

Financing Rail Freight — Contrasting Lessons from Europe and the USA

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Railroad Development Corporation (RDC) is a direct investor in wagonload-oriented rail freight businesses worldwide. So today I would like to talk about my favorite subject—the wagonload. But don't worry, I do know that I'm in Europe!

Background on RDC

I think the most interesting part from a European perspective about RDC is to note the diversity of businesses that we've invested in the past, including Europe. Note at the bottom of the table that RDC is entering the railway business in Germany with Hamburg-Köln-Express which is a start-up intercity passenger business that will be launched later this year. So we are putting our money where our mouth is in Europe...but that's a different subject, as this is a freight conference.

Country	Entity	Length Km (Miles)		Employees	Average Tons (in millions)
CURRENT:					
USA	Iowa Interstate	954	(592)	215	13.5
Argentina	ALL Central	5,690	(3,535)	1,200	3.3
Argentina	ALL Mesopotamica	2,704	(1,680)	300	1.0
Guatemala	Ferrovías Guatemala	322	(200)	13	N/A
Peru	Ferrocarril Central Andino	535	(332)	431	1.9
PAST:					Tons Last Yr of Investment
Malawi	Central East African Railways	797	(495)	417	0.22 (2008)
Mozambique	CDN-Nacala Corridor	873	(542)	404 Rail 209 Port	0.2 Rail (2008) 0.9 Port (2008)
Estonia	Eesti Raudtee	693	(431)	2,345	44.4 (2006)
FUTURE:					
Germany	Hamburg-Köln-Express	450	(280)	60	N/A

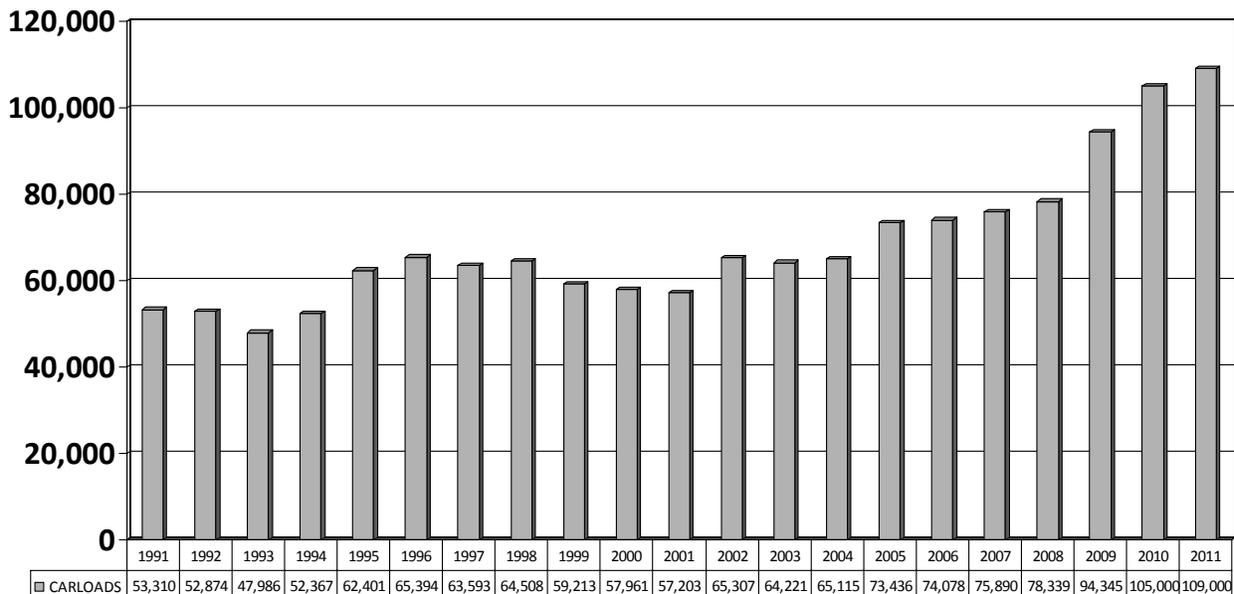
North American Case Study: IAIS

The Iowa Interstate Railroad (IAIS) is our Flagship and roughly the size of Nord Cargo in terms of volume, employment, and interestingly, turnover. But IAIS is a formerly abandoned railway. Safety culture is our main focus. We have been able to finance new locomotives which cost US\$2.8 million each and justified them purely based on the fuel savings.



Our bread and butter is the wagonload business and shown is a photo of a typical IAIS train hauling mixed traffic. Note that the traffic results in the Table (below) start at “0” on the scale, which fairly shows growth. I’ll be the first to tell you that it is better to be lucky than good. These results are based on the evolution of markets that did not exist when we originally made our investment in the railway, but that’s the whole point. You can’t be lucky unless you’re standing there already. So we survived some early times to become the railroad we are today.

IAIS TRAFFIC



Differences Between North America and Europe

The obvious conclusion is that Europe is for passengers, and freight is difficult; and America is for freight and passengers are difficult. That is why the USA is reaching out to Europe for help as we try to deal with our own desire to improve the passenger business.

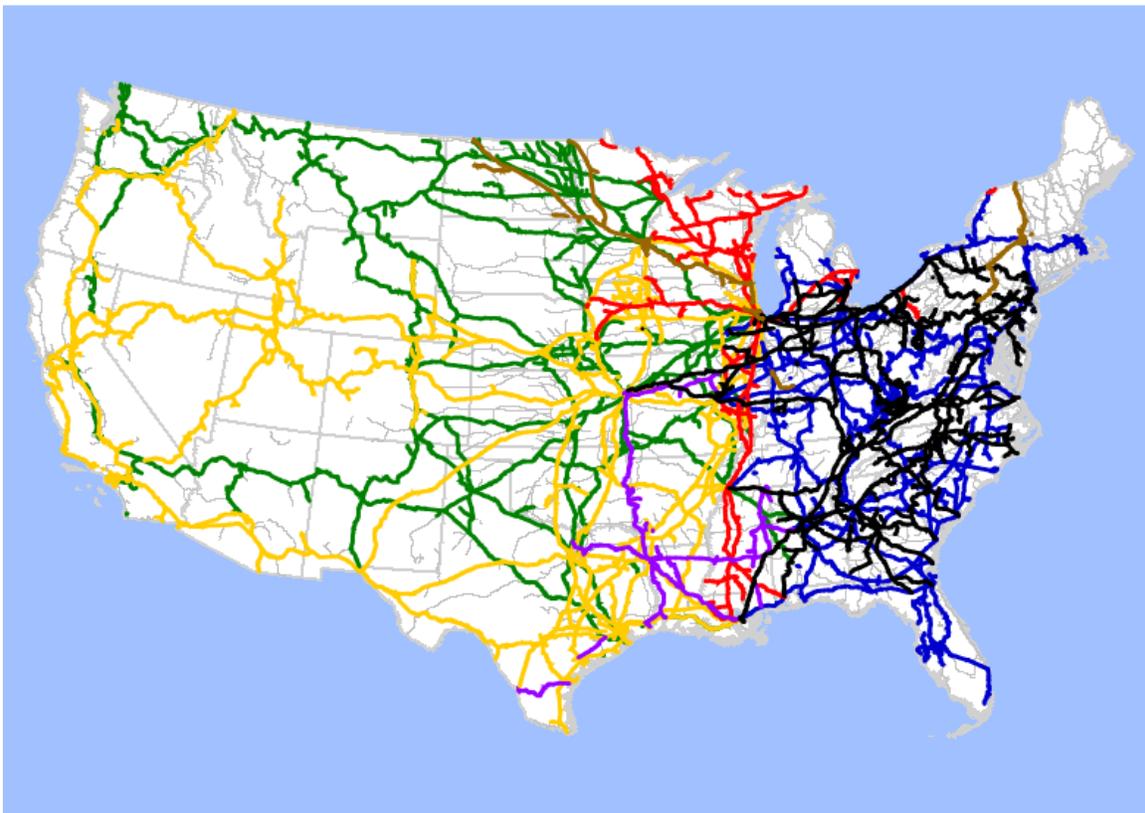
However, more important than the physical differences are the institutional differences. Note the right-hand column where I tried to point out the difference between what drives

Physical Differences:	North America	Europe
Distances	Long	Short
Traffic Patterns	Concentrated	Fragmented
Competition	Other Rail	Truck
Capacity Constraints	Line Capacity	Clearances
Orientation	Freight	Passenger
Institutional Differences:		
Traffic Driver	Competition	Regulation
Rail Competition	Parallel Rail	On-Rail
Infrastructure Control	Operator	Regulator
Funding	Private	Public

the process in Europe vs. North America. In my opinion, Europe is driven more by regulation than competition. Also, note that rail competition is primarily on the same lines as opposed to parallel lines. And a lot of the funding comes from the public. So these are not positives when it comes to reasons for investment.

However, I would like to argue that the commercial issues that we face in Europe are the exactly same as we have in North America. Please note the North American map (below) where we have lots of main lines that basically compete with each other. A college friend of mine by the name of Eric Schmidt who is the CEO of Google has described the railway business as “a network business.” There are many similarities between communication businesses and railway businesses. A major difference, however, between Europe and North America is that we have lived with deregulation for 30 years and have developed a body of institutional knowledge, but one that is very difficult to describe and document. So the best way to translate it is by actually coming to Europe and doing something!

North America: Parallel Competition in USA



Let me pick up on a point that we heard this morning which is the difference between cooperation and competition. Looking at the map you'll notice that east to west the railways run parallel to each other, but there are lots of moves where competing railways share in the interline movement of traffic. For instance, CSX and Norfolk Southern are competing in some markets and at the same time they're cooperating in other markets. They're cooperating in order to compete with trucks. That is exactly the commercial theme of North America—cooperation, which is very different from collusion!

In my opinion, the table below illustrates what I feel drives the business in Europe. Please note the top line under North America, “competition as result of deregulation,” as opposed to Europe where “regulation forces competition” but does not encourage cooperation. The only way you can win business from trucks in a network business is through cooperation.

Freight Business Drivers (descending priority)

PRIORITIES	CUSTOMERS Worldwide	NORTH AMERICA Competition as Result of Deregulation	EUROPE Regulation Forces Competition
1	Rail as Option	Rail as Option	Rail as Option
2	Capacity	Capacity	Competition
3	Service	Service	Service
4	Competition	Competition	Capacity

COMMENT: for rail competition to exist, there must be rail capacity and service!

If you look at Business Trends, and I always like to think of the wagonload as the “canary in the coal mine” because it is easy to run coal trains downhill, and most railways in Latin America and Africa are single-purpose railways where they are very efficient in moving rocks downhill. Well, there is more business to be had than rocks that need to move downhill.

Freight Business Trends

	North America	Europe
Wagonload Traffic	Stable	Declining
Operator Focus	Common Carrier	Customer-Specific
Financial Performance	Stable	Declining
Market Share	Increasing	Declining
Ownership	Private	Public

I would like to argue that the most important line in this exhibit is the “Operator Focus” because in North America we are common carriers, whereas in Europe you have block train operators and their focus is either on containers or minerals; the idea of general cargo cooperation doesn’t go very far. But the reason to focus on being a common carrier is because every year 10% of your customers go away as markets change and industry restructures. And if you keep on downsizing the network to reflect your remaining customers, you will go out of business. The great thing about the Iowa Interstate Railroad and why we were so lucky is because we were standing there when new businesses came along and our general cargo railway was available to handle businesses that nobody had heard of such as ethanol, fracking sand, and the other new businesses driving growth in North America.

Conclusions

Railways are a network business and only as strong as the weakest link. For example, in the USA there is an interchange of traffic among 600 privately owned railways; in Estonia (an EU country where we were a shareholder) the railway is 90% dependent on Russian traffic; and in the Nacala Corridor (Africa) the

business is based on 2 railways and 1 port. All of these are examples of cooperation and each one is a competitive business in terms of both rail competition and truck competition.

Wagonload

Next let’s focus on my favorite subject—the wagonload, which is driven by cooperation. In my opinion, the wagonload is a niche product, and a value-added niche product at that, and it is a better business than the trainload business.

I gave you the example earlier about being ready for unknown markets. Please note the last line of the following exhibit, “positioned to serve *unknown future markets*,” because nobody knows what the demands on the network will be five years from now. But one thing is for sure and that is if you cut off access to the network, which is one of the things that inhibits rail freight in the UK—the lack of access to private sidings—then wagonload won’t be possible in the UK, with very few exceptions. As businesses emerge, they find that they are landlocked away from the railway system and no have choice but to use trucks.

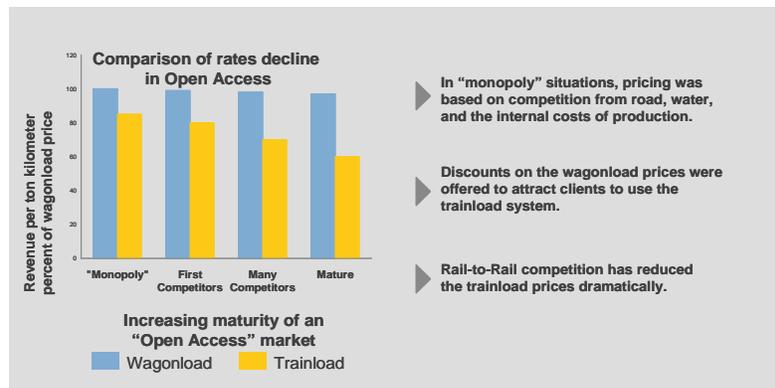
Wagonload: A Better Business than Trainload

ECONOMIC	→	Trainload = Commodity Wagonload = Value-Added Niche
MARKETING	→	Wagonload can serve medium and small customers; <i>a broader and deeper market</i>
STRATEGIC	→	Flexibility of wagonload; positioned to serve <i>unknown future markets</i>

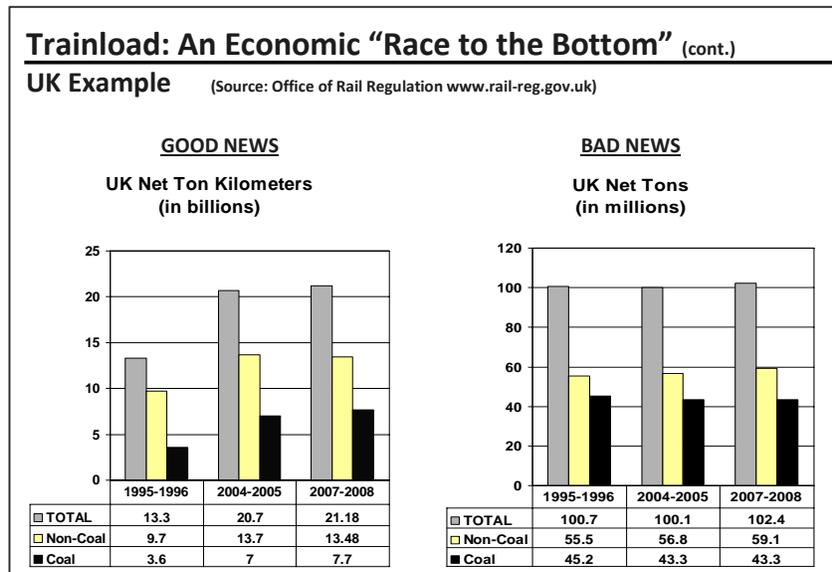
A commercial example that comes from Oliver Wyman is that with the passage of time, block trains are a “race to the bottom” which is not unlike the U.S. airline industry. It is ultimately all about price and who will pay the lowest wages and go bankrupt enough times to keep flying.

Trainload: An Economic “Race to the Bottom”

European Example (Source: Oliver Wyman, Prague Rail Conference, 2008)



Looking at what happened in the UK, a lot of the growth was simply driven by the collapse of the domestic coal industry. I would argue that that is not a great reason to close your local coal mines to import the coal a longer distance from the port so that you can restructure your railways.



How Wagonload Can Be Profitable

- Reduced shunting = increased reliability, speed...
- ...therefore lower cost, more valuable product
- More valuable product = higher revenue/wagon
- Lower costs also include asset utilization; risk sharing with asset owners, etc.
- Promote creation of, and full commercial integration with, short lines (and international connections)

Let’s focus on the wagonload as a flexible alternative. Note the last line of the exhibit that I’ve underlined, “full commercial integration”. The reason that short lines work in the USA is because short lines are considered a strategic value-added for the major network carriers. If the Class 1 railroads are not interested in seeing the short lines succeed, the business would not exist. It is a fact that there are 600 privately owned railway companies in the U.S.; 7 of them are Class 1s, and everyone else is a feeder.

“Soft” Benefits of Wagonload – Example: France

Environmental:	Most haulage electric
Congestion:	500,000 wagonloads = 1,000,000 trucks
Economic Development:	Platform for regional growth
Employment:	Thousands of jobs (including local trucking)

So let’s translate that to the specifics of a country like France. France should be an ideal country for wagonload because most of the haulage is electric, from nuclear power, the perfect green alternative for freight transportation. A few

years ago, they were hauling 500,000 wagonloads, which is equal to a million truck shipments. It doesn't get much better than that. And more to the point, there is a pervasive network of private sidings. But unfortunately that's not the way it has worked out so far for France.

So what is the opportunity? I would argue that it would be a partnership with network carriers, government as needed, and others, but also point out that the network carrier part is an absolute necessity. It is nice to have government support but as we've heard, government would *like* to take trucks off the highway, and they'd *like* to reduce pollution, and they'd *like* to have a sustainable environment, but how far has that gotten Europe? At best, it's been a subsidy to the consulting industry; it makes people feel good, but hasn't really addressed the problem.

So what is the answer? I think the answer is to recognize at the European level that this is a network business and if it's going to succeed, it must be based on cooperation. Some of those answers include X-Rail, others include short lines as they are evolving, and sometimes for light density lines there needs to be at least an upfront public sector investment which is quite common in North America. Even our own Iowa Interstate Railroad began with a loan in the State of Iowa that was 100% secured by the value of the track, but there was public funding involved. That loan was paid back a long time ago, but the point was they took a long-term view and decided that being on the network was valuable.

A Plan for Wagonload

So here's the plan. Note there is a hole in the market because you have all of the basic ingredients including client support to a certain extent, but clients do not have unlimited patience.

And the risk is relatively low because it's a diverse portfolio of businesses and the competition is truck, etc. But clearly there is a hole in the market that a private sector company should be very interested in exploiting.

Basic Ingredients Exist...	...And Risk is (relatively) Low
<ul style="list-style-type: none"> ▪ Client support ▪ Human capital ▪ Physical assets (including yards, private sidings) 	<ul style="list-style-type: none"> ▪ Diverse traffic base ▪ Defined competition (truck)
Missing Ingredients...	
<ul style="list-style-type: none"> ▪ Commercial framework for <u>truck-competitive, interline cooperation</u> ▪ Financial commitment to re-capitalization (not subsidies!) ▪ Dedicated (i.e. separate) management ▪ Institutional will 	

What's missing is the cooperation piece and getting the network carriers to agree that feeder lines are a good thing. One thing that may happen is that with the retrenchment of the state railways, if only by default, that creates a bigger opportunity for new entrances to come in. Just as importantly, note the last line "institutional will". This is not for the faint of heart in Europe, and not like it was in the USA, and just like going into Latin America and Africa was not for the faint of heart either.

Wagonload: Vision

Let’s talk about what it might look like more in the long term than the short term. In the short term, in an ideal world all of a sudden the state railways would realize that they need to stabilize the wagonload business and hope that they could

	Strategy	Execution
SHORT TERM	Stabilize	Network Operators
LONG TERM	National Network of Commercially-Independent Operators	Network & Local Operators

transition that to the private sector. That is probably a stretch goal. However, in the long-term I think that it will see an evolution of a *national network of commercially-independent* operators and it will start to look like a European version of the North American network. The way this will happen is by cooperation between the “network and local operators”. For the most part those would be feeder lines—either existing feeder lines; or new ones to be created; or network carriers that, for the purpose of serving local markets, would somehow figure out a way to do it on a retail basis.

Let’s now discuss the institutional and cultural needs. I like to use the words “institutional” and “cultural” because it gets you away from the micro focus on the European loading gauge, European signal systems, electrification, etc. The commercial theme is the same as it is in North America: encouraging cooperation, not collusion, when the competition is trucks; and also recognizing that the competition is between railways and trucks, which is why the wagonload business can be an interesting business.

Market Valuation of Wagonload vs. Block Train

If you look at how I think the financial market has started to value these things, and if you look at what it would cost to buy a block train business today, I would argue that it is more of a liquidation price—what the value is of used locomotives and rolling stock in order to recreate yet another company. In that respect, it’s not unlike what the airlines are doing in the USA.

		Financial Markets	Transportation Markets
EUROPE	Block Train	Liquidation	Commodity
	Wagonload	Unknown	Niche
USA	Block Train	Short-Term Niche	Long-Term Commodity
	Wagonload	Niche	Niche

The European financial market for wagonload is not really known but it is certainly a niche market. Comparing that with the USA, I think the block train businesses in the USA are going to suffer. At CSX’s short line conference last week, it was reported that their single biggest weakness has been their coal train business, which is a block train business. As an investor, investors like to see the word “niche” and in competition with trucks, rail is a niche for wagonload business. Note the word “unknown” in the exhibit above; I think that’s the investment opportunity right there.

So what does a North American company bring to Europe? I would argue that first and foremost is: how do you translate the mechanics of how cooperation is going to work into a network of independent operators? How to do so is almost folkloric but it can be done and the easiest way to do it is to get something going here in Europe. The other point is investment. I’ve heard even today that no one is interested in investing in wagonload, but that’s not true, because that’s why I’m here.

In conclusion, RDC has been focusing on two things this year: (1) our passenger business in Germany, and more to the point, (2) we think that in France there may be the possibility to get involved in the wagonload business and we're looking at a number of ways of doing exactly that. It will be difficult and it is not for the faint of heart, but there are fundamental aspects of this business which can make it at least a good business if not an excellent business.

Thank you very much.

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