State of the Industry

Outlook and Trends

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AASHTO Discussion

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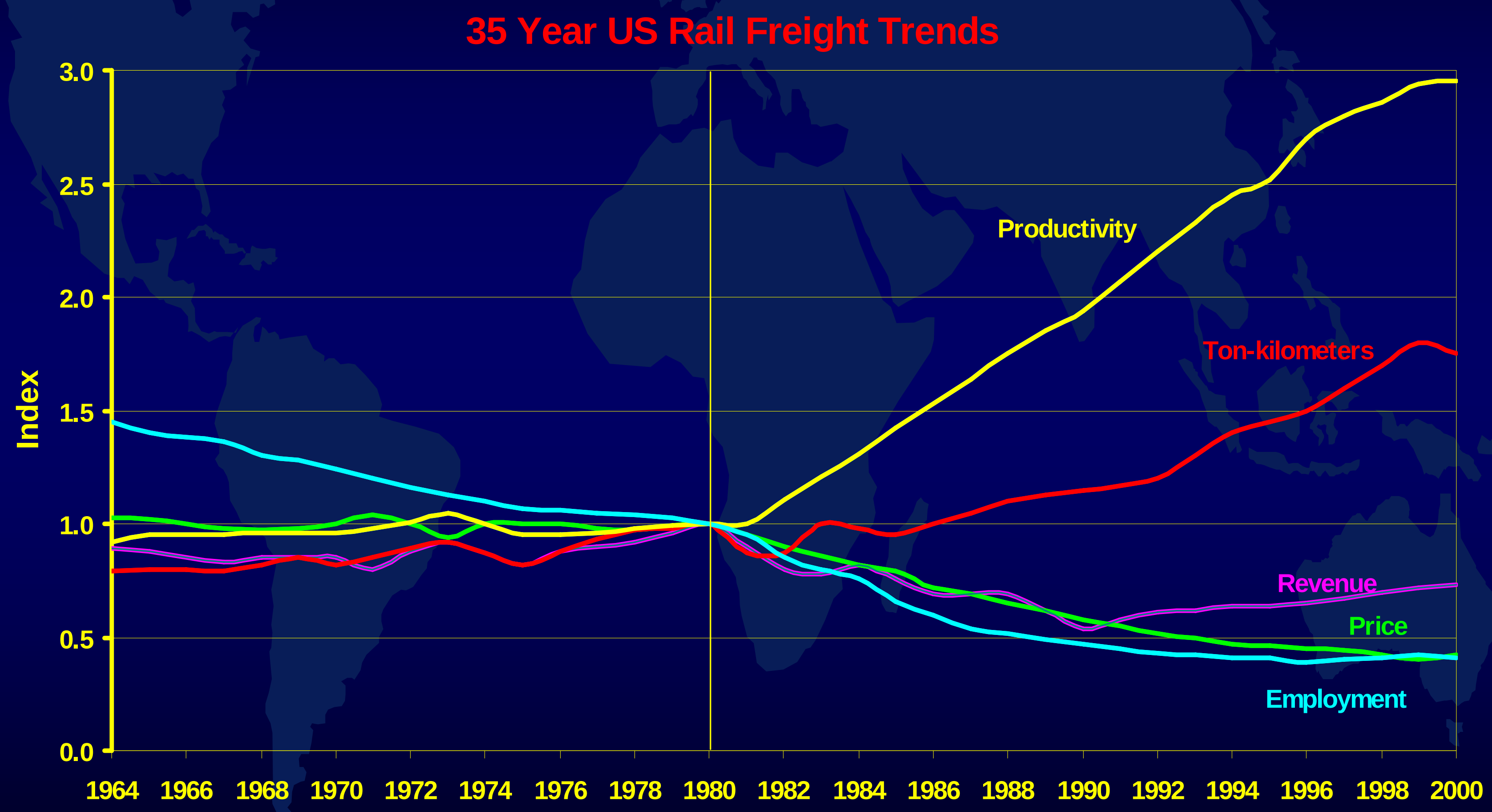
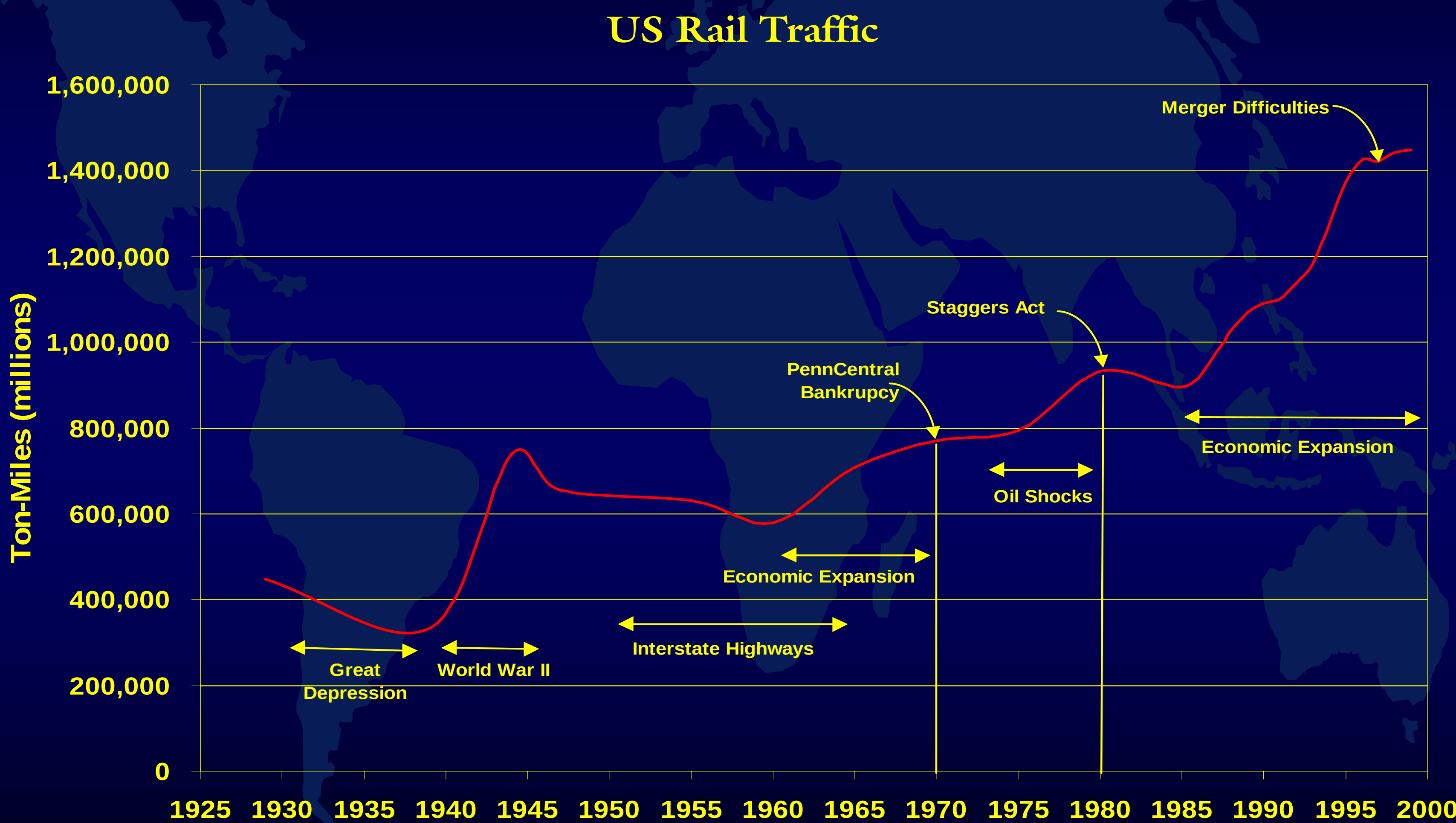
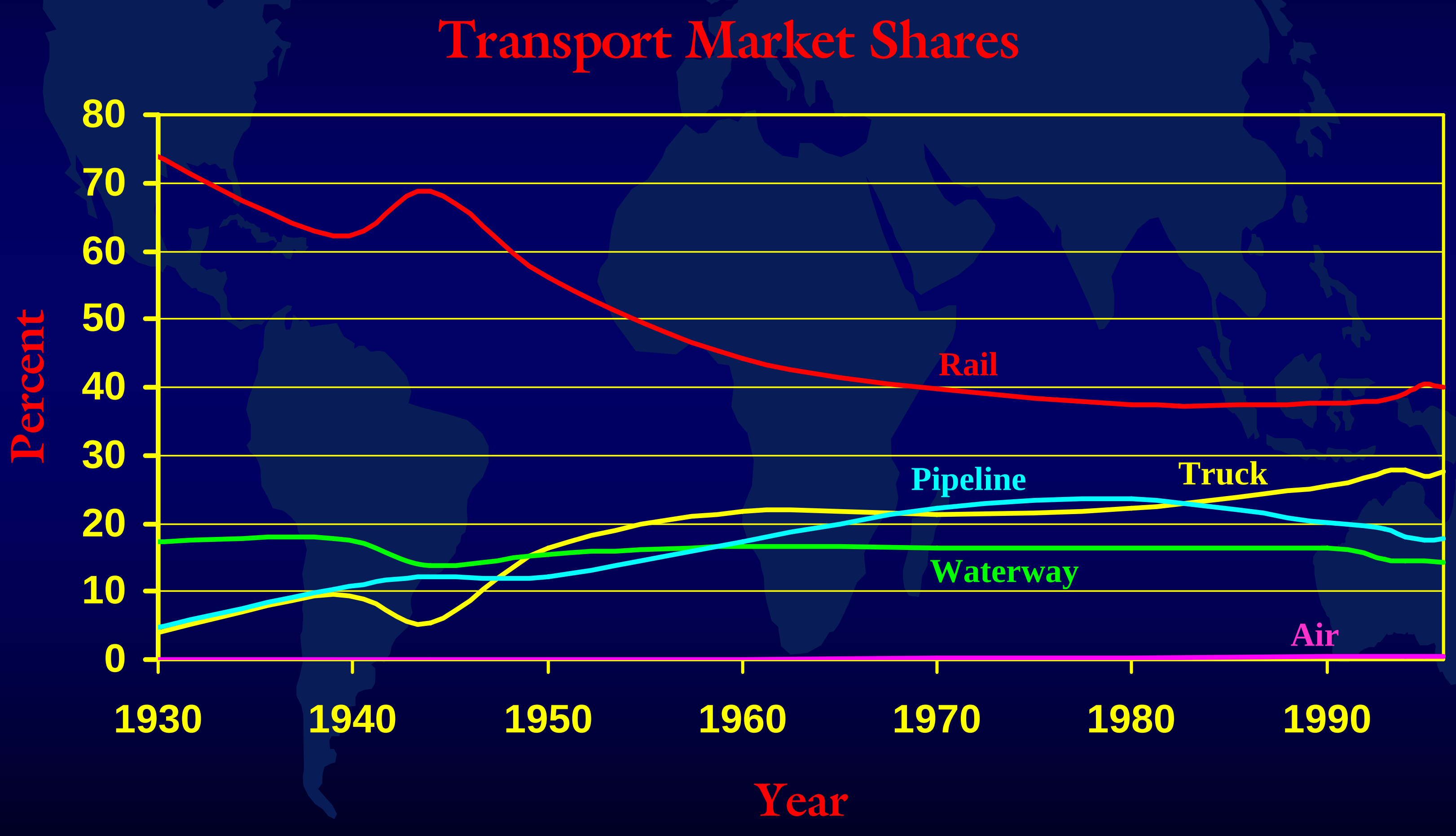
The modern rail era began in 1980



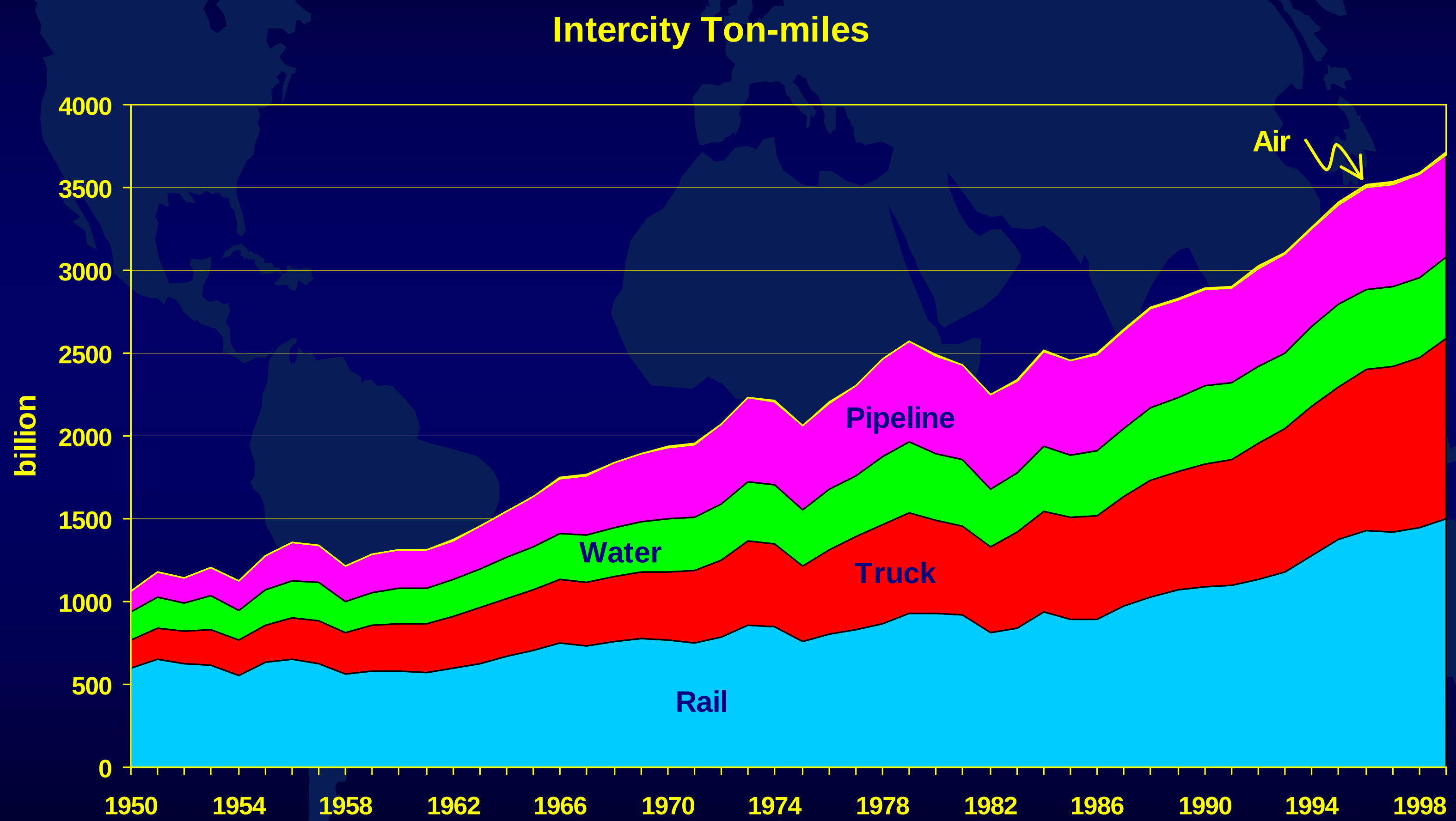
Rail traffic recovery started in 1985



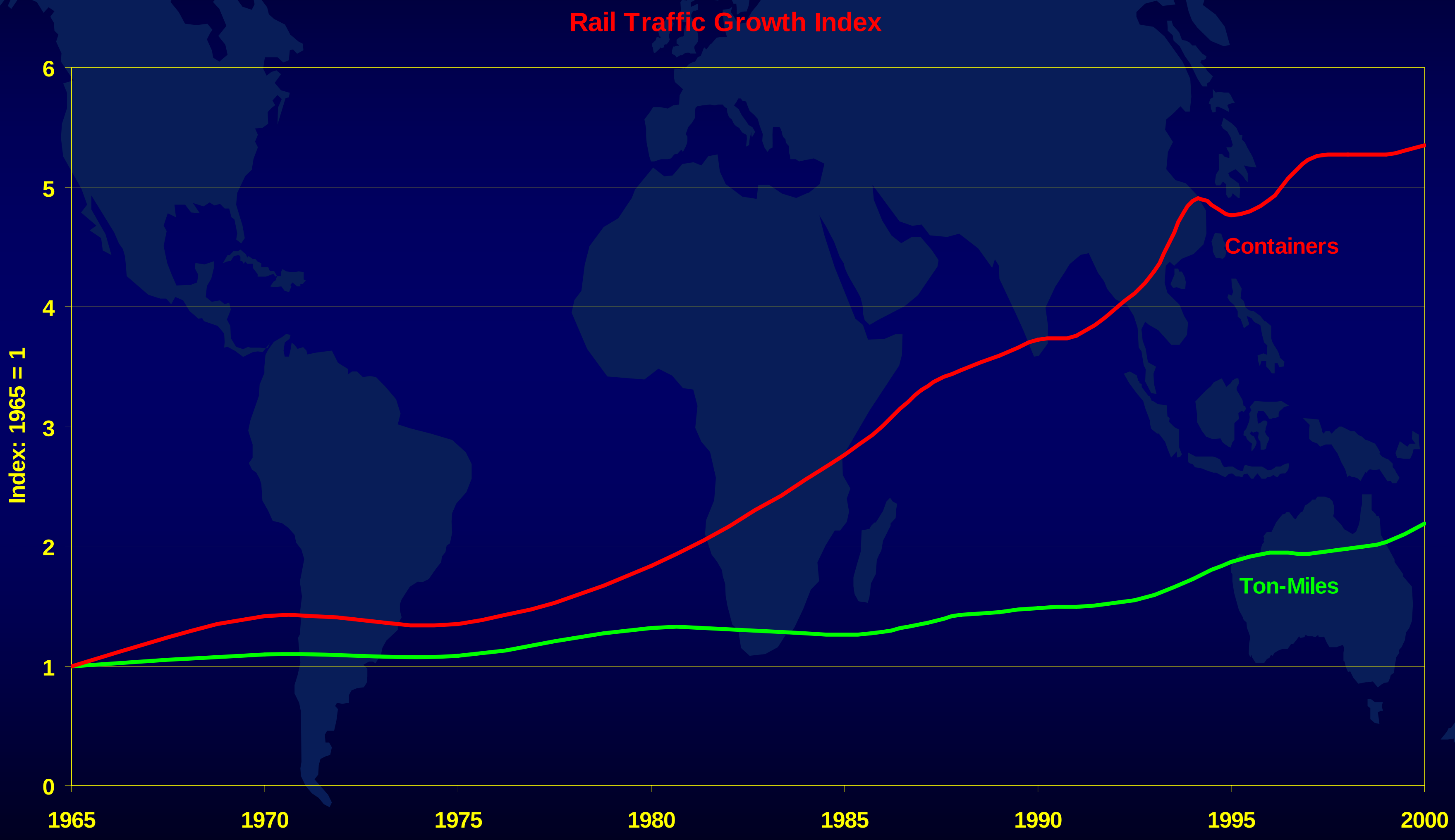
After a long decline …



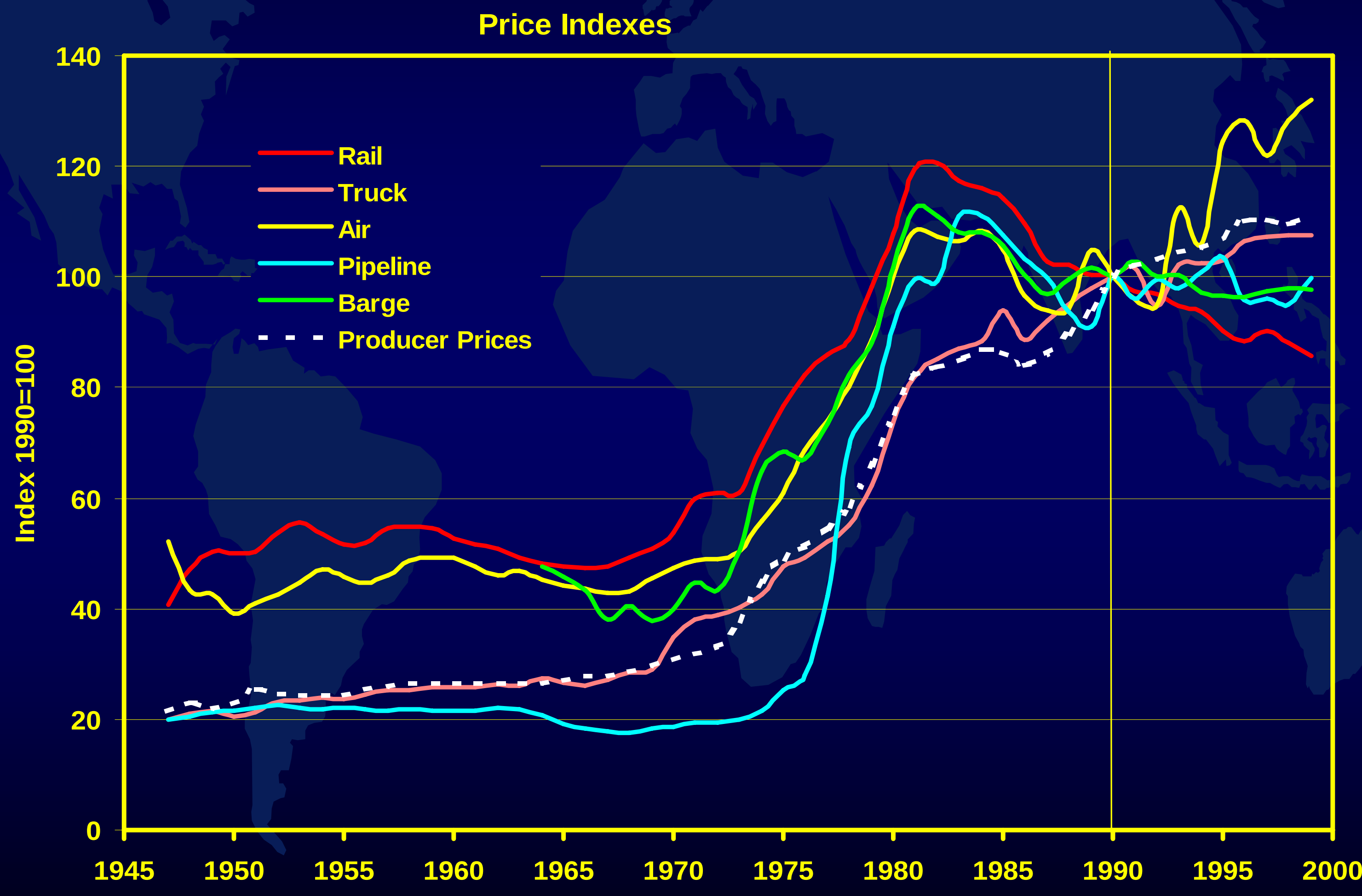
Rail market presence increased



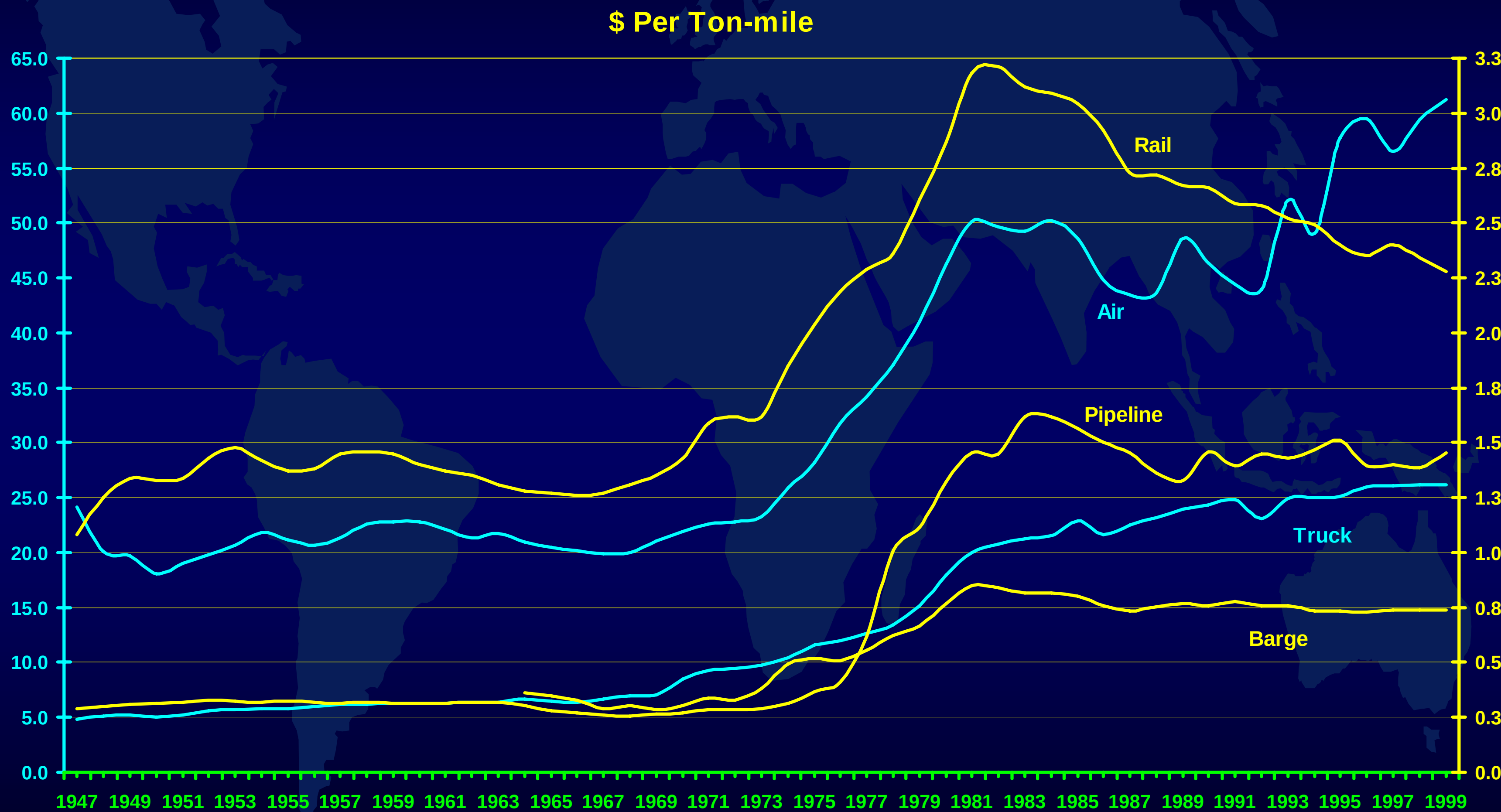
High growth in container traffic



Average rail rates declined



Even on current price basis

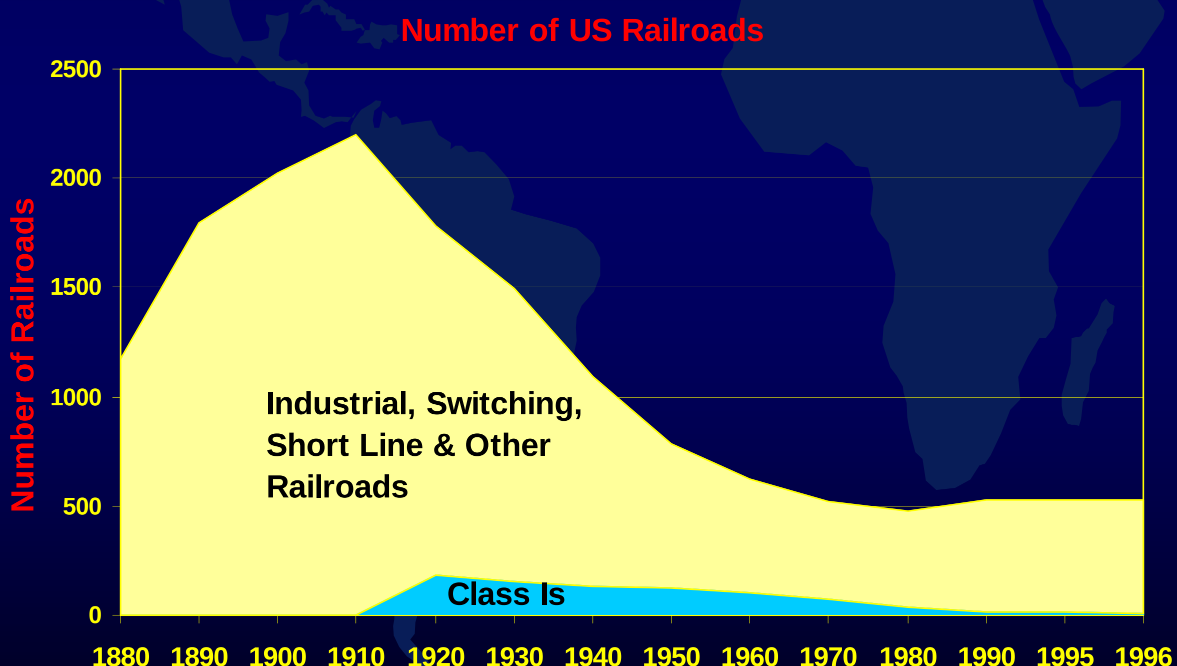


Major changes in the last 20 years

- Formation of short lines and shedding of passenger responsibilities reduced capital requirements.
- Increasingly sophisticated marketing and differential pricing helped maximize revenues in competitive environment.
- Resulting in improved plant, equipment, productivity, and much improved financial health

Consolidation an important driver

- The economics of consolidation has been a big part of rail industry history
  - Staggers made it easier to eliminate excess lines.



- Total companies increased after 1980
- While number of Class I's continued to shrink

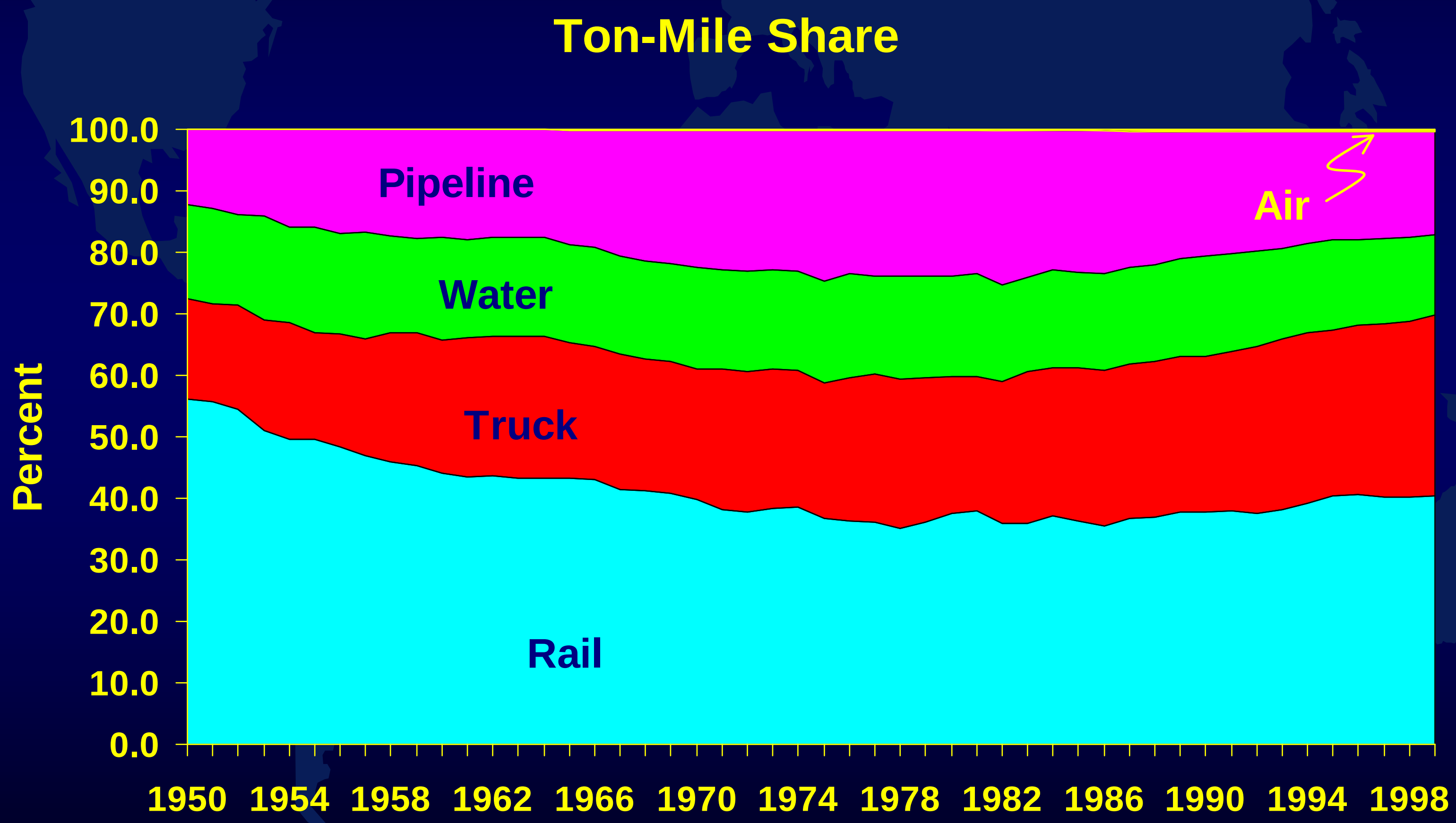
Network businesses need density

- Cost of network is high--railroads are a capital intensive business--and higher density improves profitability.
- Consolidation has permitted concentration of traffic, driving up density
  - Excess capacity in rail system has been eliminated over the last 20 years of consolidation and line abandonment
  - Class Is continue to trim lines that don’t justify continuing investment.

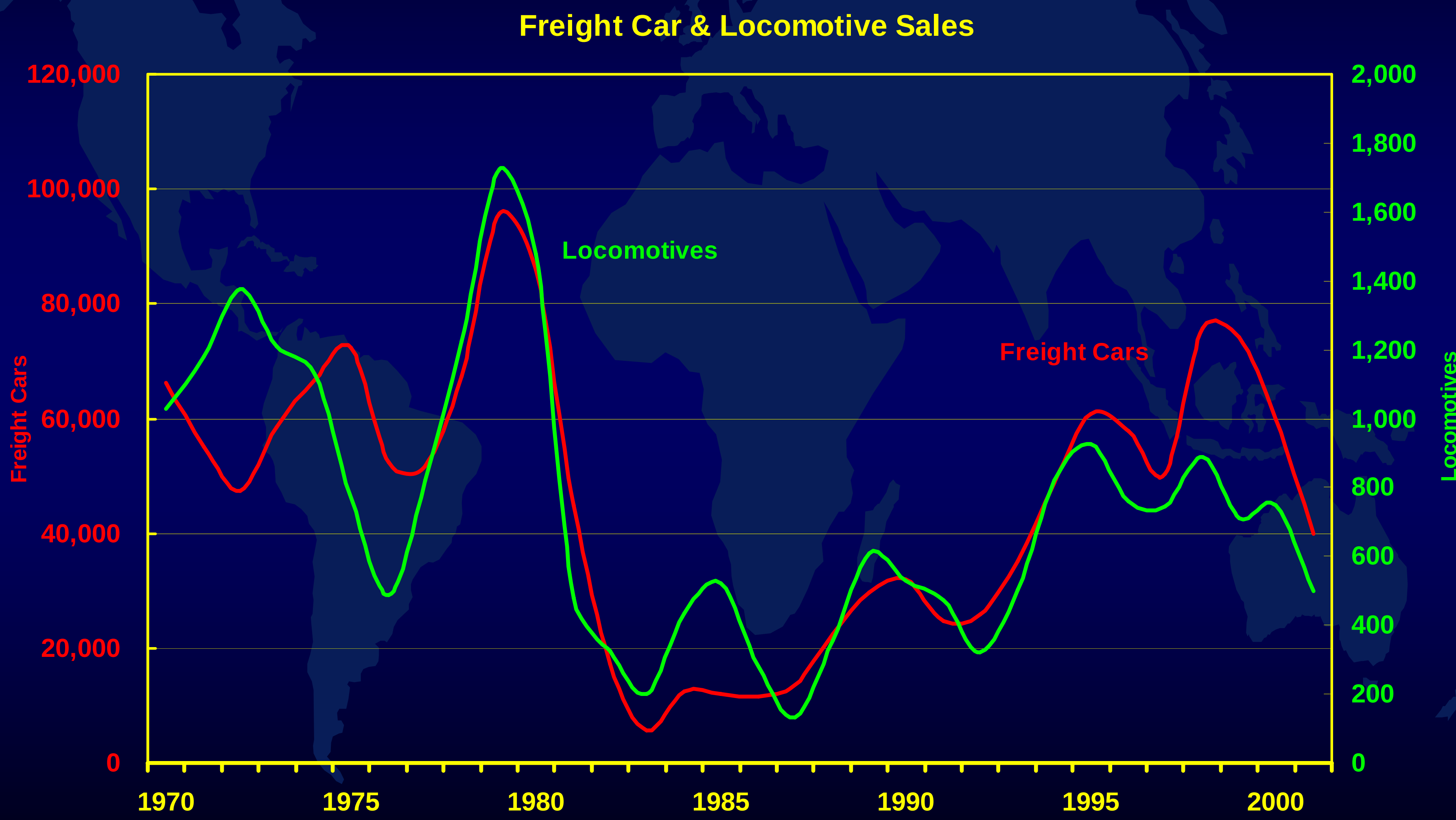
Recent consolidations caused havoc

- While consolidation has helped railroads cut costs
  - The NS/CSX acquisition of Conrail was expensive and has increased financial pressures on the two carriers.
  - Recent mergers have also resulted in service breakdowns, causing significant financial harm.
- Railroads have had difficulty earning sufficient returns in a capital intensive industry.
  - Shares have low multiples on stock market, making cost of equity capital very high and value of equity low
  - But, industry debt:equity ratios are already high

Recently, market shares have declined



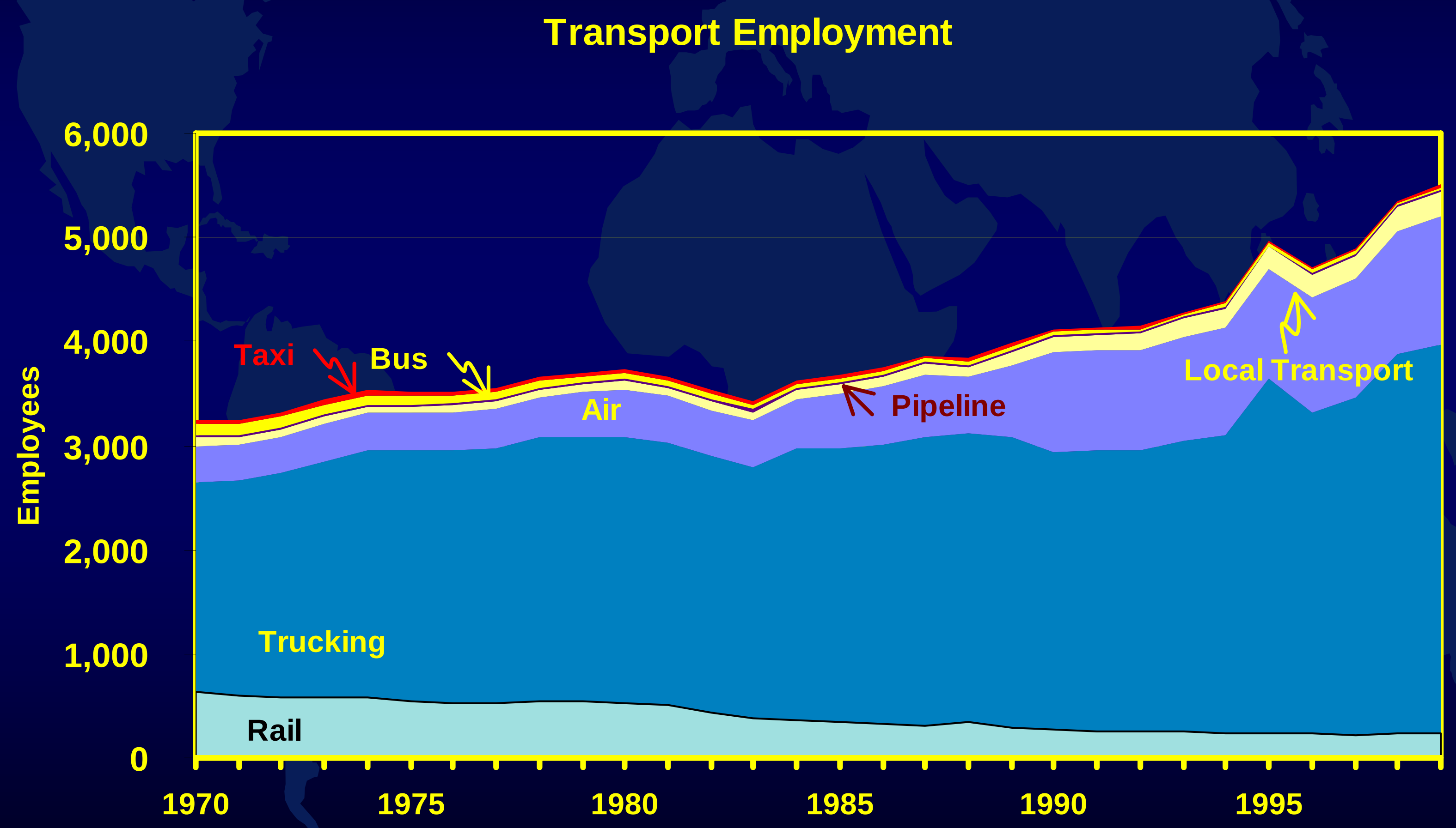
Investments have slowed markedly



Financial health driven by cost cutting

- Cost cutting was most important element of industry financial recovery
  - Eliminating excess lines, shops, stations, other assets
  - Improving utilization of equipment, eliminating excess
- Consolidation increased the ability to reduce costs
- But excess employees and assets now largely eliminated
  - Only one or two more consolidations possible
  - Other cost reductions cannot be duplicated

Employment can't go further



Outlook uncertain

- Merger problems raised political stakes
- Many shipper groups gunning for majors (CURE, ARC, CMA, NITL)
- STB actions delays decisions
- Poor financial performance and limited cost reduction potential
- Fierce competition for freight
- Many competing uses for assets

Earnings improvement needed

- More cost cutting
- New technologies
- Advanced management techniques
  - New organization structures
  - New pricing and service strategies
- Service quality again a focus for higher revenue
- Pressure to increase asset utilization further
- More industry alliances for cost reduction, increased asset utilization and traffic growth

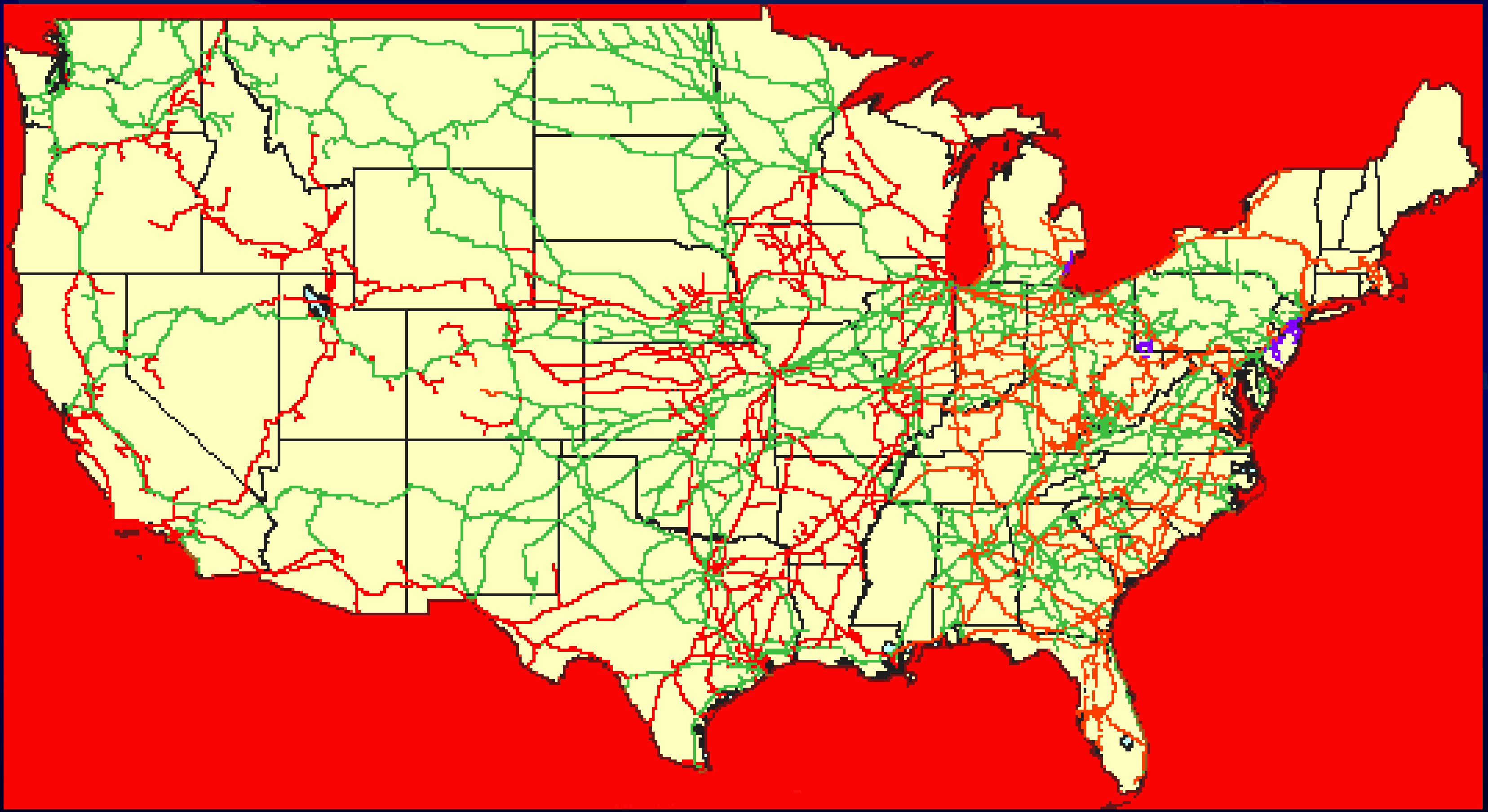
Consolidation likely to continue

- Market reach
- Cost control
  - Density, increase economies of scale
  - Equipment utilization, reduce equipment assets
  - Network utilization, reduce network assets
- Control of service delivery processes
  - Ability to create/realize economic value
  - Ability to multiply network value

Every major railroad is involved

- UP recovering from SP merger
- CSX & NS recovering from CR
- CN/IC/WC merger up next
- KCS looking isolated but valuable with Mexico
- CP now in play, CN interested
- But, BNSF/CN still a possibility
- Will it end with 3 transcontinentals?

The US network might look like this



Policy Issues

- Consolidation and increasing network density to improve economics of the industry have resulted in congestion and bottlenecks.
  - Especially during peak periods and disruptions
  - Will require some time to correct
- Should public money be used on private networks to create capacity for freight?
  - Access issues, public money may require public access
  - Differential benefits (private/public) affects who pays
  - Railroads may not want to participate

Policy Issues

- Industry has history of public/private investment
  - Highway crossings, crossing elimination
  - Real estate developments
  - Operation of commuter and passenger systems
- What future public/private investments and cooperation might make sense?
  - Grade separations
  - Joint high-capacity corridors
  - Line capacity investments to support commuter/traffic

Policy Issues

- Short lines have absorbed many light density lines and provide economic rail services to rural areas
  - Usually, thinly capitalized
  - Low margin operations
- How can state investments support short line and would such investments be worth while?
  - Bridges & structure replacements
  - Increased capacity of network for heavy axle-loads
  - Connections to increase competitiveness

Network finance and access an issue

- Inadequate ROI and capital shortages have led industry to finance many assets, limited to rolling stock so far. Infrastructure financing is the next logical step.
- Public finance of infrastructure may result in demands for public access.
- Pressure on Congress to increase competition could fundamentally change the structure of the industry.

US rail network already shares access

(Red lines show rail network with multiple users, includes Amtrak)