U.S. Freight Railroads

Presentation to the American Association Of Port Authorities

March 21, 2006
25 Years After Staggers: Solid Gains and a Promising Outlook

- Unprecedented productivity gains passed to customers as lower rates
- Dramatic safety gains
- Infusion of advanced technology
- Growth of non-Class I carriers
- Closer to financial sustainability
# 2005 Was a Good Year

## Class I Railroad Performance
(billions, except percentages)

<table>
<thead>
<tr>
<th></th>
<th>2004*</th>
<th>2005**</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Revenue</td>
<td>$40.5</td>
<td>$46.1</td>
<td>13.8%</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>$35.1</td>
<td>$37.8</td>
<td>7.8%</td>
</tr>
<tr>
<td>Net Revenue From Oper.</td>
<td>$5.4</td>
<td>$8.3</td>
<td>53.0%</td>
</tr>
<tr>
<td>Net Income</td>
<td>$2.9</td>
<td>$4.9</td>
<td>71.2%</td>
</tr>
<tr>
<td>Ton-Miles</td>
<td>1,663</td>
<td>1,698</td>
<td>2.1%</td>
</tr>
<tr>
<td>Operating Ratio</td>
<td>86.6%</td>
<td>82.1%</td>
<td></td>
</tr>
<tr>
<td>Net Margin</td>
<td>7.1%</td>
<td>10.6%</td>
<td></td>
</tr>
<tr>
<td>Return on Equity</td>
<td>6.2%</td>
<td>9.1%</td>
<td></td>
</tr>
<tr>
<td>Return on Investment</td>
<td>6.1%</td>
<td>8.2%</td>
<td></td>
</tr>
</tbody>
</table>

*From R-1 annual reports  **Preliminary, from Q4 2005 cumulative AAR RE&I report
Closing the Earnings Gap?

Class I Cost of Capital vs. Return on Investment

Cost of Capital

Return on Investment


e – preliminary AAR estimate

Sources: AAR, STB
Railroad Stocks Have Been Gaining

RR Stocks vs. S&P 500, Index 1980 = 100

Source: MSN Money
RR Earnings Are Still Modest Compared to Most Other Industries

<table>
<thead>
<tr>
<th>Industry</th>
<th>Return on Equity in 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel &amp; Iron</td>
<td>33.6%</td>
</tr>
<tr>
<td>Indust. Metals &amp; Minerals</td>
<td>25.0%</td>
</tr>
<tr>
<td>Major Diversified Chem.</td>
<td>19.0%</td>
</tr>
<tr>
<td>Major Diversified Food</td>
<td>16.4%</td>
</tr>
<tr>
<td>Lumber &amp; Wood</td>
<td>13.4%</td>
</tr>
<tr>
<td>Railroads*</td>
<td>12.3%</td>
</tr>
<tr>
<td>Median All Industries</td>
<td>12.0%</td>
</tr>
<tr>
<td>Auto Mfrs</td>
<td>11.9%</td>
</tr>
<tr>
<td>Electric Utilities</td>
<td>10.2%</td>
</tr>
<tr>
<td>Farm Products</td>
<td>9.9%</td>
</tr>
<tr>
<td>Paper Products</td>
<td>8.3%</td>
</tr>
</tbody>
</table>

*Median of BNSF, CSX, NS, and UP   Some data may be preliminary.   Source: Yahoo! Finance
Capacity Has Become a Critical Issue

“In 23 years, I have never seen a situation where the supply chain is at capacity. It’s busting at the seams.”

*Air Products & Chemicals*

“We are out of capacity as a country on virtually every segment in the transportation industry at the same time.”

*Norbridge Associates*

“None of us can do business the way we did last year. The volumes are simply too high.”

*International Transportation Service Terminal (Port of Long Beach)*
Record Traffic Means RRds Face Capacity & Service Challenges Too

U.S. Rail Traffic: % Change From Previous Year – Q1-01 to YTD Q1-06

In Response, RRs Are Increasing Capacity and Capability

- Stepped-up spending on equipment and infrastructure
- Infusion of technology
- New operating plans
- Cooperative alliances
- Aggressive hiring
- Working with customers
RRs Have Been Increasing Spending for a Long Time...

Class I Spending* on Infrastructure & Equipment Per Mile of Road Owned

*Capital spending and maintenance expenses less depreciation    Source:  AAR
...And Are Poised to Spend Even More

Class I RR Capital Expenditures ($ Billions)

- 2002: $5.7
- 2003: $5.9
- 2004: $6.2
- 2005p: $6.6
- 2006e: $8.2

p – preliminary  e – AAR estimate  Source: AAR
Railroading is Immensely Capital Intensive

Capital Expenditures as % of Revenue: Avg. 1995–2004

Sources: Census Bureau, AAR
Rail Employment is Up Too

Total Class I Employment

Source: Surface Transportation Board
First, Do No Harm

- Don’t Reregulate
- Reregulation looks to the past, not the future
- Staggers Act spurred investment, efficiency, innovation, safety
Return on Investment is Crucial

If ROI > cost of capital:
- Capital spending expands
- Stronger physical plant; more and better equipment.
- Faster, more reliable service
- Sustainability

If ROI < cost of capital:
- Lower capital spending
- Weaker physical plant, equipment
- Slower, less reliable service
- Disinvestment
Public-Private Partnerships Can Help Resolve Capacity Problems

“Relatively small public investments in the nation’s freight railroads can be leveraged into relatively large benefits for the nation’s highway infrastructure, highway users, and freight shippers.” – AASHTO

- Best used for projects whose main purpose is to meet public needs.
- RRs pay for their benefits and public pays for public benefits.
- Not “subsidy” to RRs.
Freight Rail Provides Major Public Benefits

- Fuel efficient
- Less pollution
- Reduced congestion
- Enhanced mobility
- Safer
Examples of Rail PPPs

- Alameda Corridor
- FAST Corridor
- Shellpot Bridge
- CREATE
- Alameda East
- Heartland Corridor
- MarOps
Tax Incentives for Railroad Capacity Expansion

“The rail industry today is stable, productive, and competitive, with enough business and profit to operate but not to replenish its infrastructure quickly or grow rapidly.”

– AASHTO

- 25% tax credit for projects that expand rail capacity.
- Expense infrastructure capital expenditures that do not qualify for credit.
- Will help bridge funding gap.
“As demand increases, the railroads’ ability to generate profits from which to finance new investments will be critical. Profits are key to increasing capacity because they provide both the incentives and the means to make new investments.”

– Congressional Budget Office