

OLIVER WYMAN

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ex parte 683

Memo

To **Timothy Strafford, Surface Transportation Board**
Date **January 28, 2009**
From **Jeffery Elliott**
Subject **Notice of Intent to Participate in February 11, 2009 Hearing**

This memorandum serves as notice of my intent to participate in the February 11, 2009 public hearing on the Passenger Rail Investment and Improvement Act of 2008, before the Surface Transportation Board. The speaker will be myself, Jeffery Elliott, on behalf of Oliver Wyman, a leading management consulting firm. I am willing to appear at any time that is most convenient for the Board. I have also filed my written testimony under separate cover.

OLIVER WYMAN

February 11, 2009

Surface Transportation Board
Public Hearing Commentary

PASSENGER RAIL INVESTMENT AND IMPROVEMENT ACT OF 2008

Jeffery Elliott
Partner, Oliver Wyman

Oliver Wyman is a leading international strategy and general management consulting firm with deep industry and functional expertise.

**More than 30 years of experience
serving a range of industries**

- Automotive
- Aviation, Aerospace & Defense
- Communications
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- Industrial Goods
- Financial
- Life Sciences
- Media
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- Retail
- Surface Transportation
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Oliver Wyman serves as an advisor to a wide range of industry segments, including rail shippers, 3PLs, manufacturers, suppliers, and various providers of transport services.

A sample of our clients



What they say

"Without Oliver Wyman's recommendations, I believe we would have pursued a brand strategy that would *not* have generated nearly as much profit."

"Excellent senior, mid-level, and junior staff – a real exception to the norm and a differentiator among the large consulting firms."

"Your staff are a cut above the other consultants we see."

"Great value for strategy formulation while working against our ever-changing, shortened schedule."

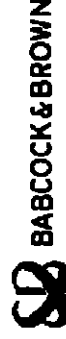
"Oliver Wyman helped our team lead themselves through the project, when possible, and led, when necessary. This 'empowerment' caused a lot of the project findings to stick and enabled the team to develop a personal conviction about the strategic options."

For nearly four decades, Oliver Wyman has provided assistance to railroads, regulators, government agencies, and investors in transportation. The firm has developed tools to help successfully address the specific needs of the industry.

Sample Tools Employed by Oliver Wyman

- **Financial modeling and forecasting**
 - Business unit strategies and financial modeling
 - Capex planning, asset allocation, and trade-off analysis
 - M&A support, diversion analysis, and synergy estimation
- **Capacity and throughput simulation**
 - Simulation of system capacities and bottlenecks across various components of the logistics supply chain
 - Software support of route and service planning
- **Operations auditing and improvement**
 - Capital planning and expansion project feasibility
 - Assessment of system performance, throughput, identification of improvement options
 - Engineering and mechanical transformation
- **Project management office**
 - Post-merger integration planning and execution
 - Coordination of investment decisions, e.g., timing of capacity expansions
 - Project planning and status reporting
 - Scope and schedule management

Sample Oliver Wyman Railroad Clients



Summary of findings

- Even at today's diminished traffic levels, portions of the freight rail network are congested, with significant bottlenecks.
- Over the next 25 to 30 years, US freight traffic will double, requiring unprecedented levels of capital expenditure.
- Today, virtually all freight rail infrastructure expenditures are financed by the private sector and secured by the financial performance of the railroads.
- Intercity and commuter passenger demand is also on the rise, and some passenger advocates see the need for approximately \$350 billion of investment by 2050.
- Passenger trains consume a disproportionate amount of rail network capacity. Increased use of portions of the freight network for passenger operations will tax the capacity at greater than twice the impact of freight.
- Passenger rail access to freight rail networks is currently provided through negotiations that ensure the owning railroad is fully compensated for the network capacity used by passenger trains.
 - Freight railroads currently accommodate passenger trains on a best efforts basis.
 - Arbitration mandated by PRIIA may adversely impact the current process by leading to a “rush to judgment” on very complex pricing decisions.
 - Passenger rail access disputes may be resolved in a way that does not compensate the host railroad for lost capacity...
 - ...And may lead to an imposition of penalties where there is not adequate payment for guaranteed service.
- The financial markets will likely see the implementation of these policies as creating contingent investment risk that will lead to increases in the cost of capital and/or the reduction in capital provided to private sector infrastructure owners.
- Without low-cost private funding, the private railroads will either need to de-market traffic or seek public funding from government entities.



The US railroad network is funded entirely by private investors. For equity alone, \$47B is provided by the top 25 investors.

Top 25 Investors in Major US Railroads

All figures in \$ millions - # of share holdings as of 9/30/2008

Top 5 = 49% of top 25 investors vs.
43% in 03/2007

Institutional Investor	BNI	UNP	CSX	NSC	CNI	CP	KSU	GWK	Grand Total
Berkshire Hathaway, Inc	\$5,896	\$634							\$6,529
Barclays Global Investors UK Holdings Ltd	\$1,057	\$1,586	\$1,015	\$1,108	\$579	\$110	\$147	\$56	\$5,659
Marsico Capital Management, LLC		\$2,372		\$1,152	\$221				\$3,746
The Vanguard Group, Inc.	\$684	\$1,091	\$697	\$771			\$120	\$38	\$3,599
State Street Corporation	\$849	\$1,140	\$781	\$780					\$3,551
FMR LLC	\$771	\$954		\$708	\$334	\$302			\$3,068
Capital Research Global Investors				\$1,226					\$3,008
Children's Investment Fund Management (UK) LLP (The)	\$1,782	\$1,710	\$971						\$2,681
Capital World Investors	\$544	\$1,231		\$265					\$2,040
JP Morgan Chase & Co.	\$391		\$278	\$1,145					\$1,815
Deutsche Bank AG			\$1,769						\$1,769
Citigroup Inc *			\$1,154				\$75		\$1,154
AXA*		\$1,033			\$1,091				\$1,107
Cascade Investment, LLC			\$940						\$940
3G Capital Partners Ltd*									\$937
UBS Global Asset Management, Inc.	\$937						\$96		\$765
Bank of America Corp.*		\$669							\$703
Harris Financial Corp.*					\$501	\$202			\$505
Jaroslowsky Fraser Ltd.					\$505				\$503
Wellington Management Co., LLP					\$187		\$232	\$84	\$410
Royal Bank of Canada					\$303	\$107			\$401
Tiger Global Management, LLC*		\$401							\$368
Philips Hager & North Investment Management, Ltd.*					\$232	\$135			\$367
Barrow, Hanley Mewhinney & Strauss Inc *	\$367								\$346
Bank of New York Mellon Corporation*			\$346						
Grand Total	\$13,479	\$12,420	\$8,353	\$7,155	\$3,953	\$957	\$669	\$178	\$47,063

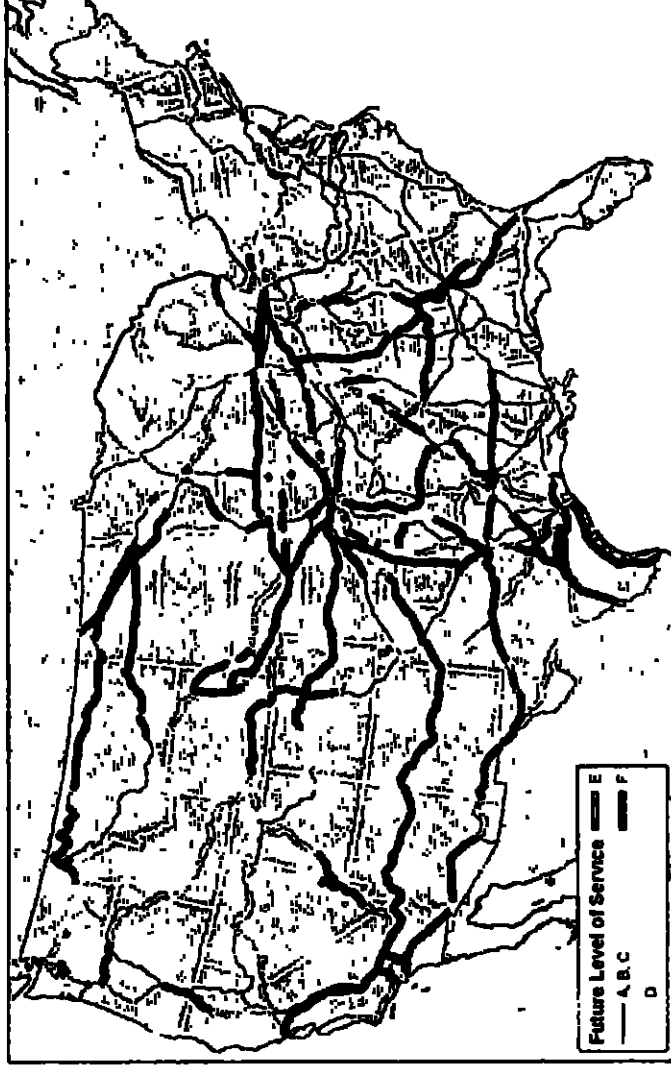
* Institutional investor not part of the top 25 investors as of March 2007



Over the next 25 years, US freight railroads will require continuous private sector equity and debt investment in new capacity to meet nearly doubled projected traffic demand by 2035.

- Projected demand growth of 88 percent by 2035-2040 (depending on impact of current recession).
- Will drive \$148 billion in capital requirements for rail infrastructure to accommodate growth without serious service disruptions
 - Estimates exclude capital needed for maintenance, rolling stock, and land acquisition expenses
 - Estimates assume no growth in current passenger rail demand

2035 Traffic Forecast with Current Network Capacity
55% of the rail network will be near or over capacity by 2035

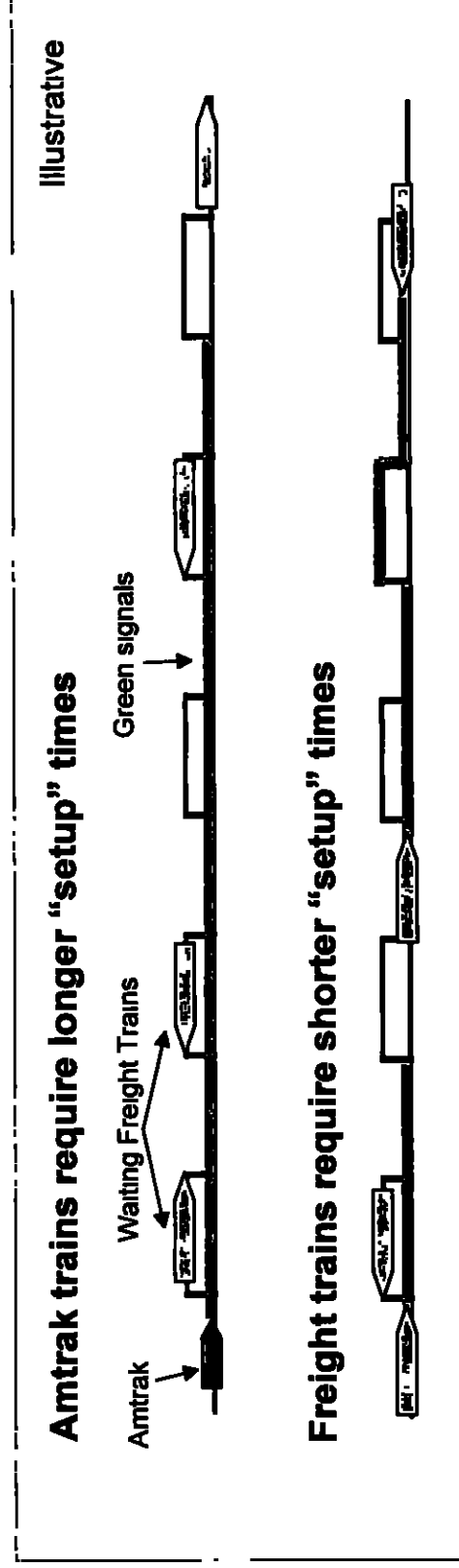


▷ **To fund this expansion, railroads need access to capital markets, and investors will require a “reasonable” return on their capital. The unintended consequences of increased regulation could be a rise in the cost of funds or the loss of sufficient sources of capital to fund future investment needs.**

Source "National Rail Freight Infrastructure Capacity and Investment Study," AAR, Sept. 2007

Passenger trains consume a disproportionate amount of network capacity and often do not contribute fully to the resources required to support the service.

- Compared to freight, Amtrak trains:
 - Operate at higher speeds – 79MPH vs. 50-70MPH
 - Operate on a strict schedule with regular station stops
 - Often times run against the current of traffic
 - Therefore, they require longer “setup” times, during which freight trains must wait.

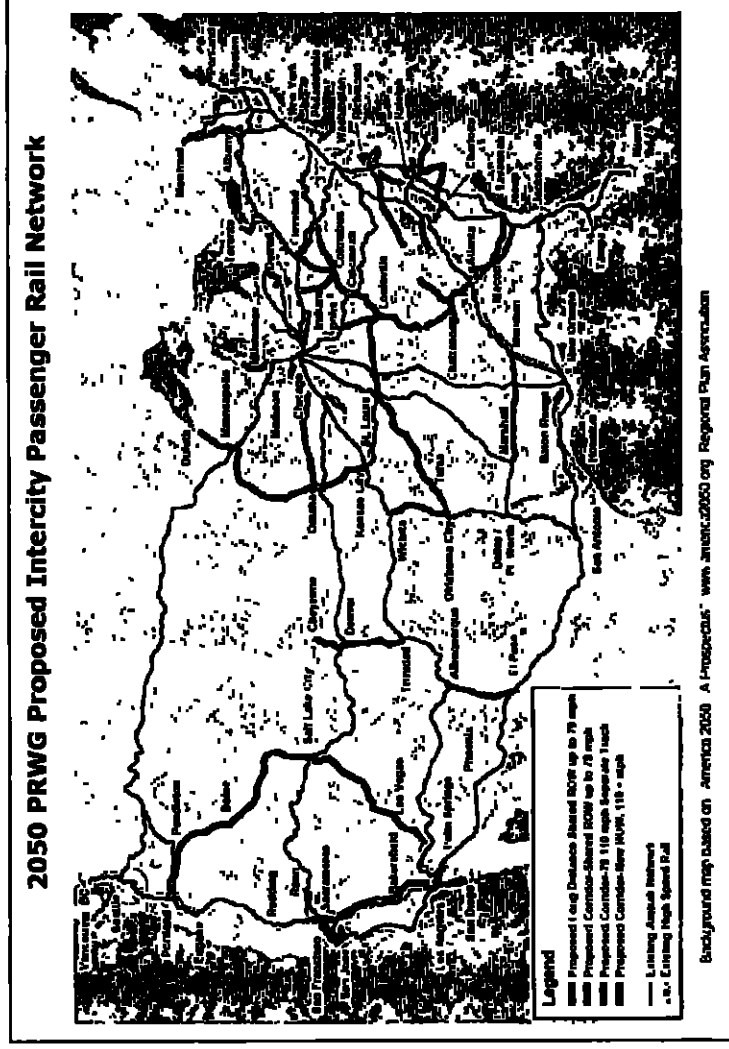


- Amtrak trains utilize 2 to 5 times the capacity of an average freight train, depending on the complexity of the railroad infrastructure and volume/mix of freight traffic.
- Amtrak trains already severely impact corridors at full capacity, forcing increased private sector investment:
 - Denver CO to Helper UT (UP)
 - Houston TX to Los Angeles CA (UP)
 - Wenatchee WA to Everett WA (BNSF)

Promoters of intercity passenger rail predict rapid expansion to 2050. This would put further pressure on freight rail networks and may create the risk that private funds will be diverted to low-return actions.

- Estimated infrastructure investment required for station and rolling stock expenses of \$357B
- This vision requires joint use of freight railroad infrastructure and significant additional funding for freight railroad capital expansion.
- The aspiration of Passenger Rail Working Group (PRWG) was funding of \$5B per year, but all that has been appropriated is \$1.2B-\$1.4B for Amtrak capital expenses.
- While PRWG recommends \$5B of annual investment, the total cost would be approximately \$8B per year. Funding so far has not matched the needs addressed by this vision.
- This vision does not include new and expanded commuter services, which will also consume additional privately funded freight railroad line capacity.

► **The unintended consequence of under-funded passenger rail growth could be the creation of contingent risk due to the diversion of essential infrastructure from freight to passenger projects.**



Source "Vision for the future U S intercity passenger rail network through 2050," Passenger Rail Working Group, Dec 2007

The American Society of Civil Engineers gave rail and transit infrastructure in the US low grades in its just released 2009 Report Card for America's Infrastructure. It also finds that significant potential increase in passenger rail demand will add to freight railroad capacity challenges.

Key Report Card 2009 Grades

Rail: C-

A freight train is three times as fuel efficient as a truck, and traveling via passenger rail uses 20 percent less energy per mile than traveling by car. However, growth and changes in demand patterns create bottlenecks which are already constraining traffic in critical areas. Freight and passenger rail generally share the same network, and a significant potential increase in passenger rail demand will add to the freight railroad capacity challenges. More than \$200 billion is needed through 2035 to accommodate anticipated growth.

"In 2009, all signs point to an infrastructure that is poorly maintained, unable to meet current and future demands, and in some cases, unsafe."

Transit: D

Transit use increased 25% between 1995 and 2005, faster than any other mode of transportation. However, nearly half of American households do not have access to bus or rail transit, and only 25% have what they consider to be a 'good option.' The Federal Transit Administration estimates \$15.8 billion is needed annually to maintain conditions and \$21.6 billion is needed to improve to good conditions. In 2008, federal capital outlays for transit were only \$9.8 billion."

The impact of proposed commuter operations on freight networks will further tax already over-burdened privately financed freight networks.

- Commuter rail demand has been increasing recently, driven by increased roadway congestion and gas price volatility.
- New or expanding commuter rail service has been proposed in numerous cities:
 - Expansion coming soon: Chicago, Florida, Philadelphia, California, New Jersey
 - Potential startups: Denver
 - Recent commuter rail startups: Nashville, New Mexico, Salt Lake City
- Commuter rail networks can be highly disruptive to freight operations:
 - Created localized congestion
 - Require windows when freight operations are limited or absent
 - Consume most of their capacity during peak hours due to concentrated, frequent service
 - Many closely spaced stops with a high density of boarding and debarking, and associated unpredictable events
- Complex negotiations may be required to ensure that the host freight railroad is adequately compensated for:
 - Loss of capacity
 - Additional infrastructure maintenance
 - Expansion needs for capacity
 - Growth potential – what will happen in the future

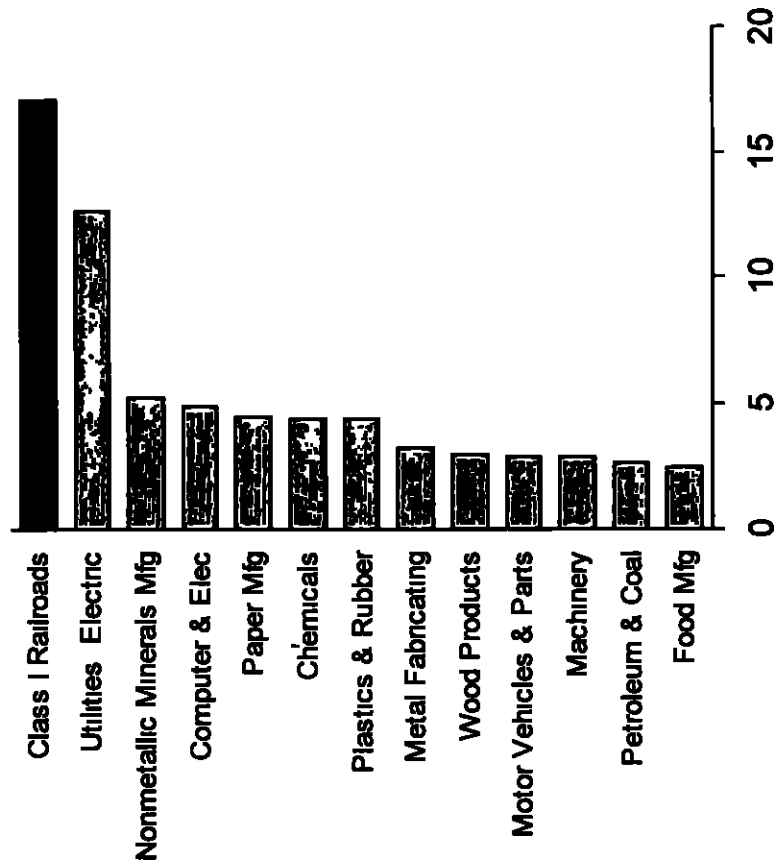
Congested rail networks increase operating and capital costs faster than traffic grows.

- As a rail line segment reaches its full capacity, trains take longer to traverse the line segment.
 - More trains means more meets.
 - More trains means more “slots” being utilized.
- As a rail line segment reaches its full capacity, “unplanned events” become much more significant.
Examples:
 - Weather
 - Railroad equipment failures
 - Track failures
 - Grade crossing incidents
- Because passenger trains carry a higher multiplier in terms of capacity impact, railroads need to pursue excess capacity to handle passenger train demand.
- Freight railroads cannot provide their shippers with service guarantees when their networks are at or near capacity.

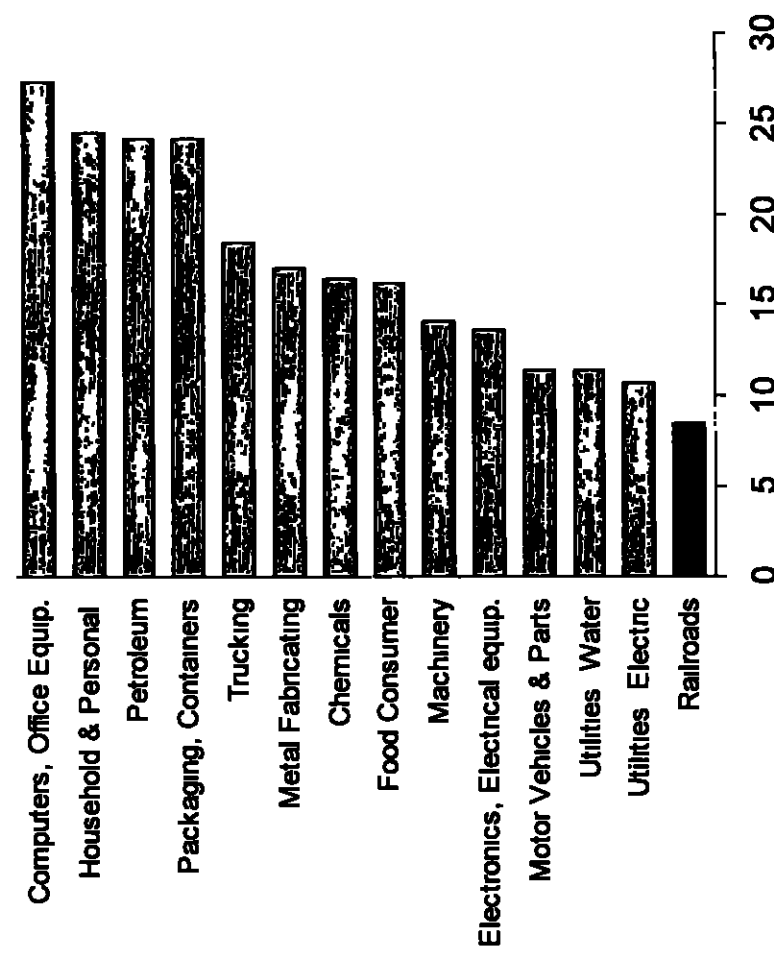
► **Private investors will anticipate the true costs of passenger trains on freight networks, based on their current and future capacity needs, and adjust the risk profile of carrier investments accordingly.**

Freight railroads are arguably one of the most capital intensive industries in the United States, but have among the lowest return on equity.

**Capital Expenditures as Percent of Revenue for Various Industries
Average 1996-2005**

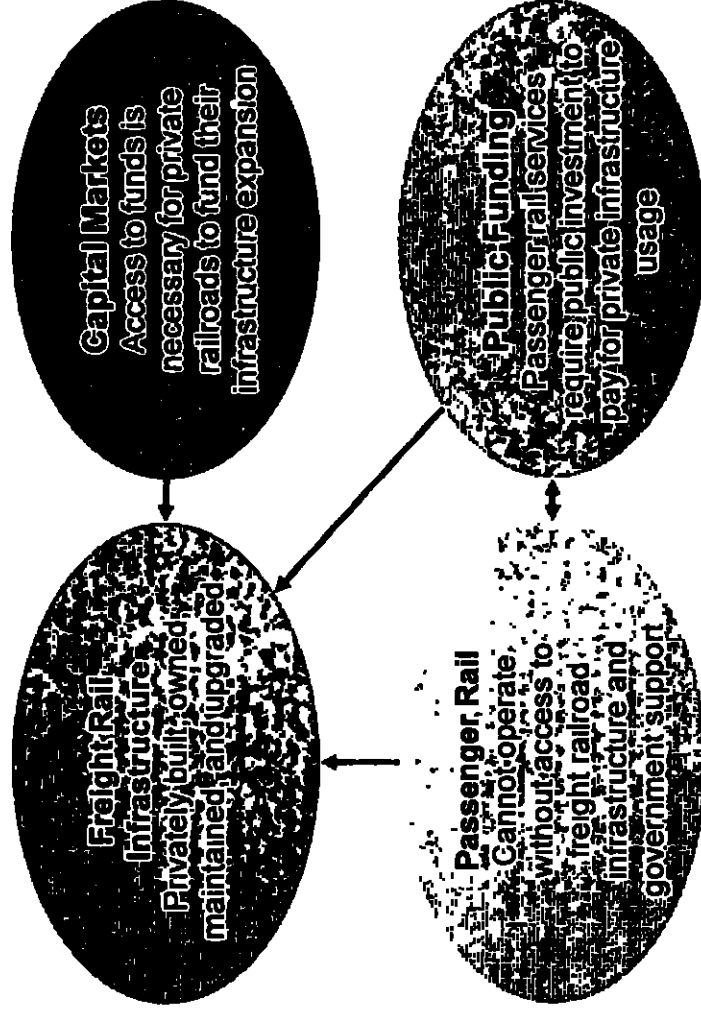


Return on Equity (%) for Various Industries, 2005



Source: Lefthand chart: U.S. Census Bureau; Righthand chart: Value Line 2005. Industries are not exact matches across charts due to different data sources.

Freight railroads rely on access to the capital markets to fund their infrastructure. Capacity used by passenger rail must be fully funded to ensure adequate rates of return.



- To fund capacity upgrades, freight railroads must have access to capital markets and secure reasonable rates of return.
- Anything that reduces railroad returns (such as cross-subsidy of passenger rail) reduces access to capital markets, risking the national infrastructure that supports both freight and passenger services.
- If freight railroads cannot secure capital investment from private sources, taxpayers will ultimately have to make up the difference.

► **Performance penalties for services that are not fully compensatory and arbitrations that could lead to the taking of capacity from property owners could have the unintended consequence of reducing rail return on equity and increasing borrowing cost.**



The current process of negotiation between freight and passenger rail operators represents a fair and balanced approach based on objective data: the capacity required to provide a service and the cost to provide that capacity.

- Current situation:
 - A freight rail network that operates reliably and efficiently, and is self funded.
 - Passenger rail uses the freight rail network as its primary infrastructure and pays for the capacity it uses.
 - Freight and passenger operators negotiate to ensure a fair balance between services provided and funding to maintain and grow capacity.

Successful Example: California Capital Corridor (Sacramento – Oakland, CA)

- Public-private partnership between Union Pacific and Amtrak
- Trains operated by Amtrak on UP infrastructure
- Ridership has paid for growth and frequency of service needs
- Union Pacific receives reasonable compensation - \$2.25M per year for train miles plus \$10M/year in capital funding

- Success due to:
 - Passenger operator had capital funding to make necessary physical improvements and pay for ongoing maintenance.
 - Passenger and freight operators teamed together to create a fluid, schedule-minded corridor.
 - Both freight and passenger are able to grow their respective businesses.

CA Capital Corridor Relevant Stats

	Daily Trains	Riders	Revenue	Revenue to Cost Ratio
1998	8	462K	\$6.25M	30
2008	32	1.7M	\$23.4M	53
Growth	300%	268%	274%	77%

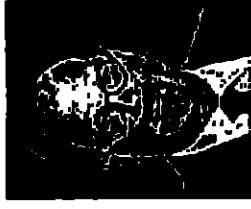
▶ **Both freight and passenger rail can grow successfully when goals are in alignment.**

At this point, we see potential unintended consequences of the proposed new rules.

- Freight railroads need adequate compensation and right of refusal for services. Without that:
 - Railroads will face new costs and operating issues.
 - Railroads will be unable to raise needed capital from investors.
 - Railroads will not be able to maintain service to customers, leading to lower revenues.
 - A repeat of these three factors will lead to a “death spiral.”
- If the new rules lead to passenger trains paying less for the capacity they use up front, then longer term the federal government may end up subsidizing both passenger and freight rail to keep them viable.
- The current process of negotiation for passenger rail access to freight networks is successful. It entails thorough discussion of highly complex issues:
 - The real cost of operations and service, and the impact on freight shippers
 - The large capacity and thus capital needs passenger rail imposes on the freight rail network
 - With the understanding that:
 - Railroads must make a return commensurate with the equivalent freight business.
 - Returns can be adjusted for the amount of risk sharing in the agreement.
 - Compensation must cover the higher costs and risks of providing guaranteed passenger services

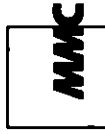
► **The process is not broken – but mandating pricing decisions by arbitration may break it, to the detriment of both freight and passenger rail services in the United States.**

Jeffery P. Elliott



- Jeffery Elliott is a Partner in the Surface Transportation and Energy unit at Oliver Wyman, based in New York. He has over 25 years of experience working in the transportation industry and in transportation and logistics consulting, with a focus on corporate planning and strategy, business design, transactions support, marketing and sales strategy, and operations and maintenance performance improvement.
- His recent experience includes the following.
 - Created a successful long-range growth strategy for a large North American railroad, assessed several merger and acquisition options, and provided valuation, deal structuring, regulatory, and PMI assistance
 - Led a transformation of a large Class I railroad's engineering function by applying world-class maintenance practices to railroad infrastructure maintenance
 - Created the investment strategy, transformation plan, and business case for purchase of a North American transportation intermediary by an investment consortium
 - Developed an intermodal growth strategy for North American transportation firm
 - Assisted a hedge fund in developing operating and financial criteria for selecting transportation and logistics investments and aided in portfolio creation
 - Led due diligence for potential transportation sector acquisitions for several private equity and infrastructure funds
 - Created new price and market strategies for a North American railroad
 - Provided M&A assistance and developed regulatory strategy for a Mexican rail company
 - Designed integrated performance metrics for a large North American railroad
 - Designed an operations improvement plan for a large Brazilian railway
 - Analyzed accessible capacity of rail and port infrastructure and created a long-term capital plan for a large Brazilian iron ore company
- Prior to joining Oliver Wyman, Mr. Elliott was a Principal with consulting firm A.T. Kearney. Mr. Elliott also served in executive positions in transportation and marketing with the Consolidated Rail Corporation (Conrail), with a focus in turning around underperforming business units.
- Mr. Elliott has a B.A. in chemistry and an M.S. in public policy and management from Carnegie-Mellon University, and M.B.A. essentials from the University of Michigan-Ann Arbor.

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