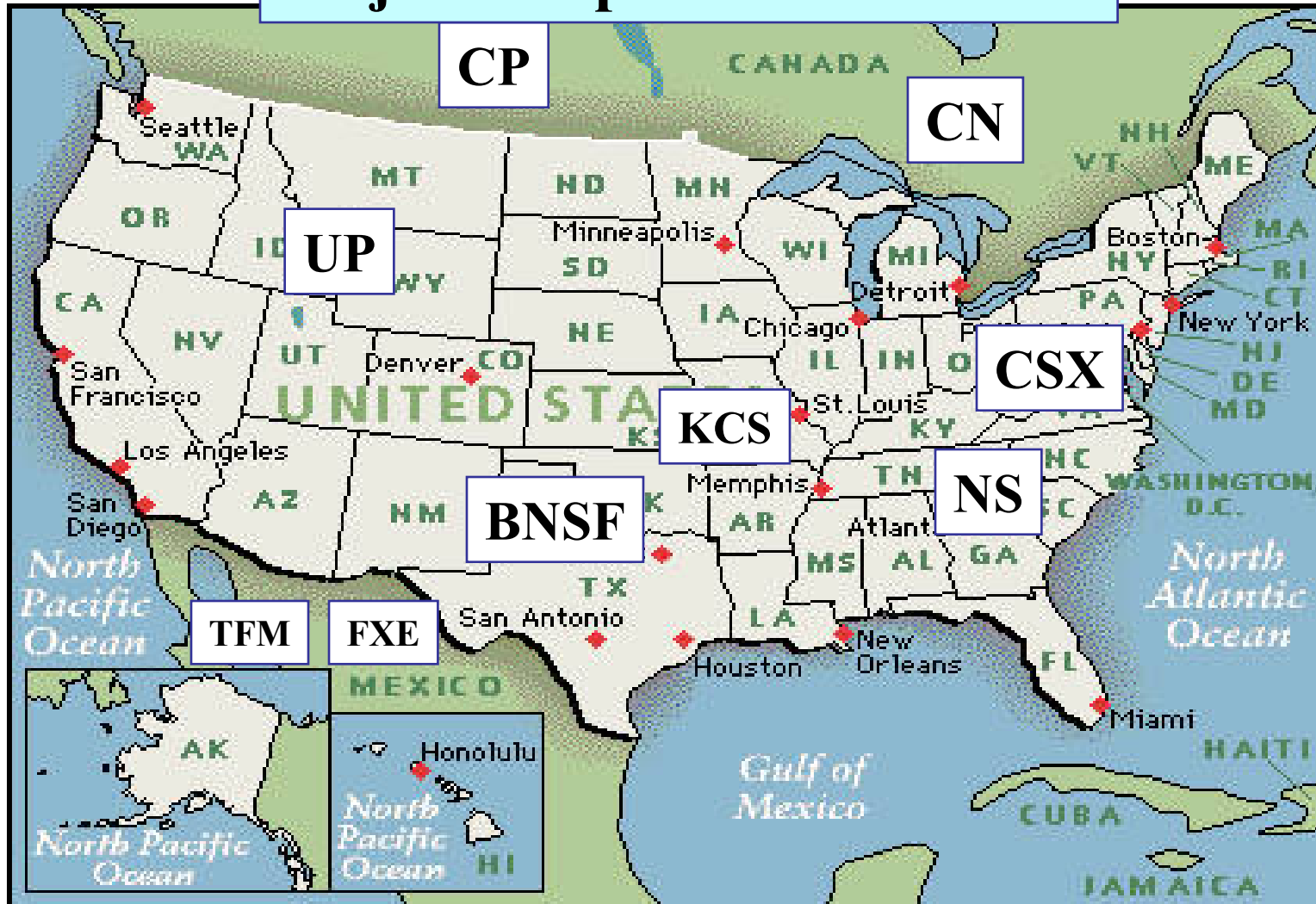
- ❑ Traffic is up
- ❑ Freight volumes expected to double in 20 years
- ❑ Increasingly, new highways are a non-starter
- ❑ Railways will have a bigger role
 - ❑ *If they can do the job*

Source: Jim McClellan NS Sr. VP Strategic Planning June 2004

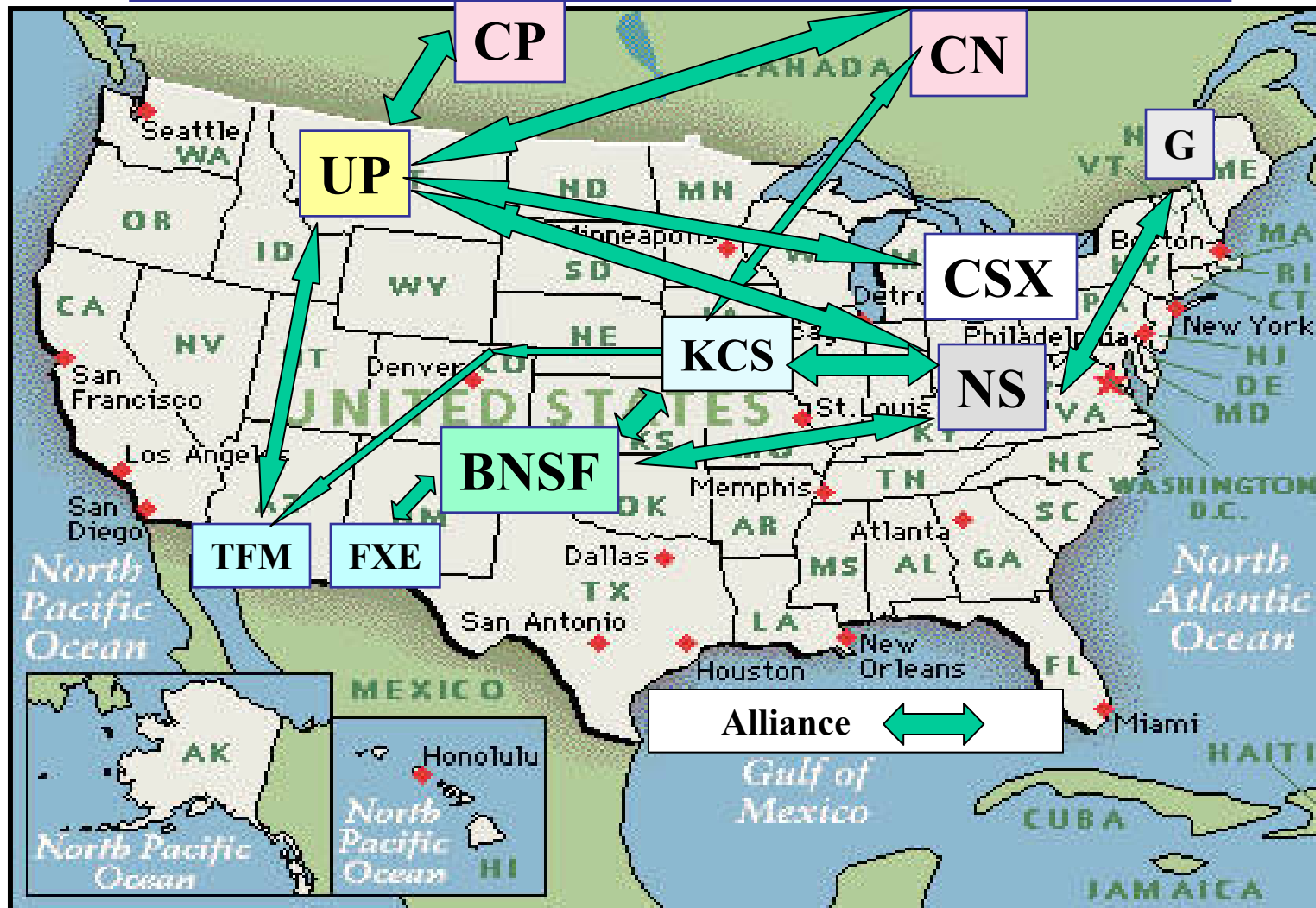
❑ **Strategic Alliances Are an Alternative to Mergers**

Source: Tom O'Connor VP SK October 2006

Major Independent Railroads



Major Independent Railroads Showing Some of the Rail Strategic Alliances



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Background on Snavely King

- ❑ Snavely King Majoros O'Connor & Lee has provided consulting services to the Rail Industry, rail shippers and hundreds of other clients in transportation, telecommunications and utilities in the US, Canada and Overseas.
- ❑ For more than three decades SK has built its success on developing and applying practical market and economic solutions for its clients.
- ❑ The firm's financial and strategic advice is backed by the professional staff's wide experience in designing and applying business solutions, evaluating corporate transactions, analyzing start-up companies, and in providing strategic planning services to commercial, institutional and government clients.
- ❑ In more than 2,000 projects, the analyses and expert advice provided by SK have significantly assisted both private and public sector clients.

Tom O'Connor

- ❑ Tom O'Connor is Vice President of Snavely King Majoros O'Connor & Lee, an economic and management consulting company. He has been engaged in the business of economic analysis for more than thirty years, beginning as an economist with the Interstate Commerce Commission (now the Surface Transportation Board) and subsequently in economic consulting and management positions of increasing responsibility with:
 - ❑ The United States Railway Association as Manager of Local Rail Services Planning
 - ❑ Conrail as Assistant Director of Costs and Economics
 - ❑ Association of American Railroads as Assistant Vice President of Economics
 - ❑ DNS Associates as Vice President, and since 1988 with
 - ❑ Snavely King Majoros O'Connor & Lee as Vice President
- ❑ Tom O'Connor's practice centers on transportation with specific focus on negotiations and infrastructure issues including rationalization and redesign of the railroad infrastructure in the US as well as rebuilding of the railway infrastructure in Eastern Europe.
- ❑ Mr. O'Connor's work in the Balkans in Eastern Europe focused on both transportation and telecommunications.
- ❑ Tom O'Connor has provided testimony on a wide range of issues in proceedings before courts and regulatory commissions in the United States and Canada including:
 - ❑ Interstate Commerce Commission; Surface Transportation Board; United States Railway Association; Regulatory Commissions in New York, Indiana and Pennsylvania; State Courts in Indiana, Montana and Virginia; Arbitration Panel in New York; Mediation Panels in Massachusetts and Washington DC; Canadian Crown Commission; US District Court for Eastern District of Virginia, and US District Court for Arizona
- o Military- US Army - Combat Engineers o Education- Economics BA and Graduate - Phi Beta Kappa