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RAILROAD REREGULATION UPDATE

The Latest Attempt to Increase Government Oversight

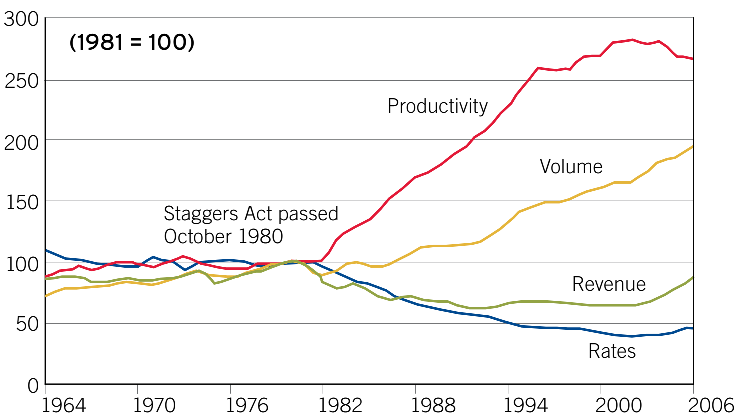
Ever since the federal government partially deregulated railroads with the Staggers Rail Act in 1980, there have been periodic attempts to rollback the legislation and increase government oversight of the industry. Most knowledgeable observers believe the latest attempt, pending right now in Congress, would cause severe damage to the safety, service and infrastructure gains railroads have made over the last 28 years.

Groups of shippers upset about rising freight rail rates are pushing the latest legislative action. They are asking for regulation that would fundamentally shift billions of dollars to shippers through new government regulation. Opponents of the legislation argue that enacting controls would lower rail revenues, and therefore, the dollars railroads have available to spend on infrastructure improvements and equipment.

Here are a few facts to consider.

Before the Staggers Act, nearly 25 percent of the rail industry was in bankruptcy. Freight rail rates were rising, and safety was deteriorating. The government forced railroads to provide services that the market did not support. Because profits did not allow railroads to invest in upkeep and replacement, rail infrastructure and equipment were in poor condition.

U.S. Freight Railroad Performance Since Staggers



Source: AAR

Since Staggers, safety and efficiency have grown along with rail traffic. The train accident rate is down 68 percent, the employee injury rate is down 81 percent, and productivity has increased 167 percent. These massive productivity gains have been passed along to customers. Average rail rates (adjusted for inflation) fell 55 percent from 1981 to 2006, saving shippers billions of dollars per year.

Employee salaries have increased since passage of Staggers. When adjusted for inflation, average wages at Class I railroads have increased 27 percent.

During the same period, railroads spent more than $420 billion on infrastructure and equipment, putting the nation's rail network in better condition than ever before. This year, all railroads combined are investing a record $10 billion in equipment, infrastructure and innovation. Union Pacific alone plans to spend $3.1 billion on capital improvements during 2008.

Ongoing expansion is necessary if rail is to continue moving products essential to the nation's health. Because of rising freight traffic in recent years, U.S. railroads have worked off much of their excess capacity. Demand for freight rail service is expected to continue growing. According to the U.S. Department of Transportation (DOT), freight railroad demand will rise 88 percent by 2035. As traffic grows, railroads will have to concentrate on building new capacity to handle the growth, in addition to restoring and replacing existing capacity.

Cambridge Systematics, an economic and transportation consulting firm, recently studied the DOT projections and estimated the cost of the rail traffic increase. According to Cambridge, it will take investment of $148 billion (in 2007 dollars) to keep pace with economic growth and meet the DOT's forecast demand, while maintaining rail's current market share. That's in addition to the hundreds of billions of dollars necessary to restore and replace existing rail infrastructure over the same period. This assumes no shift from road to rail, which may add to demand for rail.

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The Latest Attempt to Increase Government Oversight (continued)

The study also found that, if capacity needs are not properly addressed by 2035, an estimated 16,000 miles of rail corridors will be so congested that a service breakdown would occur, disabling the U.S. rail system.

Even though rail profits have improved in recent years, railroads still do not earn enough to cover their cost of capital. Even in 2006, when railroads moved record volumes of freight and had record profits, rail earnings were still lower than most other industries. In 2006 the median return on equity for firms in the Fortune 500 was 15.4 percent. For railroads on the list, the return was 15.0 percent. In reality, however, these return levels are overstated because they don't take into consideration the high replacement cost of rail assets. On a replacement cost basis, rail returns would be several points lower. That is why the American Association of Railroads filed a petition with the Surface Transportation Board in late April 2008, asking the agency to institute a rulemaking proceeding to adopt the use of replacement costs to determine whether freight railroads are earning adequate revenues.

Return on Equity: Selected Industries – 2006

Industry	ROE%
Oil & Gas Equip., Services	31.8%
Petroleum Refining	30.7%
Pharmaceuticals	24.2%
Mining, Crude-Oil Prod.	21.8%
Aerospace and Defense	21.5%
Chemicals	20.9%
Beverages	18.0%
Fortune 500 Median	**15.4%**
Food & Drug Stores	15.4%
Railroads	**15.0%**
Energy	14.9%
Food & Grocery Wholesalers	14.8%
Motor Vehicles & Parts	12.6%
Utilities: Gas & Electric	10.6%
Packaging, Containers	9.6%
Telecommunications	6.4%

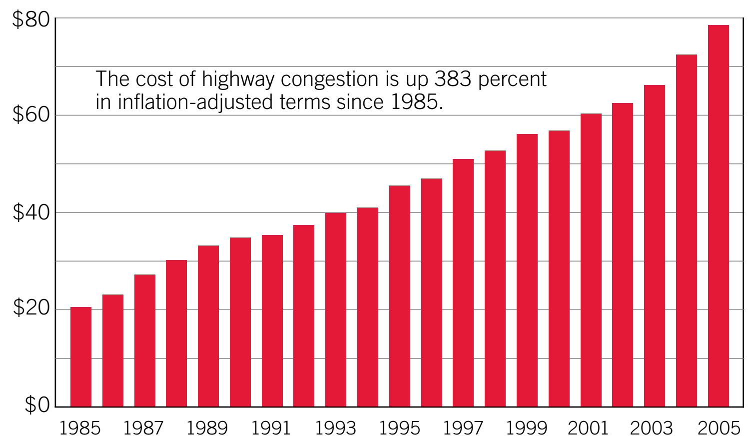
Source: Fortune (April 30, 2007)

To expand infrastructure and service, railroads must, like every other business in a free market economy, set prices that give them the resources they need to support the growth their customers want and need.

This is critical in an era of rising fuel prices, since railroads are one of the most environmentally friendly modes of transportation.

- Because railroads are, on average, three or more times more fuel efficient than trucks, every ton-mile of freight that moves by rail instead of truck reduces greenhouse gas emissions by two-thirds or more. Union Pacific moves one ton 290 miles on one gallon of diesel fuel
- According to the EPA, a typical locomotive is far cleaner than a typical truck in terms of pollution per unit of freight moved.
- A typical train takes several hundred trucks off our highways. Railroads help reduce highway congestion, the costs of maintaining existing roads, and the pressure to build costly new roads. According to a study by the Texas Transportation Institute, the annual cost of highway congestion in the United States is $78 billion just in wasted travel time (4.2 billion hours) and wasted fuel (2.9 billion gallons).

Estimated Cost of U.S. Highway Congestion Due to Wasted Travel Time and Wasted Fuel
(Billions of Constant 2005 Dollars)



Source: Texas Transportation Institute

Many shippers oppose current efforts to reregulate the industry. The Waterford Coalition – made up of rail customers like Target, Nike, Michaels Stores and Hewlett-Packard – has written to Congress to express concern that the legislation "may needlessly and unfairly set rates and mandate service for only one segment of freight rail users at the expense of other customers." The Coalition is encouraging Congress to "consider policies to promote freight rail expansion that serve the interests of all users."

Even with the Staggers Act, rail remains a partially regulated industry. The Surface Transportation Board (STB) still retains authority over a variety of non-rate areas and can set maximum rates for a large portion of rail traffic. The STB also can take other action, if a railroad is found to have engaged in anticompetitive behavior.

A Regulation Perspective

John C. Kenefick

Few are as familiar with government regulation of the rail industry as John Kenefick, former UP chairman and chief executive officer. Kenefick began his railroad career in 1947, when virtually all shipping rates were regulated by federal or state government entities. During the 1970s, he prepared the company to take advantage of a deregulated industry, which emerged following passage of the Staggers Act in 1980. Kenefick's foresight on acquisitions, entering new markets and establishing new rail corridors laid the groundwork for Union Pacific's position as one of North America's largest railroads. Here are his insights:

What were the effects of regulation on railroads before the Staggers Act?

Well, a lot of railroads went out of business, partly because of outdated regulation. There was no ability to respond to market conditions or compete on the basis of efficiency, because the Interstate Commerce Commission had to approve all rates, and every railroad had to charge the same rate for a commodity between two points. Also, railroads could not easily get out of unprofitable operations or abandon unprofitable lines. Eventually, many railroads went into bankruptcy, including the Rock Island, the Milwaukee Road, and all of the railroads in the Northeast. Some of these railroads disappeared. In the East, the government had to spend billions of dollars of taxpayer funds to rebuild the railroads.

As the 60s and 70s rolled along, you obviously started to see competition from trucks and the evolution of Interstate highways. How did discussions start that ultimately led to creation and approval of the Staggers Act?

I certainly recall the discussions because I was there when those were being held. Because we were regulated on what we could charge, we had to sit by and watch trucks take the best business. A couple of examples help clarify the situation we faced. We used to haul sugar beets from the farms and elevators to the refineries, and the rates set by the government were very low to appease the farmers. But then we would ship the sugar from the refineries to the processors, and the rates to haul refined sugar were high. When the trucks came in, they took the profitable sugar business, leaving us with the poor rates for moving beets. It really hurt the business.

How did you focus the discussions with Congress?

There was much discussion on how to best deregulate and what it would do to prices. Ironically, there was virtually no discussion of a shift to contract rates. It was a side issue.

So contract rates, one of the most profound aspects of the Staggers Act, was almost an afterthought?

Exactly. It turned out we had a new opportunity that we didn't know existed. If you look at the Staggers Act, it was intended to allow certain levels of rates to be set to cover costs. It never occurred to us that if we could receive a contract rate for 1,000 carloads of coal, we could also get a contract for a single carload of freight. It shows government intervention can have unintended consequences.

So did you get out on the railroad a lot?

You're darned right I did. In the old UP days, I made two inspection trips a year. We covered all of the main lines by daylight twice a year. By the end of each trip, we had a good idea of where capital was needed. With deregulation, we had an opportunity to look at where we wanted to build new lines or branch lines, especially if customers came to us and asked for a service.

As you know, there is some discussion in Washington about the need to re-set some industry regulations. What risk do you see to Union Pacific and the other railroads?

Reregulation has only one real goal: to reduce rates, take money from railroads, and put it in the pockets of shippers. If that happens, railroads will invest less in new capacity and the rail industry will be smaller. The nation needs us to expand to help with highway congestion and environmental challenges, but reregulation would restrict what we can do. It also would reduce hiring and could hurt maintenance and safety. I hope people on Capitol Hill are smart enough to see these problems.

International Reregulation Perspectives

Henry Posner III

The implementation, or even the prospect of implementing reregulation as contemplated in the USA, will have the economic effect of transferring value from railroads to their customers; this, in turn, will have a direct impact on railroads' ability to fund their infrastructure. This is a politically expedient but shortsighted approach: certainly in the short run customers may see rates go down, but at the same time, those customers want increased capacity, and there's no way to increase capacity while at the same time railroads suffer reduced profitability. This is basic Economics 101.

My experience is that no matter where you go in the world, as long as you have the freedom to run your railroad like a business, there should be capital available to fund the operation and infrastructure, much like we have in North America. But capital is always smarter than we are, and smarter than any of the regulators and politicians we've had to deal with over the years. Whenever you introduce either unfair regulation or the prospect of unfair regulation, your sources of funding will vaporize because capital does not like risk.

After Estonian Railways was renationalized by the government, the company lost half of its business and went from handling 40 million annual tons to 20 million annual tons. The lesson from this is that railroads are only as good as the countries in which they operate. You can have a perfect railroad; but if your country takes unwise political actions, or if there is a political disruption, your railroad will be worthless. More importantly, it will be unable to fulfill its natural role as a major contributor to the national economy.

Henry Posner III is a founding principal and chairman of Railroad Development Corporation (RDC), a railway investment and management company with interests in the U.S., Argentina, Peru, Guatemala, Malawi and Mozambique. RDC (www.rrdc.com) was also a shareholder in Eesti Raudtee (Estonia) until its renationalization in January 2007. He serves as chairman of Iowa Interstate Railroad; chairman of Ferrovias Guatemala, which suspended operations in September 2007 as the result of actions taken against it by the public sector and is now in binding arbitration under the Central American Free Trade Agreement; a director of America Latina Logistica-Central (Argentina); and a member of the AAR's Security Working Group. He also serves as a member of the advisory board of Princeton University's Institute for International and Regional Studies.

Edward Burkhardt

Rail deregulation enacted by the United States in 1980 has been hugely successful. It has accomplished everything it was intended to do.

Any government action that places higher regulatory burdens on the carriers will turn out to be counterproductive. Those who understand transportation issues recognize there are always going to be different pricing levels based on different commodities' needs and ability to pay. In fact, that has occurred under both the current deregulated scenario we have and the previous regulated regime. There's nothing wrong with this. In fact, it is the way a free market works.

When certain special interests among the shipping public act scandalized about differential pricing, it's simply because they've got an ax to grind. Under reregulation, their profits – which are sufficient to allow them to pay their rail charges – would go up, while rail profits would go down.

I'm very encouraged to see the rail industry finally getting to the point of earning its cost of capital, and am excited to see a renaissance in the railway business after years of decline. If the object of reregulation is to pull down the share of the market-based prices going to the rail carriers in favor of certain politically-powerful rail customers, then we are going to reverse the gains experienced since deregulation and get into a situation where the railways are once again consuming rather than generating capital. We suffered with that for years, and it almost killed our industry. That's a fact.

Edward Burkhardt is the founder, president and CEO of Rail World, where he has led investment groups that privatized and restructured the Estonian Railway and purchased railway assets in the United States and Canada. He has been involved in a number of other successful railway privatizations around the globe, including in New Zealand, Australia, Canada, Poland and the UK. Prior to creating Rail World, Burkhardt founded and was chairman, president and CEO of the highly successful Wisconsin Central Transportation Corporation. Previously, Burkhardt spent more than 25 years with several Class I railroads in the United States, including 20 years with Chicago & North Western Transportation Corporation. He currently is Chairman of Montreal, Maine & Atlantic Railway, a 750-mile regional railway serving Northern New England and Eastern Canada.