



RAIL LOG NETWORK

Paneltech International LLC

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Rail Infrastructure- Part 2- The Real World

On September 9th we, along with 436 other rail shippers, attended a rail forum sponsored by the AAR in Kansas City. Roger Nober, chairman of the Surface Transportation Board, called the class 1 railroads to the session to explain their preparations for the fall "peak season" surge in rail volume.

Arrayed across the front of the very crowded room were senior executives from the KCS, BNSF, CSXT, UP, NS and CP as well as Mr. Nober and Ed Hamberger of the AAR. For whatever reason, the chairs behind the CN placard were empty and the CN didn't participate.

Most of us never get a chance to watch the leaders of the U.S. rail industry and their overseer, the STB, in action in such circumstances. In retrospect, we were struck by two things at the session: 1) the forum's apparent inability to come to grips with and to seriously address the growing need for incremental rail infrastructure investment and 2) the (to us) bizarre railroad-STB working relationship.

It may be too early to say we are in the midst of a full-fledged rail infrastruc-

ture crisis but, as Mr. Nober stated at the meeting, "We may be at its leading edge." The driver? Strong, year-after-year growth in Asian imports (You can find the chart, used by Mr. Nober in Kansas City, a chart illustrating the steadily climbing trend in Asian imports, on the STB's website).

"...the recent rail congestion problems suggest that U.S. railroads may have reached the practical limit of their productivity increases without major expansion in the capacity of their basic infrastructure. Increasing the volume of freight movements on a fixed network by handling larger shipments over a longer distance at greater velocities cannot be continued indefinitely. Indeed, one of the lessons of the western railroad crisis is the sensitivity of current railroad operations to even a slight downturn in the velocity of the system."

**William Brennan
USDA Agricultural
Marketing Services
July 1998**

This growing rail demand problem must be exacerbated by the massive amounts of capital required, the "lumpiness" of such investments and the difficulty the railroads undoubtedly face when trying to justify these investments to industry analysts and their investors.

So what will the rail industry do about this supply/demand imbalance? Last month we repeated McKinsey's advice- divide up operating and asset management functions within the railroads. While this seems sensible, it is also very unlikely. It is far more likely that railroads will: 1) Try to squeeze more capacity out of current assets, 2) Ration their capacity through a mix of higher rates and restricted service and 3) Exploit their pricing power, as it becomes imperative, to garner adequate rates of return.



**PANELTECH
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BUSINESS GUIDELINES

- *Learn all we can about what our customers need so we can do everything in our power to provide it*
- *Continuously reduce our costs of operation so we can pass cost savings on to our customers*
- *Safeguard the assets (logs) that our customers entrust us with*
- *While protecting genuinely proprietary information, serve as our customers' "eyes and ears" where we operate*
- *Reward loyalty with loyalty*
- *Grow the rail log network to improve network efficiencies, to enhance customer market power*

"If BNSF doesn't make enough on the operating earnings side, we must pull back on assets associated with our lowest profit traffic...Eventually, we will be "right-sized" as the profitability of remaining traffic yields returns that exceed our cost of capital. That is simply the way free enterprise must work."

**Matt Rose
BNSF CEO
Senate Testimony
May 9, 2001**



The impact on the forest products industry? Not good if you are an undifferentiated timber seller; reduced mobility will lead to fewer log sales options and reduced bargaining clout with mills. Not good if you are a mill owner either, especially if your mill is off the beaten track and singly rail-served; while reduced log sales options will give the mills more bargaining power with log sellers, the railroads could theoretically capture all mill economic profits as they seek to boost their ROI's to justify the new infrastructure investments. The general public's likely reaction to mills who complain about being in this unfortunate "captive shipper" situation? "That's between you

and the railroad—we're not impacted by your division of those profits anyway. We have our own infrastructure problems—severely congested roads—and this may also help address our mobility problems." The end game? Lower timberland rent will make timberland conversion to other uses (land development, recreation uses, conservation, etc.) far more attractive (see flowchart on this page).

How will the railroads manage to squeeze more capacity out of their very costly rail systems? They will likely be forced to change their marketing focus. It seems likely that they will transition from marketing to specific industrial customers to selling more standardized services to "all comers" seeking point-to-point rail services. The offer? "We don't care how you get your cargo to our regional rail hub but, if you meet the requirements of our hub, here's a very competitive rate to take your cargo to this destina-

tion hub". This also suggests an opportunity for specialist regional gatherer-distributors.

Rail Industry Cost of Capital = 9.4%
 Rail Return on Capital = 6.8%

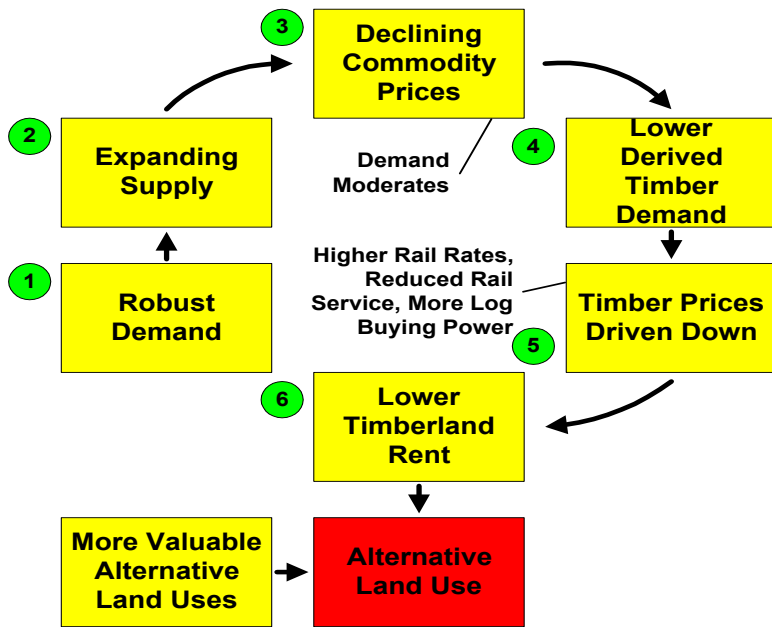
Roger Nober
 Kansas City Meeting

What about the STB? Aren't they charged with making sure that rail rates are *fair*? Hasn't Mr. Nober gone out of his way to make certain that even the smallest shippers voices are heard? Don't bank on long term help from the STB if you are a captive shipper (see article on page 3). If you look back at the late-1970's rail "deregulation" process, the politicians seemed to simply run out of political options— they either had to deregulate the railroads or to fully nationalize them. An equally

difficult choice— let the railroads fully exercise their pricing power or embark on more massive public transportation infrastructure funding— will likely soon confront politicians. A more efficient multi-modal system that provides affordable access to the growing imports of manufactured products, a more highly-specialized system that focuses the railroads' efforts on

their inherent competitive advantages (versus head-to-head competition with more flexible trucks), a system that provides the railroads with rates of return that are acceptable to their investors thereby justifying needed incremental infrastructure investments— that, it will likely be argued, is a system that is more *fair*, more fair to our entire nation.

We are enjoying one of those "\$100 million years" that we have written about in the past. It is easy, at such times, to ignore and put off, as those at Kansas City did, this serious infrastructure funding issue and its likely long term impacts on all of us.





The STB, Captive Shippers and New Mill Investments

Roy reports from his trip to Kansas City that Roger Nober seems to be a much more shipper-friendly leader of the STB than was Linda Morgan. He had an opportunity to visit one-on-one with both of them— at the hearings on the proposed BNSF-CN merger with Ms. Morgan and more recently, in Kansas City, with Mr. Nober. Why, then, do we so readily dismiss the STB as a viable protector of rail rate “fairness” for small, captive shippers?

As the yellow insert on this page from the GAO makes vividly clear, the STB rail rate dispute resolution process isn’t shipper-friendly. It is decidedly small shipper *unfriendly*, in our opinion. However, this isn’t a clear, “good guys” and “bad guys” situation. When Congress, via the Staggers Act, granted the railroads the right to charge their customers the prices that the market would bear, they were undoubtedly swayed by the recognition that the railroads had to improve their economic viability if they were to avoid nationalization or continued public subsidies.

Most mills have been very profitable this year and many are reinvesting surplus cash back into their processes to improve their relative, long term cost positions, to help them perform better in more typical, fully-supplied markets. Would “captive” mills make these investments if they believed that those new investments would yield economic profits that might very well flow not to the mills’ investors but, instead, back to their rail services provider? We doubt that they would.

“After a shipper files a complaint, the Board assesses whether the railroad dominates the shipper’s transportation market...The board first determines the railroad’s revenues and variable costs associated with moving the shipper’s commodities. By statute, a railroad does not dominate the market if its revenue is no greater than 180 percent of its variable costs for transporting the shipper’s commodities. If the railroad’s percentage exceeds the statutory level, the Board next determines whether the shipper has a competitive alternative in the form of access to other railroads or other forms of transportation (trucks or barges). ..If the Board finds that a railroad dominates the shipper’s market, the Board proceeds with further assessments to determine whether a rate is reasonable. Under its standard guidelines, to determine whether a rate is reasonable, the Board requires the shipper to demonstrate how much an optimally efficient railroad would need to charge. To accomplish this task, the shipper must construct a model of a hypothetical, optimally efficient railroad to replace the dominant railroad. ..constructing a hypothetical railroad is a difficult task, particularly for small shippers, because the time and cost associated with the model’s development may outweigh the compensation afforded the shipper should the Board determine that the challenged rate was unreasonable. The 4I rate complaints that GAO reviewed cost shippers from about \$500,000 to \$3 million each and required a few months to about 16 years to resolve through the rate complaint process...”

GAO Reports
March 2, 1999

In a September-October 1999 *Harvard Business Review* article, Peter Baumgartner stated, “As value has shifted toward the customer, distribution— once the backwater of strategy— has become the mainstream.” Ignoring distribution, focusing exclusively on internal process efficiency, could be a serious mistake for these captive mills. Few of them have much pricing power in their end use markets. While many have log purchasing power, every day there are more competitive, alternative uses for the timberlands they depend upon.

“...during the most recent downturn, railroads resisted lowering rates. This change in mindset among the railroads breaks a long period of ongoing price reductions for shippers...Better pricing also recognizes...the need for the railroads to earn a return on capital invested.”

Moody’s Investors Services
North American Railroad Industry Outlook
January 2004

“There is no real national housing market in the US, so localized bubbles co-exist with very weak property markets. Up to 15 metropolitan areas could suffer a price crash of 10-15% as interest rates go up, warns Dick Berner of Morgan Stanley— largely in regions which have seen values close to double in the past five years, confirming that prices can go down as well as down. During the first quarter of 2004, prices dropped in Vermont, North Dakota, South Dakota, Iowa and Nebraska... By contrast, prices surged by 12.2% on average across California, Oregon, Washington, Hawaii and Alaska...”

Allister Heath
The Business
 July 25, 2004

Recent Paneltech Developments

LOGS

We made substantial changes in our rail car allocation in September. We are currently moving cars in anticipation of expanded operations in Colorado. We made two new, longer term agreements with companies in the US South. We are moving a log loader and a large number of cars to Oroville, Wa (on the Washington-BC border) to transload logs from the BC Interior. Finally, we received word from the public authorities in So. California that they wish us to begin executing a plan we submitted to them, a plan that is primarily focused on the large volume of the more defective and stained logs in the area.

WEBS

The new resin plant started up after Labor Day, as we planned, and it is already in limited commercial production. Krishan is already hard at work, utilizing his new “tool”, to develop improved products for our customers. We are also in the process of bringing in some more technical help.

CONSULTING

Consulting activity has picked up a little in the past few months. We haven't changed our business focus (reduce industry consulting). On the other hand, when we find opportunities to do consulting projects that enhance our understanding of issues that are very important to our company and to our industry, we will, once again, put on our “consulting caps”.

Industry Discontinuities = Opportunities?

Over the past two months we have discussed the growing likelihood of a major “discontinuity” in our business environment— a discontinuity resulting from our rapid convergence on rail and highway infrastructure constraints. Large scale discontinuities like this tend to change the “rules” of competition. For instance, we often forget that we were forced to shut down 3BBF of PNW Lumber capacity between 1988 and 1994 as a result of the serious timber supply discontinuity, the “Spotted Owl” public timber withdrawal. We also often forget how disruptive it was to us when Japan’s financial markets crashed in 1989, reducing Japanese hous-

“French physiologist Claude Brenard once remarked, ‘It is what we think we already know that often prevents us from learning’...just as individuals can be blind to industry dogma, they can also be oblivious to deep change...Dramatic change always creates opportunities for radical innovation, but only if you’re paying attention.”

Hamel & Getz
Harvard Business Review

Very hot commodity markets like the ones we have enjoyed over the past few months promote what Fed Chairman Greenspan famously called “irrational exuberance”— overly-optimistic views of our future pricing and customer demand, notions that “this time it is different”. At such times, we tend to ignore fundamental changes in our business environment, to invest and to collectively over-shoot reasonable long term trends in demand. If Mr. Nober of the STB is right, if we really are at the leading edge of a transportation infrastructure crisis, we should carefully consider new investments that increase our class