U.S. House of Representatives
Committee on Transportation and Infrastructure
Washington, DC 20515

James L. Oberstar
Chairman

John L. Mica
Ranking Republican Member

David Heymsfeld, Chief of Staff
Ward W. McCarragher, Chief Counsel

James W. Coon II, Republican Chief of Staff

March 3, 2008

SUMMARY OF SUBJECT MATTER

TO: Members of the Subcommittee on Railroads, Pipelines, and Hazardous Materials

FROM: Subcommittee on Railroads, Pipelines, and Hazardous Materials Staff

SUBJECT: Hearing on Investment in the Rail Industry

PURPOSE OF THE HEARING

The Subcommittee on Railroads, Pipelines, and Hazardous Materials is scheduled to meet on Wednesday, March 5, 2008 at 11 a.m. in 2167 Rayburn House Office Building to receive testimony on investment in the rail industry. The purpose of this hearing is to examine recent interest by Wall Street investors in the railroad industry, including concerns raised by the activities of the Children's Investment Fund, a hedge fund.

BACKGROUND

The railroad industry is currently enjoying a "renaissance" after many years of poor financial health due to rising costs, loss of market share, and bankruptcies. A 2006 Government Accountability Office report examining the health of the freight railroad industry found that its financial health has improved substantially since passage of the Staggers Act as railroads have cut costs by streamlining their workforces, right-sizing their rail networks, and reducing their track mileage, equipment and facilities to more closely match demand. Freight railroads have also expanded their businesses into new markets—such as the intermodal market—and implemented new technologies, including larger cars.

Over the past 10 years, the seven Class I railroads (Union Pacific ("UP"), BNSF Railway ("BNSF"), Norfolk Southern ("NS"), CSX, Canadian National ("CN"), Canadian Pacific ("CP"), and Kansas City Southern ("KCS")) have reported progressively greater income. The average rate of return on net investment rose from an annual average of 2% in the 1970s to 4.4% in the 1980s, 7% in the 1990s, and 7.4% from 2000 to 2006. From 1996 to 2006, the net income of the seven Class I railroads has increased 205%, from $3.696 billion in 1996 to $7.559 billion in 2006.

This success has led to renewed interest from Wall Street investors. In 2006, Atticus Capital, an activist hedge fund, publicly filed as a major shareholder of the UP, CSX, NS, and BNSF railroads. In February 2007, private equity firm Fortress Investment Group ("Fortress") completed a buyout of short-line rail service provider RailAmerica. In April 2007, Warren Buffett purchased an 11% equity stake in BNSF, as well as holdings in NS and UP. A few weeks later, CSX reported that activist shareholder The Children's Investment Fund ("TCI") had purchased 2.5% of CSX shares.

This activity continued in 2008, with Mr. Buffett increasing his equity stake in BNSF to 18%. TCI is currently engaged in a proxy fight with CSX management after announcing in December it controlled approximately 20% of CSX stock with another fund and that it will nominate an alternate slate of directors to the CSX Board at its May 2008 Annual Shareholder Meeting.

REASONS FOR INVESTMENT BY WALL STREET

Railroads are an attractive investment for investors for a number of reasons. First, railroads currently enjoy greater pricing power than at any other time since passage of Staggers. This is due to increasing highway congestion, truck driver shortages, a strong pricing environment for the railroads and expectations of robust long-term growth in freight demand.

Second, after losing market share to highways for over 40 years, railroads are regaining market share due to: (1) off-shore manufacturing, where large shipments of freight produced in Asia and transported by ocean to U.S. ports lend themselves to longer-haul, non-time sensitive rail shipments within the nation; (2) a sharper focus on reducing fuel costs; and (3) growing public frustration with congested highways.

Third, the railroads are realizing enormous operational improvements. According to a Wall Street analyst, "we see the railroads as only in the middle of their operating turnaround following the merger-related service disruptions of the 1990s, and improving technologies, increasing capacity, and a renewed focus on efficiency should result in continued productivity." These improvements include new and efficient diesel locomotives; longer train lengths, ongoing transitions from trailers to double-stacked containers, and new and extended rail sidings as some of the potential drivers of productivity enhancements for the railroads.

Fourth, railroads are benefiting from secular growth trends in both coal and corn/ethanol (a secular trend is a long-term trend upward or downward. This is in contrast to a smaller cyclical variation with periodic and short-term duration). Increased demand for coal has been a multi-year trend and is expected to grow, as more than 140 coal-fired power plants are expected to come on-line over the next 20 years, according to the Department of Energy. Additionally, corn exports are surging due to consumption in developing Asian countries, as well as greater corn usage domestically for ethanol production. Further, ethanol will continue to grow given the government-mandated doubling of consumption by 2012.

Finally, over the past five years, the average free cash flow return on capital (i.e. operating cash flow minus capital expenditures divided by average debt and equity) for the railroads improved on average from 2% to 5.5% during 2006. Railroads are increasingly able to generate free cash flow through all parts of the economic cycle. Analysts see better free cash growth potential for the railroads compared to other transportation sectors, especially once the railroads complete major capital expansion upgrades in the next few years. Importantly, railroads are increasingly returning cash flow to shareholders in the form of dividends and stock repurchase programs, with roughly $2 billion programs over the past five years at the five U.S. railroads (UP, BNSF, NS, CSX, and KCS).

THE CHILDREN'S INVESTMENT FUND

TCI is an activist hedge fund founded in 2004. It is registered in the Cayman Islands and headquartered in London. It is one of approximately one of 8,000-9,000 hedge funds, with an estimated $2 billion in assets as of 2005.

Hedge funds are private (not registered with the Securities and Exchange Commission ("SEC")) investment funds that buy and sell all types of securities listed on both public and private exchanges. Much of the investing activities of hedge funds involve aggressive or sophisticated tactics as financial leverage (i.e. borrowing on margin), derivatives, concentrated positions and shorting of securities and financial instruments. Over the past decade, the activities of hedge funds have had a notable influence on stock and bond prices in the U.S. and increasingly international finance markets.

Hedge funds such as TCI are distinct from more traditional investors for a number of reasons. First, traditional investors, such as individual investors, business entities such as mutual funds, trust companies, and financial organizations, are subject to a wide array of regulatory compliance requirements and oversight from both public (i.e., the SEC, the Department of Labor, and federal and state bank examiners) and private (e.g. stock exchanges, accounting rulemaking and standards boards) entities. Hedge funds are often free of much of this regulatory oversight.

Second, hedge funds are generally regarded as high-risk, high-return operations. They are structured to avoid SEC regulation, including limits on the use of borrowed money, strict record keeping and reporting rules, capital structure requirements, mandated adherence to specified investment goals and strategies, bonding requirements, and a requirement that shareholder approval be obtained (through proxy solicitation) for certain fund business. Further, they may only accept funds from "accredited investors," defined by the SEC as persons with assets of $1 million or more. Additionally, hedge funds are commonly understood to utilize aggressive use of portfolio management tactics as financial leverage (i.e. borrowing on margin), derivatives, concentrated positions, and shorting of securities and financial instruments. These high-risk activities may result in a high return for an investor, though it often results in a high degree of failure for a hedge fund. A study by the New York University School of Business found the attrition rate for hedge funds is about 20% per year, and the average life span is about three years.

The performance record of hedge funds is mixed. Some studies find they generally outperform common benchmarks such as the Standard & Poor's 500, but others conclude they have lagged. The short life span of many funds creates obvious difficulties for measurement, including a strong survival bias: the many funds that shut down each year are not included in return calculations. Annual return figures conceal a wide variation from year to year and from fund to fund. In any period, the law of averages dictates that at least a few funds will do extremely well. These success stories may explain the continued popularity of hedge funds, including TCI.

On October 16, 2007, TCI sent a letter to the CSX Board of Directors and established a website (www.strongercsx.com) to publicly air concerns with CSX management. TCI stated these actions were the result of its private attempts to discuss their concerns with CSX management that were "consistently rebuffed." On the date of the TCI letter's publication, TCI owned 17.8 million shares, or 4.1% of CSX, making it CSX's third largest institutional shareholder.

In the letter, TCI advocated CSX management make a number of changes to its current operations, including (1) freezing capital investment until a favorable regulatory environment is achieved, including the outcome of H.R. 2125, the Rail Competition and Service Improvement Act; (2) improving corporate governance at CSX, including changing the Board composition and separating the Chairman and CEO roles; (3) improving management of CSX's capital expenditure budget; and (5) improving its relationship with labor and government regulators, including Congress. In prior correspondence with CSX, TCI made additional recommendations; including increasing its stock buyback program and raising shipper rates 7% each year for 10 years.

A copy of the entire TCI-CSX correspondence is attached at the end of this memo.

On December 19, 2007, TCI announced it had filed a Schedule 13D with the SEC disclosing that they and several individuals had formed a group whose members own in the aggregate 8.3% of the outstanding common shares of CSX. The members of the group also hold in the derivative securities providing economic exposure equivalent to an additional 11.8% of CSX's outstanding shares.

TCI's SEC filing disclosed that it intends to nominate five directors for election to the CSX 11-member Board (not including Chairman and CEO Michael Ward) at its 2008 Annual Meeting of Shareholders. TCI stated in its announcement that its "goal is a strong CSX that can provide the returns shareholders deserve, the service shippers demand, a safety record communities can count on, and a working environment employees can be proud of."

CONCERNS WITH TCI'S INTEREST IN CSX

Due to the reputation of hedge funds' short-term investment outlook, TCI's interest in CSX has raised concerns. TCI previously suggested CSX increase its "buy back" program to 20 percent of outstanding shares each year until leverage reached five times Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA"), an indicator of a company's financial performance. Stock buy backs are a method for a company to return value to its shareholders. Because a company cannot be its own shareholder, repurchased shares are absorbed by the company, and the number of outstanding shares on the market is reduced. When this happens, the relative ownership stake of each investor increases because there are fewer shares, or claims, on the earnings of the company. However, running up debt can also lower a company's bond rating, making it difficult and/or more expensive to acquire capital on the credit market. Maintaining an investment grade rating is important for a capital intensive business like a railroad. If CSX followed TCI's suggestion, it would increase its value to its shareholders to the detriment of its long-term performance. According to a Wall Street analyst, "the railroads are one of the rare industries where under spending on capital expenditures for even a year or two can ensure five or ten years of operating problems."

Second, TCI suggested CSX would make an attractive candidate for a leveraged buyout (LBO) or consolidation. A LBO is the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of LBOs is to allow companies to make large acquisitions without committing a lot of capital. Wall Street analysts contend activist shareholders or private equity firms may seek the sale of a railroad to a strategic buyer as an exit strategy or unlock shareholder value. While Class I railroads are subject to strict regulatory scrutiny, analysts contend smaller railroads such as KCS and Genesee & Wyoming have characteristics that would be attractive for financial acquisition and would not need to meet the same merger rules. However, analysts view CSX as the most likely consolidation candidate of the larger North American railroads. While LBO economics prefer higher return industries compared to the railroad industry, large private equity firms currently have a virtually unlimited ability to raise capital. This means private equity firms can target industries with lower returns, which makes railroads attractive at a time when they are reporting all-time highs on returns on capital. If CSX were to be subject to a consolidation or LBO, it could disrupt service to many of its shippers and impose an unacceptable impact to the U.S. economy.

Finally, there is little regulatory authority to govern TCI's activities except in extreme instances. As mentioned above, TCI is not regulated by the SEC. Further, the Surface Transportation Board ("STB" or "Board"), which is the economic regulatory agency for the railroad industry, has authority to regulate some railroad transactions, but not others. Any authority that the Board might have over the takeover of a rail carrier by a non-carrier such as an investment partnership or hedge fund would derive from either the provision in the law that applies to acquisitions of rail property by non-carriers[1] or the provision that applies when transfers of stock and control of a company are involved.[2] The latter provision may apply if a non-carrier acquired a single rail carrier that itself owns another rail carrier (for example, a large railroad that owns a small railroad), but it is doubtful that authorization requirement would apply if the two or more carriers being taken over operate as a single integrated transportation system. And the former provision, which generally applies to transfers of physical property, requires Board authorization if a person other than a rail carrier acquires a "railroad line."[3] This provision appears to be focused on discrete lines, not carriers, and would not normally be applied if a non-carrier sought to take over a major rail carrier. Finally, the STB lacks authority over a leveraged buyout or to block an acquisition of a large rail carrier system by a non-carrier, such as TCI.

However, TCI's status as a foreign-owned company would allow its activities to fall under the authority of the Committee on Foreign Investment in the United States ("CFIUS") under the U.S. Department of the Treasury should it attempt to gain a controlling interest in CSX. Section 5021 of the Omnibus Trade and Competitiveness Act of 1988 provides authority to the President to suspend or prohibit any foreign acquisition, merger or takeover of a U.S. corporation that is determined to threaten the national security of the United States. The President can exercise this authority to block a foreign acquisition of a U.S. corporation only if he finds: (1) there is credible evidence that the foreign entity exercising control might take action that threatens national security,

[1] 49 U.S.C. 10901.

[2] 49 U.S.C. 11323(a)(4) (providing that Board approval and authorization is required for the "[a]cquisition of control of at least 2 rail carriers by a person that is not a rail carrier.").

[3] 49 U.S.C. 10901.

and (2) the provisions of law, other than the International Emergency Economic Powers Act do not provide adequate and appropriate authority to protect the national security.

FORTRESS INVESTMENT GROUP & RAILAMERICA

Fortress Investment Group ("Fortress") is a New York-based global investment firm founded in 1998 that manages approximately $40 billion in assets. Though Fortress was founded solely as a private equity firm, it has since added hedge funds and real estate asset trading to its investment offerings. Fortress is unique from similar investment firms in that it's the first of its kind in the United States to become a publicly traded company, though the investment services it offers are entirely private enterprises.

A private equity fund ("PEF") is a broad term for privately-owned collective investment scheme that invests in companies not traded on a public stock exchange. These funds use non-traditional investment strategies, including venture capital, buyouts, merchant banking, and special situations (investment in a distressed company or specific one-time opportunities). The PEF industry holds over $500 billion in capital and the 20 largest firms control companies with more than four million employees.

PEFs aim to beat investment returns available in the stock market for a small, wealthy group of investors. To accomplish this, PEFs will buy all outstanding shares of stock in a target company and remove it from public trading markets – thus making the target a privately owned entity. Through various mechanisms – including management restructuring, selling unprofitable divisions, and personnel cuts – companies are retooled and turned around, and then often brought back into the public stock markets or sold to another firm. This typically occurs over a period of three to seven years.

A PEF is similar to a hedge fund in comparison to traditional investment vehicles, as both attract high dollar investors, are subject to little regulation, and are high-risk/high-reward ventures. As PEFs are classified as private business partnerships, like hedge funds, their performance can be difficult to track. However, using all information available, the University of Amsterdam released a study in April 2007 concluding that over time, private equity fund portfolios outperform the Standard & Poor's 500 by 3% on average, but underperform the index by 3% ultimately due to excessive fee structures.

In November 2006, Fortress announced its intent to acquire RailAmerica, a short line and regional rail service provider operating approximately 7,800 miles in the United States and Canada. Following necessary approvals from the STB, the acquisition was made complete on February 14, 2007 when shareholders approved the buyout that equaled approximately $1.1 billion.

Fortress stated in its filings with the STB that it saw potential to improve RailAmerica's "efficiency, financial strength, and ability to meet the needs of shippers." In particular, Fortress expected future improvements to be made through "continued investment and improved managerial efficiency." However, RailAmerica's actions following Fortress' acquisition have raised concerns.

Prior to acquiring RailAmerica, Fortress claimed "[to] have no current plans to…abandon any rail lines in connection with the proposed transaction." However, after the acquisition was complete, RailAmerica announced September 21, 2007 that it would cease rail service on its Coos Bay Branch Line in southern Oregon operated by the Central Oregon & Pacific Railroad ("CORP") due to "unsafe conditions in three tunnels," giving shippers one day to respond to the news.

Following a Federal Railroad Administration ("FRA") investigation to examine the tunnels and assess damage, RailAmerica insisted that despite the railroad's private ownership status, that federal, state, and local governments provide a total of $20 million to repair the tunnels. This issue has yet to be resolved and as a result, local shippers face higher costs, more trucks are on local roads, and the local economy has suffered.

CORP announced December 13, 2007 that service across the Siskiyou Subdivision between Medford, Oregon and Montague, California would be severely limited effective January 15, 2008. Further, if CORP could not reach a sufficient volume of rail cars or level of income on the line, service could cease altogether by April 15, 2008. Freight intended for California headed down the Siskiyou Subdivision is now rerouted north to Eugene and onto a Union Pacific line, the only Class I link for CORP. This cutback in service could mean increased costs for shippers and less competition for rail service.

<u>Witnesses</u>

Mr. Snehal Amin
Partner
The Children's Investment Fund

The Honorable Joseph Boardman
Administrator
Federal Railroad Administration

The Honorable W. Douglas Buttrey
Board Member
Surface Transportation Board

Mr. John E. Giles
Chief Executive Officer
RailAmerica

Mr. Robin Greenwood
Assistant Professor
Harvard Business School

The Honorable Francis P. Mulvey
Vice Chairman
Surface Transportation Board

The Honorable Charles D. "Chip" Nottingham
Chairman
Surface Transportation Board

Mr. Michael Ward
Chairman, President, and CEO
CSX Corporation