

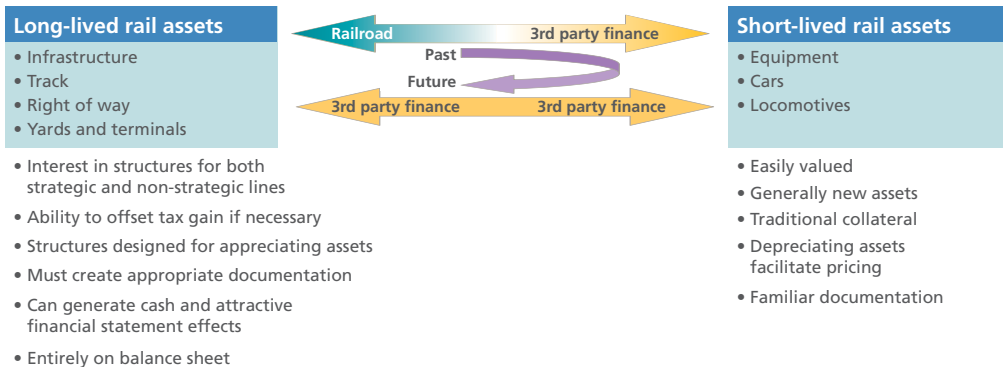
Monetizing Rail Assets to Unlock Value

North American freight railroads have experienced spectacular growth in intermodal and bulk traffic over the past several years, leading to an increase in capacity issues across their networks. In response, railroads have made unprecedented investments in assets, including turning to third parties to finance and provide needed new freight cars and locomotives.

Most railroads to date have not, however, developed a similarly wide range of options to fund their infrastructure capacity needs. They may in the future need to consider new financial structures, such as extending the third-party financing of rail assets to include not merely rolling stock but infrastructure as well. Such financing, by providing a creative way to raise additional capital at potentially a lower cost, could enable railroads to unlock the value of their vast non-liquid assets, generating cash to support capacity expansion and at the same time potentially lowering operating and maintenance costs.

Large investors in infrastructure in several other transportation sectors are now signaling an interest in financing essential rail infrastructure as a means of earning attractive longer term and stable returns. Assets of interest to investors include strategic and non-strategic rail lines and terminal facilities. In selected cases, railroads may not find it necessary to own infrastructure assets, even where commercial strategies require that they must control, operate, or access them. In most cases, transaction structures can be created that preserve the value of the railroad's franchise.

Increasing third-party financing of rail assets



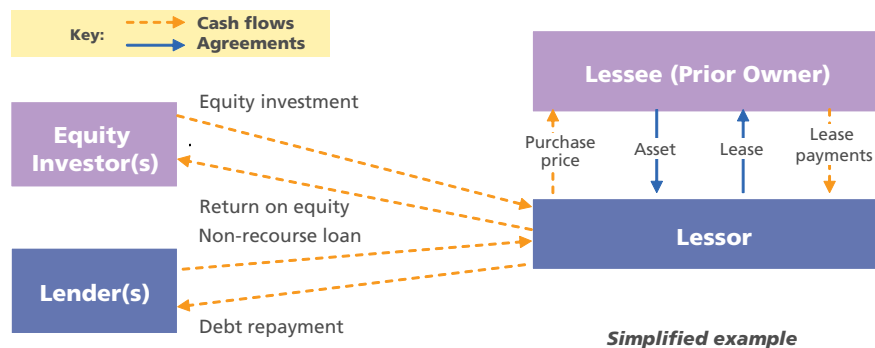
Strategic Lines: Operate, Don't Own

Investors have suggested several transaction structures that could be used to monetize the full current value of rail lines or segments of lines, while ensuring that the railroad maintains complete and exclusive control of operations and with the option to repurchase the line in the future. Gains, if an issue, can be offset up to the railroad's annual infrastructure capital expenditure.

For example, one structure, similar to the traditional sale-leaseback transaction, could provide substantial capital funding with net capital costs below current levels. In this structure, an equity investor (lessor) would acquire a strategic line or other infrastructure from the railroad (seller, then lessee) and then lease it back. The two parties would enter into a lease agreement for a set period of time and the lessee would have the option to purchase the asset back at the end of the lease period. The purchase and sales agreement and ultimate property rights transfer would be structured to preserve the value of the seller's franchise and would free up funds to be redeployed in other projects where returns may be higher.

Such a structure could have a positive effect on both the railroad's P&L and its balance sheet. In some cases, the buyer-lessor's cost of funds may be less than the railroad's cost of funds, resulting in the opportunity for increased earnings. Transfer of ownership to the investor also may in some cases open opportunities for additional services to be offered, including ongoing infrastructure maintenance or other services where unit costs might be lower.

Example sale-leaseback transaction



Non-Strategic Lines: Sell with Easement

Recent transactions with regional railroads and suppliers suggest that major financial and infrastructure investors are showing a growing interest in regional and non-strategic branch lines that serve major rail customers or "clusters" of secondary and branch lines that serve smaller customers. For a railroad focused on high-density, mainline traffic, serving these secondary lines adds time and complexity to blocking and carload services, and often diverts capital, capex, locomotives, and crews from higher density traffic flows.

Line transfer programs in which the railroad owns the infrastructure but leases it to shortline operators may provide another possible opportunity to utilize infrastructure investor funds. These programs can leave capital tied up in assets that railroads may not wish to continue to own. Infrastructure investors on

the other hand are seeking opportunities to own such infrastructure and could provide an option for a three-party transaction that optimizes the benefits to each party.

One potential option that investors appear willing to consider could grant the selling railroad a perpetual easement or other superior and long-term property right in the line and set up a service contract or other arrangement that provides assurances with regard to the level of service to be provided by the shortline operator (including the right to replace the operator).

The Class I (or current line owner) in return receives cash that can be used for higher priority and higher return projects and possible relief from maintenance and future capex obligations. At the same time, the transaction could be structured so that the Class I maintains its ability to use the line and access strategic customers, as well as to provide mainline service to traffic that originates or terminates on the line.

Several third-party structures also may be applicable to situations in which different railroads own parallel lines. The railroads could monetize both lines and consolidate traffic onto the lower cost line. Ownership and maintenance could then be turned over to a third party, which might better support such joint usage.

Terminal Railroads and Facilities: Sell Outright

Under a similar approach, infrastructure investors also may find major terminal railroads and terminal facilities (e.g., waterside bulk loading, intermodal, auto terminals) attractive investment projects. Recent transactions suggest investors are signaling interest in acquiring terminal facilities and operations that are expensive to duplicate, serve multiple users, and are generally less complex to operate. Selling such terminal operations can liberate capital tied up in infrastructure that in some cases is used by multiple carriers, under programs that could reduce costs and provide for a truly neutral operator.

Facilitating Third-Party Transactions

Oliver Wyman has found that a fact-based and aggressive approach to assisting railroads in structuring third-party financing of infrastructure can lead to a completed transaction in time frames competitive with traditional approaches. Experience in working with both railroads and investors to value rail asset portfolios and advise on transaction strategies and structures significantly shrinks the learning curve.

If you would be interested in discussing Oliver Wyman’s perspectives on structures for monetizing rail assets, please contact your Oliver Wyman account partner or one of the following partners:

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Oliver Wyman

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Oliver Wyman's Rail Practice

Oliver Wyman's Rail Practice employs the largest and most experienced staff in the world dedicated to the rail industry and is widely recognized as the premier management consultancy to private freight and state-owned freight and passenger railroads. It has carried out major strategic, operational, and financial planning and evaluation assignments for nearly all major railroads in North America and for state-owned railways in Europe, Asia, South America, Africa, and Australia.

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