

2006 EIA Energy Outlook and Modeling Conference

Return to Coal, from Where and at What Price?

Commercial and Regulatory Issues and Trends Impacting the Coal Transportation and Supply Markets

March 27, 2006

By:

Peter A. Pfohl

Slover & Loftus

(202)347-7170

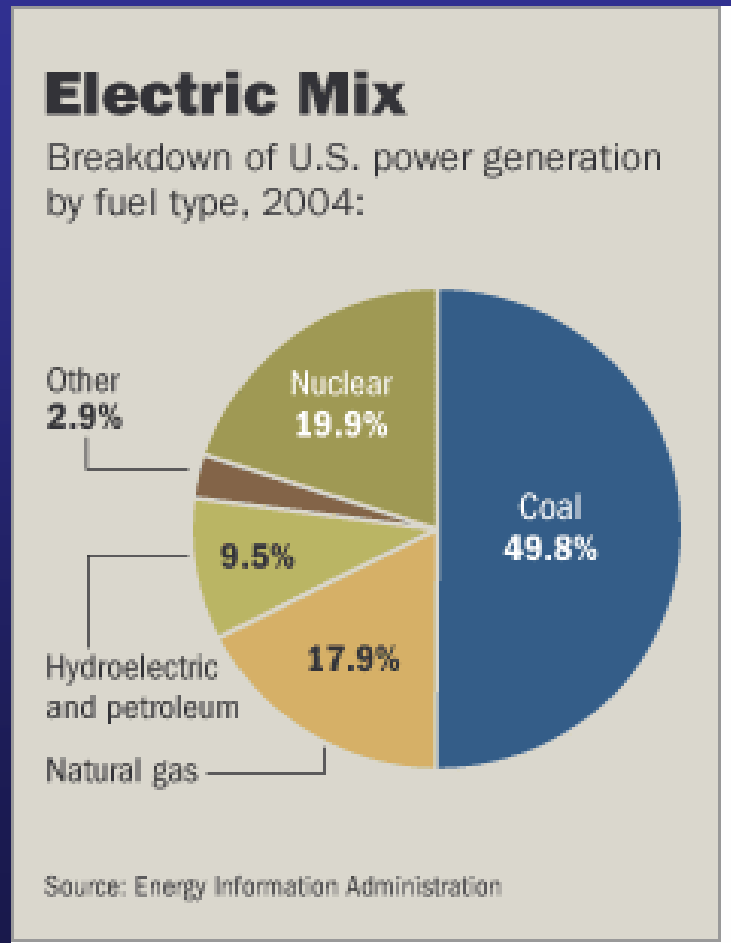
pap@sloverandloftus.com

INTRODUCTION AND OVERVIEW

- Coal Has and Remains the Electric Generation Dominant Fuel
- Coal Transportation Costs are a Significant Component of Generating Electricity
- History and Recent Trends in Western Coal Transportation Pricing
- Western Coal Supply Market Issues

KING COAL

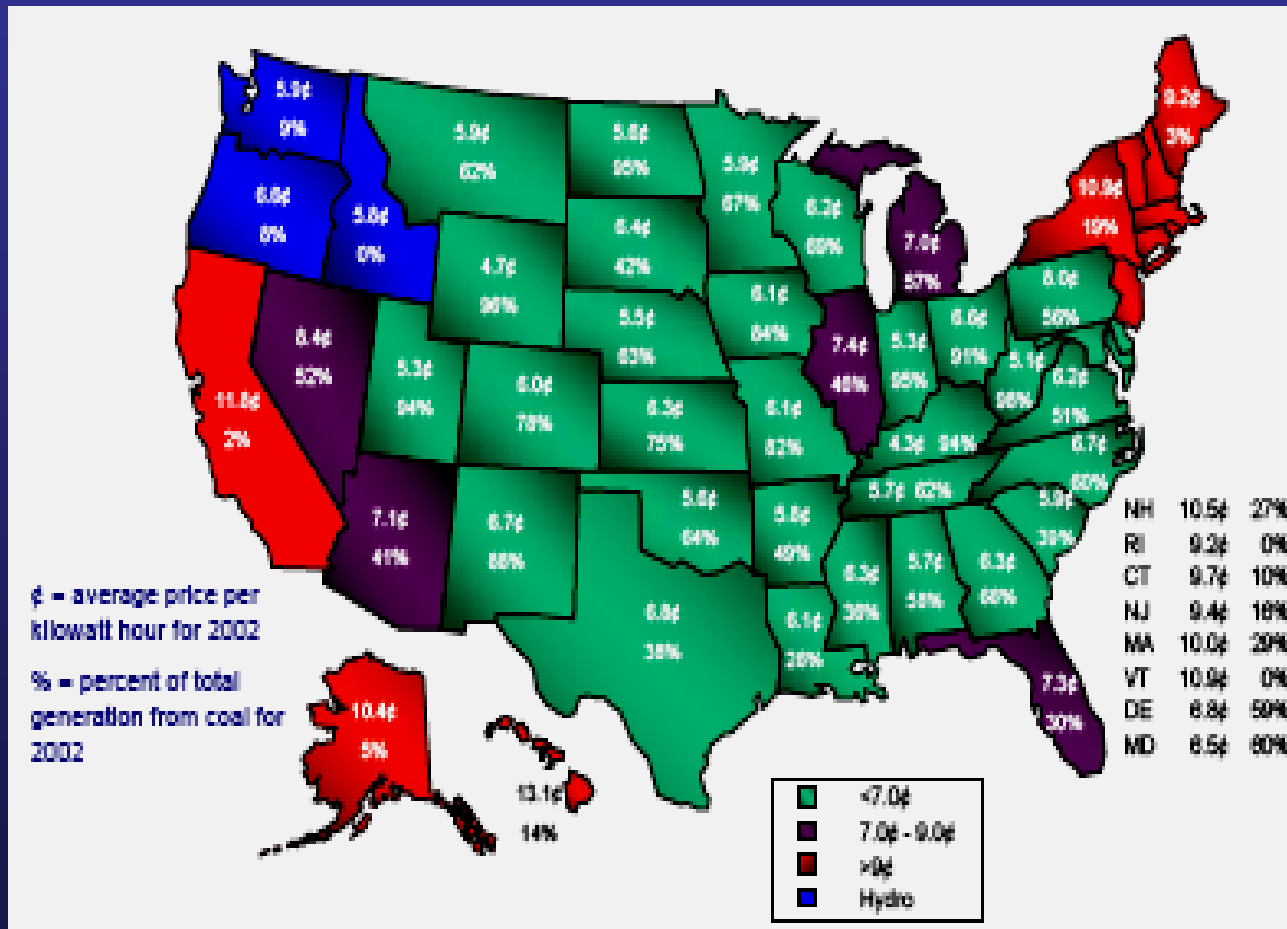
- Coal is a primary contributor to the production of electricity
- Coal remains the baseload dominant fuel for electric generation



(Wall Street Journal (March 15, 2006))

KING COAL (con't)

- Factors favoring coal
 - Abundant supply
 - A secure and stable U.S. domestic source
 - Low cost (especially for surface mined western coal)
 - Price differential with other fuels

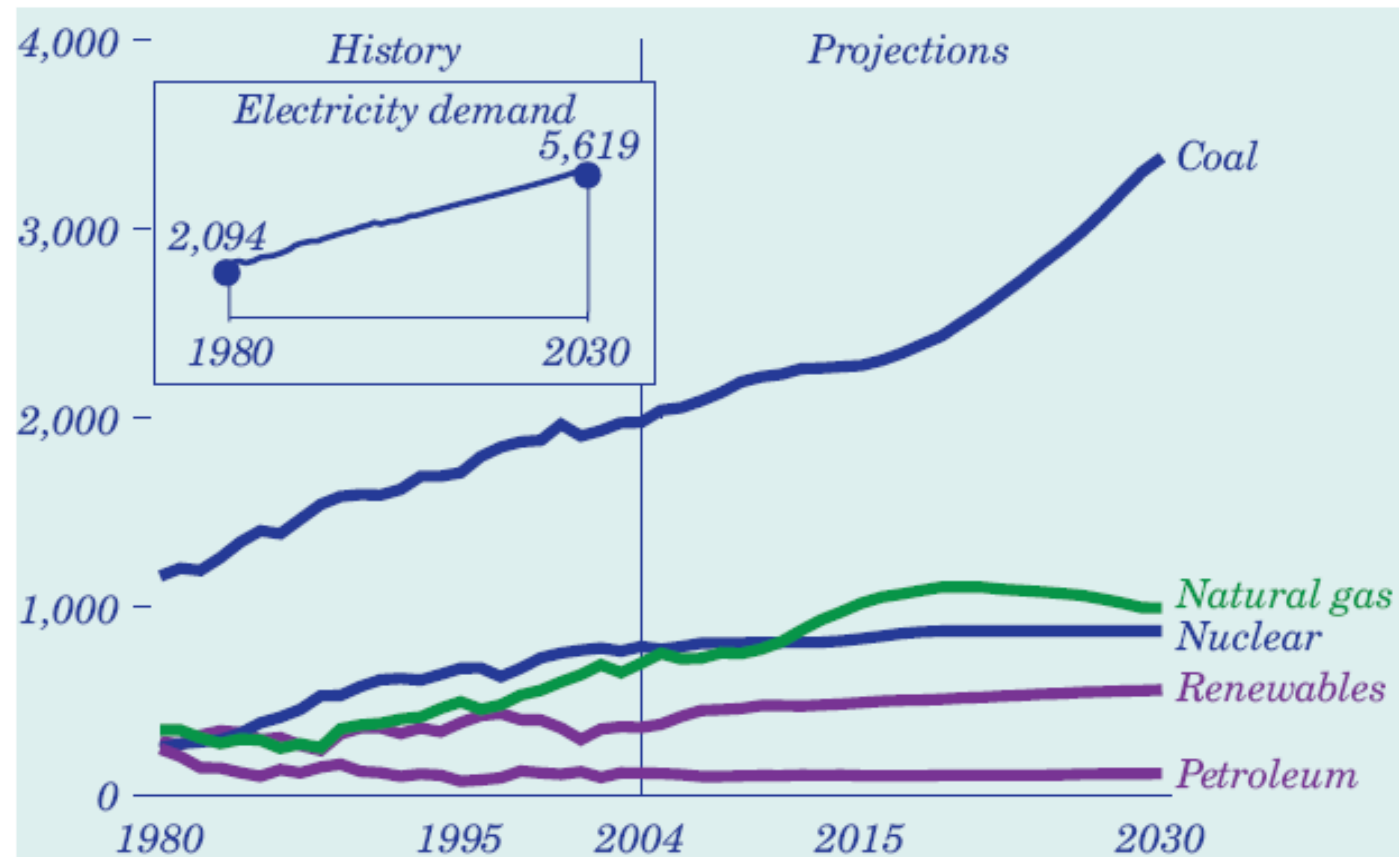


(American Coal Council: *Opportunities to Expedite the Construction of New Coal-Based Power Plants* (Nov. 2004))

KING COAL (con't)

- EIA's Energy Annual Outlook 2006

**Figure 5. Electricity generation by fuel, 1980-2030
(billion kilowatthours)**



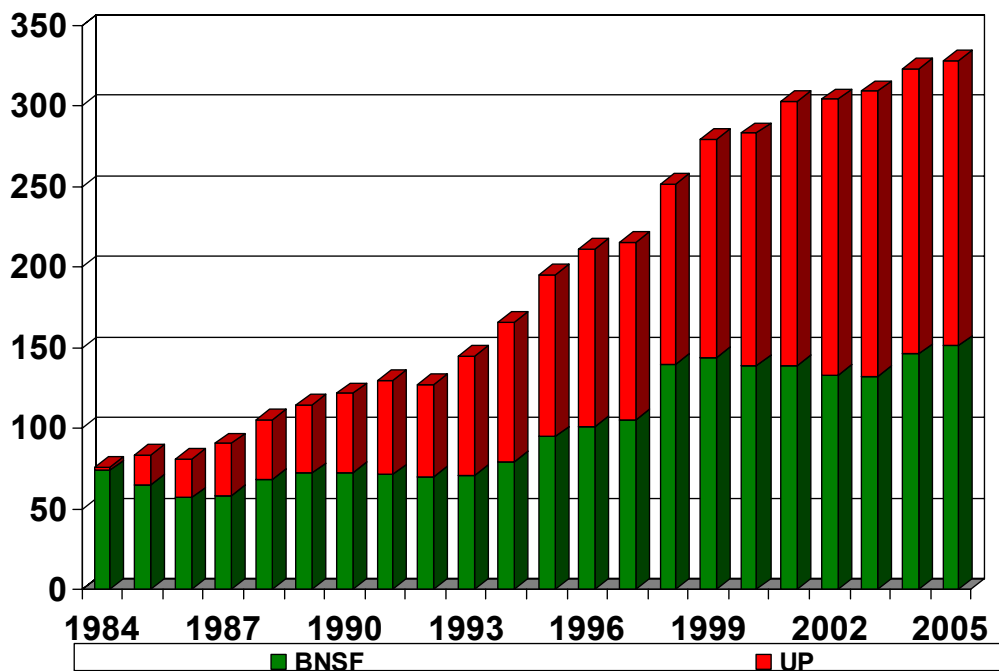
WESTERN COAL TRANSPORTATION ISSUES

- Historical Issues/Trends
 - Staggers Rail Act of 1980: a watershed event
 - ICC takes proactive stance to open up Southern PRB coal reserves to 2-carrier competition
 - *“The public interest requires that these coal resources be made available to consumers under the most favorable terms possible. Ensuring competition for the transportation of coal is the best means to guarantee that result”*
(Finance Docket No. 28934, et al., Chicago and North Western Transp. Co. -- Construction and Operation of a Line of Railroad, 363 I.C.C. 906, 927 (1981))
 - 1984 – early 2000s
 - Increased rail-to-rail competition through private, confidential contracts
 - Rate reductions through pass-through of some productivity gains (see *EIA, Energy Policy Act Transportation Rate Study: Final Report on Coal Transportation*)
 - Railroads become more profitable due to productivity gains and cost savings
 - BNSF’s CEO Matt Rose testified that, during this period: “railroad expenses were reduced even more deeply than rates,” and he concluded that these results “allowed the industry to gradually shore-up its finances.” (*Statement of Matthew K. Rose Before the Senate Subcomm. on Surface Transportation (May 9, 2001)*)

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Southern PRB
 - Significant (but generally consistent) PRB market growth
 - UP and BNSF Reach Market Equilibrium

**PRB JOINT LINE PRODUCTION
1984-2005**



WESTERN COAL TRANSPORTATION ISSUES (con't)

- Dark Clouds?
 - Industry Consolidation
 - Since 1980, the number of major “Class I” railroads in the U.S. has shrunk from 42 to 4
 - “Big Four” now control 90%+ of annual ton-miles
 - Two lead carriers remain in both the West (UP and BNSF) and the East (CSXT and NS)
 - Any “next round” of mergers would produce a national rail duopoly -- putting control of most American rail freight in the hands of two mega-carriers
 - Southern PRB: UP and BNSF reach market equilibrium (see previous slide)
 - Regulatory Results

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Trends in STB coal maximum rate case decisions

Recent PRB STB Maximum Rate Case Decisions

Case Name/ Year of Decision	Movement Involved	Equipment Supplier/Type	Period	Prescribed or Permitted Rate	Prescribed or Permitted Rate (Mills per Ton- Mile)
1996-2002					
41191	WTU v. BN (1996) PRB to Texas	RR/Steel	4Q95	\$13.68 ^{1/}	12.2
42051	WPL v. UP (2002 Reconsideration)	PRB to Wisconsin	1Q00	\$13.65 ^{2/}	10.7
2003-2005					
42056	TMPA v. BNSF (2004 Reconsideration)	PRB to Texas	2Q01	\$18.61 ^{3/}	13.4
41191	WTU v. BNSF (2003 Reopening)	PRB to Texas	2Q03	\$18.04 ^{4/}	16.2
42057	Xcel/PSCo v. BNSF (2005 Reconsideration)	PRB to Colorado	1Q01	\$7.87 ^{5/}	20.5

- 1/. Mills per ton-mile based on Rawhide to Oklaunion O-D pair.
- 2/. Mills per ton-mile based on Black Thunder to Edgewater O-D pair.
- 3/. Mills per ton-mile based on Jacobs Ranch to Gibbons Creek O-D pair.
- 4/. Mills per ton-mile based on Rawhide to Oklaunion O-D pair.
- 5/. Mills per ton-mile based on Eagle Butte to Pawnee O-D pair.

Recent Non-PRB STB Maximum Rate Case Decisions

Docket Number	Case Name/ Year of Decision	Movement Involved	Equipment Supplier/Type	Period	Prescribed or Permitted Rate	Prescribed or Permitted Rate (Mills per Ton- Mile)
1997-2002						
41185	APS v. ATSF (1997)	NM to AZ	RR/Steel	2Q95	\$3.60 ^{1/}	31.2
2003-2005						
42069	Duke v. NS (2003)	Cent. App. To NC	RR/Steel	1Q02	\$16.45 ^{2/}	50.5
42072	CP&L v. NS (2003)	Cent. App. To NC	RR/Steel	3Q02	\$16.74 ^{3/}	49.3
42070	Duke v. CSXT (2004)	Cent. App. To NC/SC	RR/Steel	2Q02	\$17.30 ^{4/}	59.8
41185	APS v. BNSF (2004 Reopening)	NM to AZ	RR/Steel	2Q03	\$6.91 ^{5/}	59.9
42058	AEPCO v. BNSF and UP (2005)	NM to AZ	SH/Mixed	1Q01	\$9.35 ^{6/}	21.1

- 1/. Mills per ton-mile based on McKinley to Cholla O-D pair.
- 2/. Mills per ton-mile based on High Power Mountain to Belews Creek O-D pair. The Board found the tariff rate was not unlawful.
- 3/. Mills per ton-mile based on Marrowbone to Mayo O-D pair. The Board found the tariff rate was not unlawful.
- 4/. Mills per ton-mile based on Sara to Cliffside O-D pair. The Board found the tariff rate was not unlawful.
- 5/. Mills per ton-mile based on McKinley to Cholla O-D pair.
- 6/. Mills per ton-mile based on Lee Ranch to Apache (Low Capacity Cars) O-D pair. The Board did not prescribe a rate. The case was dismissed.

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Railroad Commercial Issues
 - Public Pricing of Western Coal Services
 - Fall, 2004: UP and BNSF each institute new “public pricing” programs to apply on western coal movements
 - Railroad Public pricing characteristics:
 - » Higher rates
 - » Shorter terms (1-3 years)
 - » Unilaterally decreed service terms
 - » Imposition of fuel surcharges
 - » A reluctance to compete for traffic that enjoys access to both systems
 - DOJ Investigation (Feb. 2005: DOJ “is looking into the possibility of anticompetitive practices involving the transport of coal”)

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Railroads Recent Message: “Get used to” rate increase “pain”:

Pricing Environment . . . Pricing remains strong. After 25 years since the Staggers Act deregulated the industry, demand finally outstrips capacity. BN believes that 2-3% pricing growth is sustainable with 3-5% volume increases, which will more than offset 2.5%-3% cost inflation, resulting in double-digit EPS growth over the foreseeable future.

Rapid price increases have been painful for BN's customers, although the railroad has provided transportation managers with data to help explain the increases to their bosses. The goal is obviously to obtain greater acceptance of price increases and manage expectations for the future, i.e. get used to price increases.

(UBS Investment Research, BNSF, Highlights from Meeting with Management (Aug. 29, 2005) at 4)

WESTERN COAL TRANSPORTATION ISSUES (con't)

Changing Business Environment

Unprecedented levels of demand have created a very strong pricing environment Across all business groups, we are obtaining solid price increases in the marketplace. At the same time, we are working to reduce the complexity and inflexibility of long-term contracts so that we can respond more quickly to changing market conditions. One clear example is in our coal business where we have instituted new coal pricing mechanisms for all shipments from the Southern Powder River Basin (SPRB) in Wyoming, as well as spot movements out of Colorado and Utah. We have simplified the way we do business with our customers by clearly communicating the revenue we need in order to reinvest in our coal business, while sharply reducing the administrative burden of dozens of separate contracts. In total, 322 million tons of coal moved out of the SPRB in 2004, and that is expected to grow to over 500 million tons by 2013. Our goal is to participate in meeting that growing demand, but only if the financial returns are sufficient to justify the necessary investment.

Dick Davidson, UP Chairman and CEO, UP 2005 Annual Report

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Wall Street's Message: A "secular" pricing story:

We continue to recommend overweighting the North American railroads as we believe the stocks will have 10%-20% annual EPS growth between now and 2010, due primarily to their secular pricing story (our contention for the past year has been that it's secular, not cyclical). . . . [W]e believe the secular pricing story will lead to EPS growth rates over the next 5 years that is almost 3x the historical EPS growth rate of the industry. Given this accelerated EPS growth rate and the likelihood that the North American railroad industry will earn its cost of capital on a sustainable basis for the first time in at least 50 years, we contend that the industry will be revalued higher We're not concerned about regulatory risk as the current environment in Washington is understanding of the railroad industry's plight to earn its cost of capital. . . .

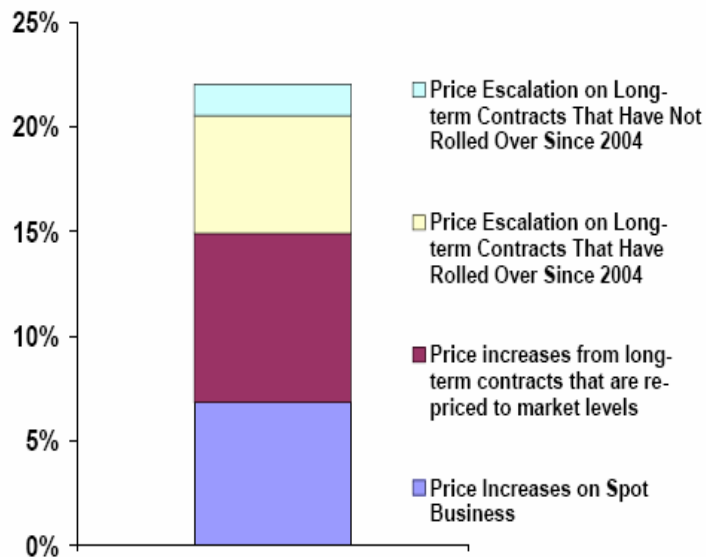
(Morgan Stanley, Air Freight and Surface Transportation, Secular Pricing Leaves 50%-100% More Upside Potential in Railroad Stocks (Jan. 23, 2006))

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Railroad Revenue Growth Driven by Pricing

Exhibit 3

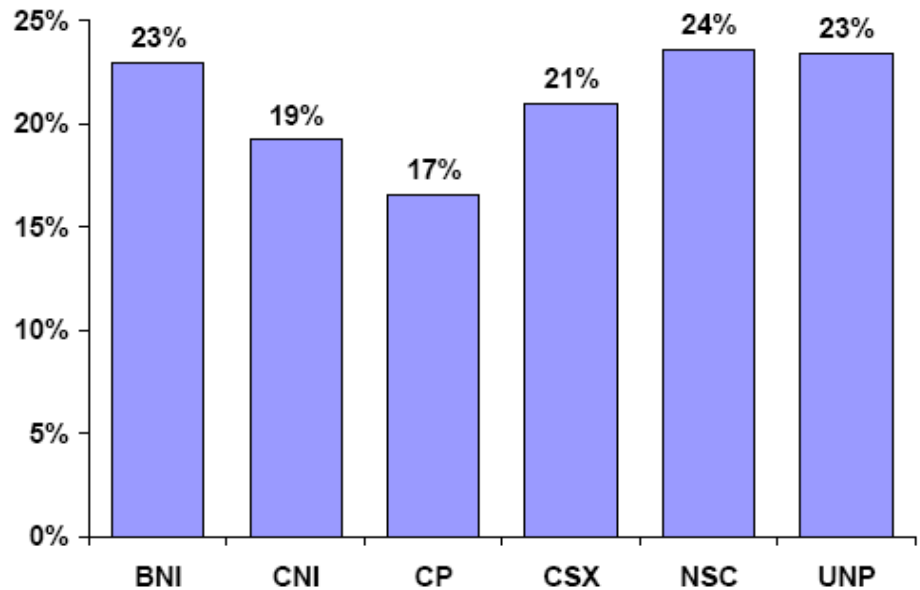
Morgan Stanley Estimated Railroad Industry Revenue Growth from Pricing Initiatives, 2006E-2010E (percent above 2005 revenue)



Source: Morgan Stanley Research

Exhibit 5

Cumulative Revenue Growth from Pricing, 2006E-2010E

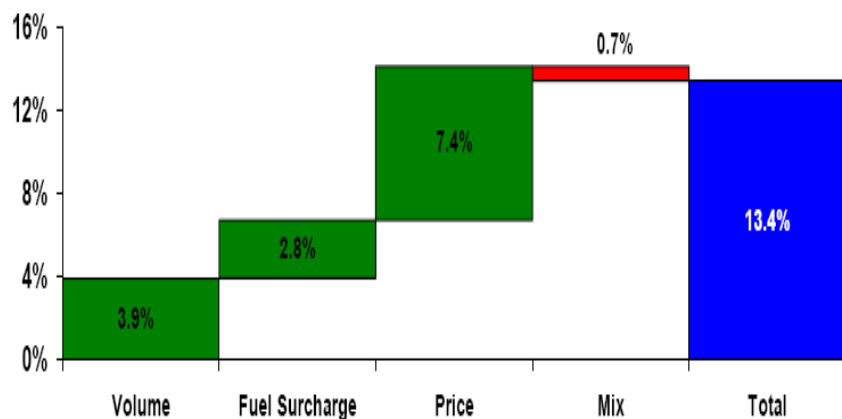


Source: Morgan Stanley Research

(Morgan Stanley, Air Freight and Surface Transportation, Secular Pricing Leaves 50%-100% More Upside Potential in Railroad Stocks (Jan. 23, 2006))

WESTERN COAL TRANSPORTATION ISSUES (con't)

Exhibit 3
Morgan Stanley's Estimate of UNP's 2006E Sources of Revenue Growth



Source: Morgan Stanley Research

Exhibit 9

UNP Stock Catalyst and Risk Table

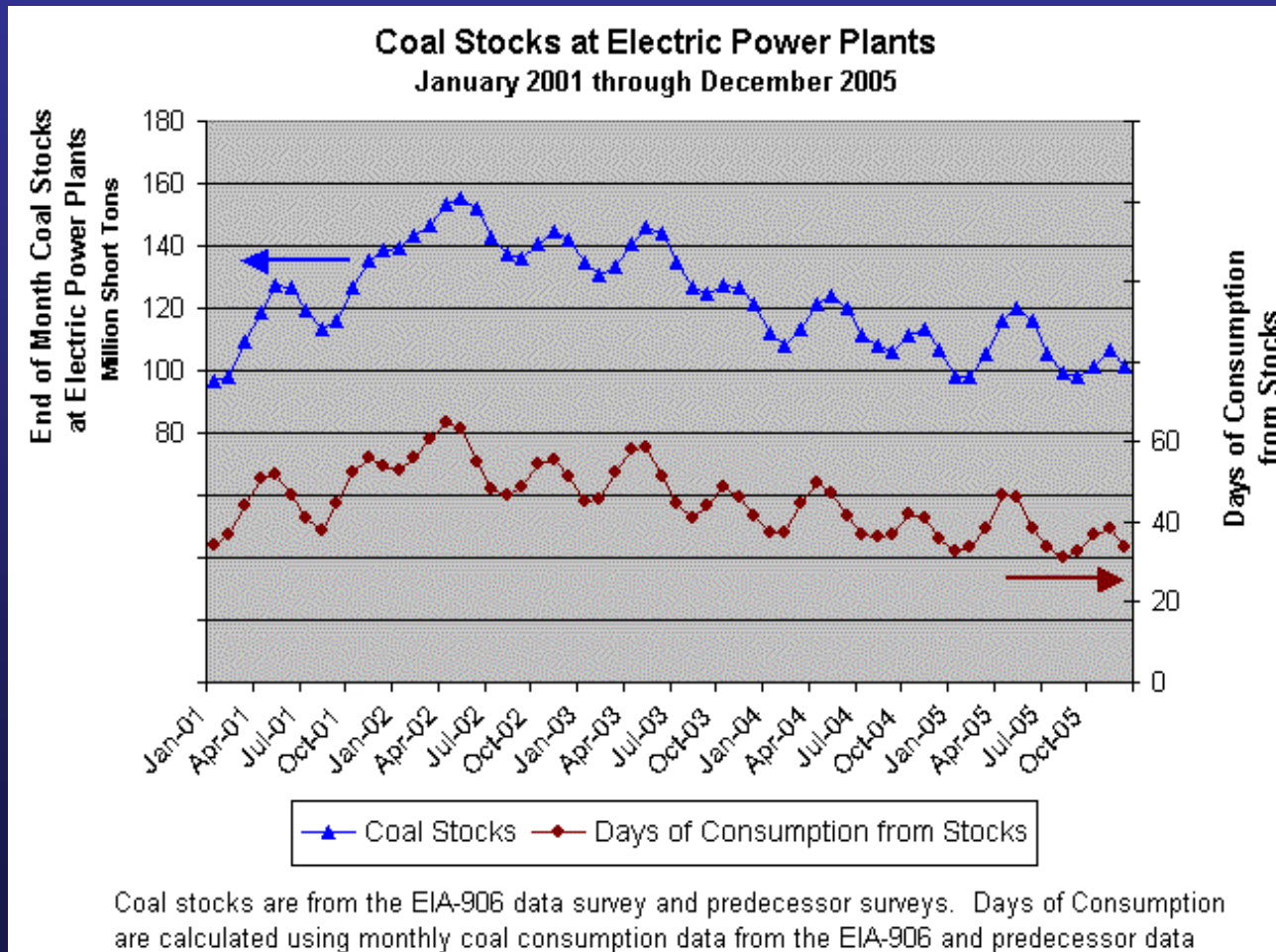
Stock Catalyst/Risk	Impact on Fundamentals/Stock
Rising customer pricing	Positive: UNP is not only benefiting from rising industry pricing, but has also shifted its longstanding strategy of winning market share through price discounting. Among the major railroads we believe UNP has the most long term contracts currently below market rates leaving it with more untapped upside from the recent upward pricing trend.
Recent signs of operational stability	Positive: Given UNP's recovery from a bridge fire and heavy port traffic in January as well as recent hurricanes, flooding, and snow storms we believe the worst of its operational struggles are behind.
Strong demand for PRB coal	Positive. Given the under delivery of PRB shipments due to rail and mine issues, a warm summer, low utility inventory levels and record high natural gas prices we believe the demand for PRB coal is likely to remain strong throughout 2006 and likely into 2007.

Morgan Stanley, Union Pacific, Raising Price Target as Our Thesis is Unfolding Earlier than Expected (March 15, 2006)

WESTERN COAL TRANSPORTATION ISSUES (con't)

– Service Problems

- Deliveries not meeting demand – dwindling stockpiles
- Insufficient capacity/slack capacity?



Source: EIA Coal News and Markets, Week of February 19, 2006

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Coal Customers' have concerns about supply/demand factors in the current market environment

- BNSF's Chairman, President, and CEO Matt Rose:

“we don't bring capacity on sooner than we need it, so we always have a natural tightness”

(William C. Vantuono, “Fluidity, velocity, capacity, consistency,” Railway Age, (Dec. 2004) at 15-19)

- UP Vice President of Marketing, Jack Koraleski:

“[i]n some ways, we are where we always wanted to be, with demand for our services outstripping the supply”

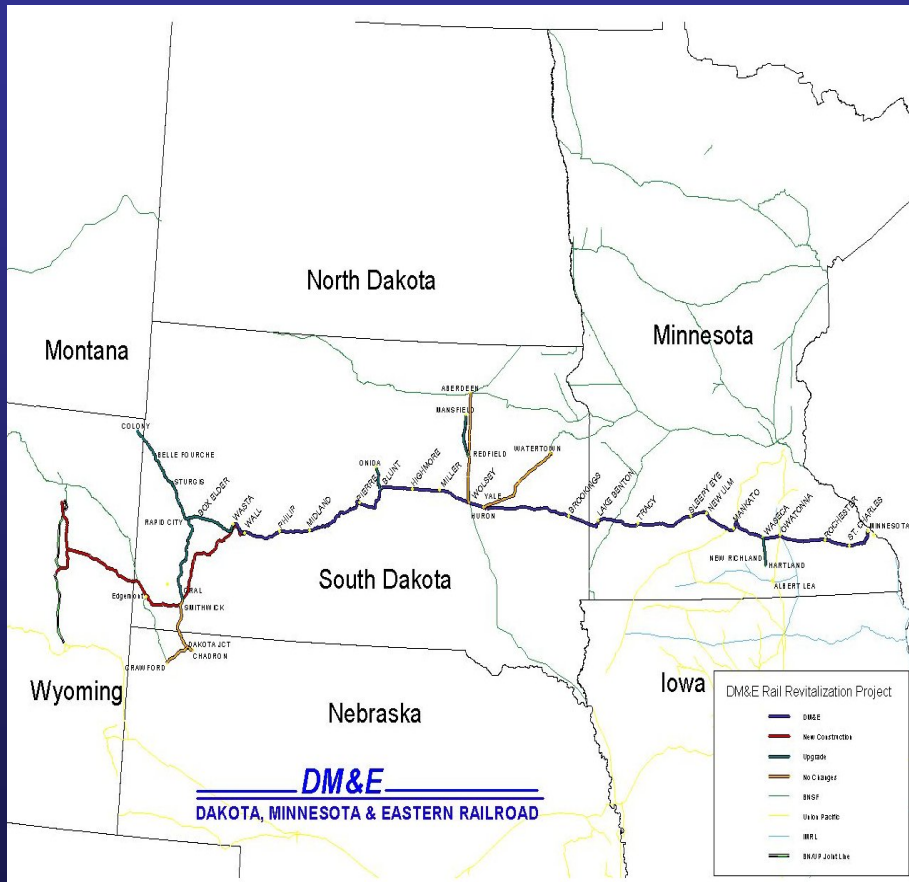
(Joe Ruff, “UP to charge more, turn away some cargo,” Associated Press (Jan. 28, 2005))

WESTERN COAL TRANSPORTATION ISSUES (con't)

- Fuel Surcharges
 - Issue: The railroads continue to apply fuel surcharges on traffic that are not directly tied to carrier fuel costs of the involved service
 - The Problem: Coal customers subject to railroad fuel surcharges are seeing fuel surcharges that have exceeded 20% of the carrier's rates
 - Addressing the Problem:
 - Similar fuel surcharges being applied across all transportation industries
 - There has been some political pressure applied on this issue
 - STB public hearing on railroad fuel surcharges scheduled for May 11, 2006
 - The STB's notice seeks comments regarding "concerns that recent fuel surcharges collected by railroads are designed to recover amounts over and above increased fuel costs"
 - The STB notes the limits on its jurisdiction over rates and states that "this hearing is not intended to address the level of surcharges"
 - Possible unreasonable practice claim?

WESTERN COAL TRANSPORTATION ISSUES (con't)

• NEW RAILROAD COMPETITION?

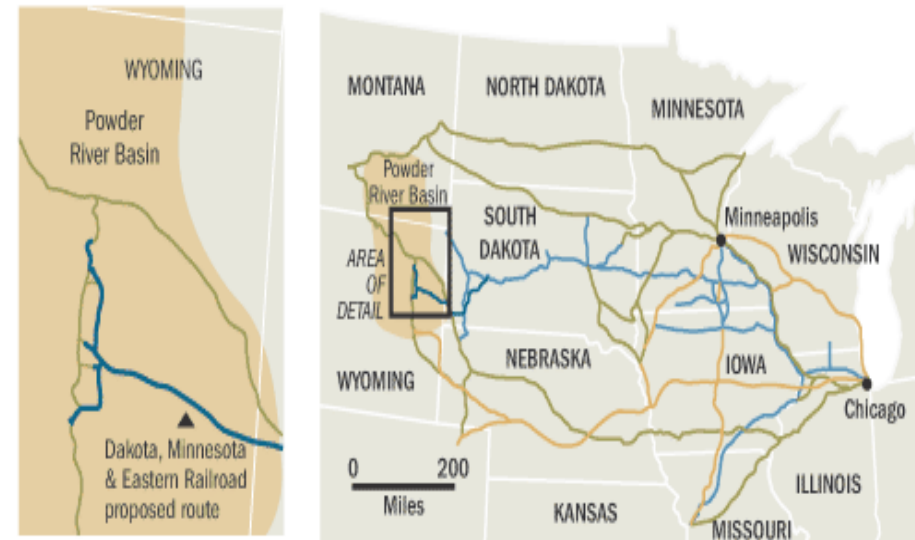


(DM&E Railroad)

Breaking a Bottleneck

Rail routes to the Midwest and East from the Powder River Basin.

- DM&E existing railroad*
- Union Pacific
- DM&E proposed route
- Burlington Northern Santa Fe



*Includes the Iowa, Chicago & Eastern Railroad, which DM&E purchased to extend its geographical reach for coal deliveries.

Source: Dakota, Minnesota & Eastern Railroad Corp.

(Wall Street Journal (March 15, 2006))

WESTERN COAL TRANSPORTATION ISSUES (con't)

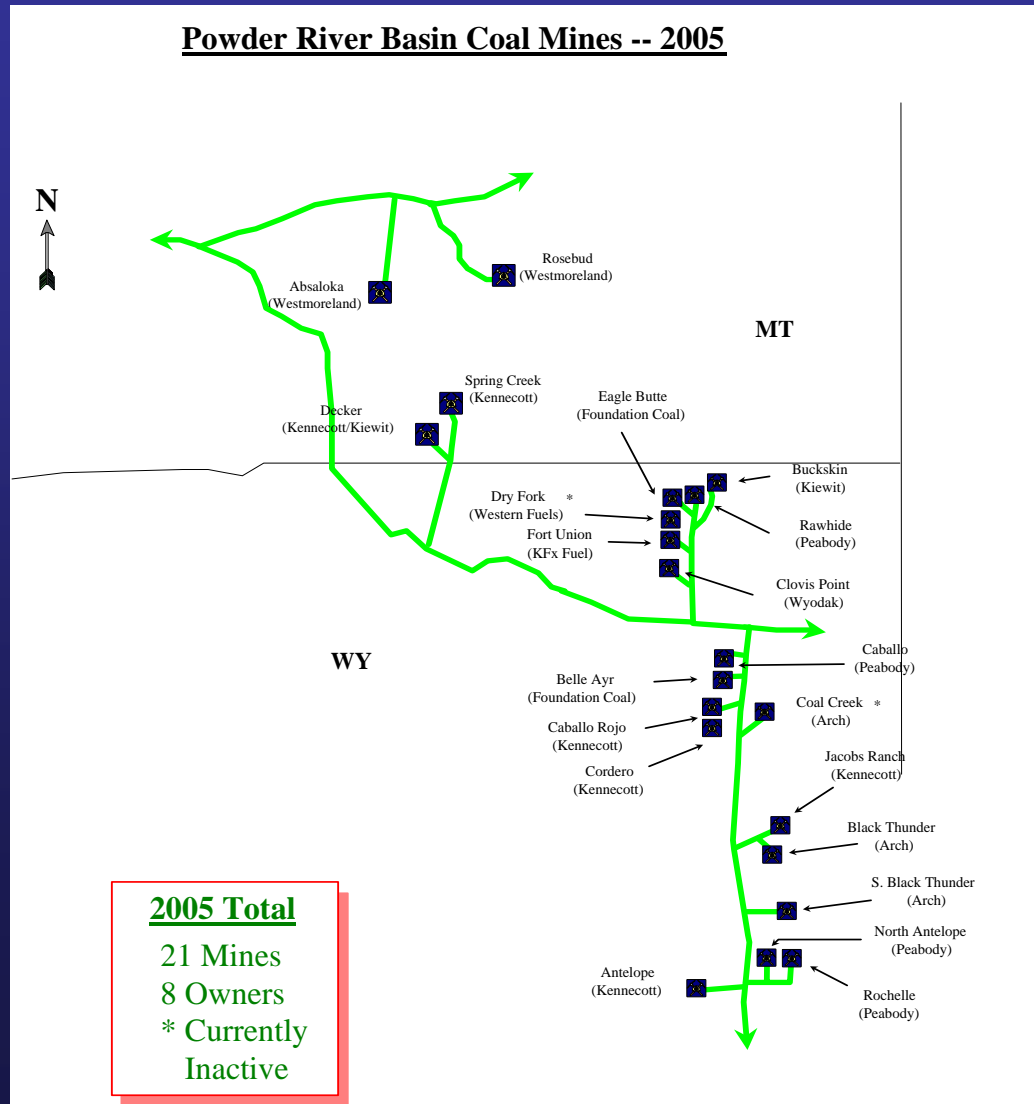
- Incumbent Carriers' Response to DM&E's \$2.5 Billion public financing plan:

“[DM&E’s] now turning to look for government money. You know, we continue to believe this would be very, very bad public policy especially now that the industry is really improving its returns and allowing more expansion capital to be put in.”

*(BNSF CEO Matt Rose,
BNSF 4Q05 Investors Conference)*

WESTERN COAL SUPPLY ISSUES

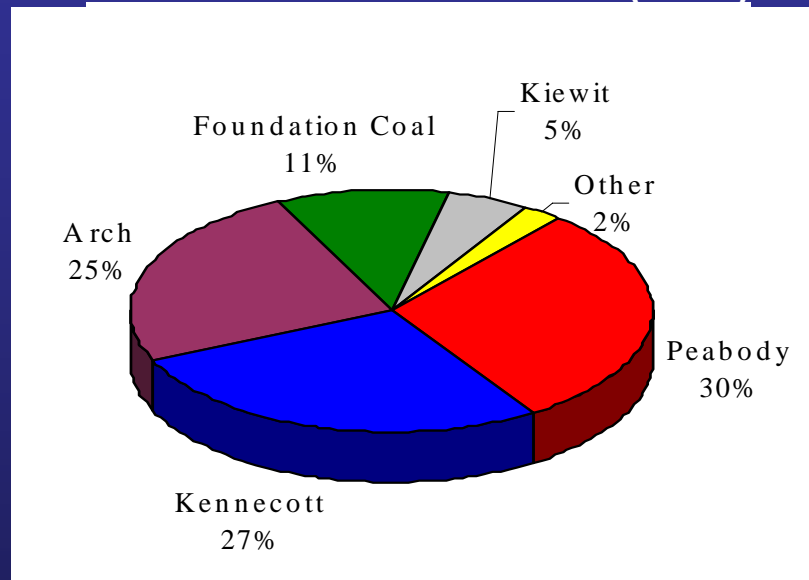
- PRB Overview



WESTERN COAL SUPPLY ISSUES (con't)

- Southern PRB Market Shares and the PRB “Big Three”

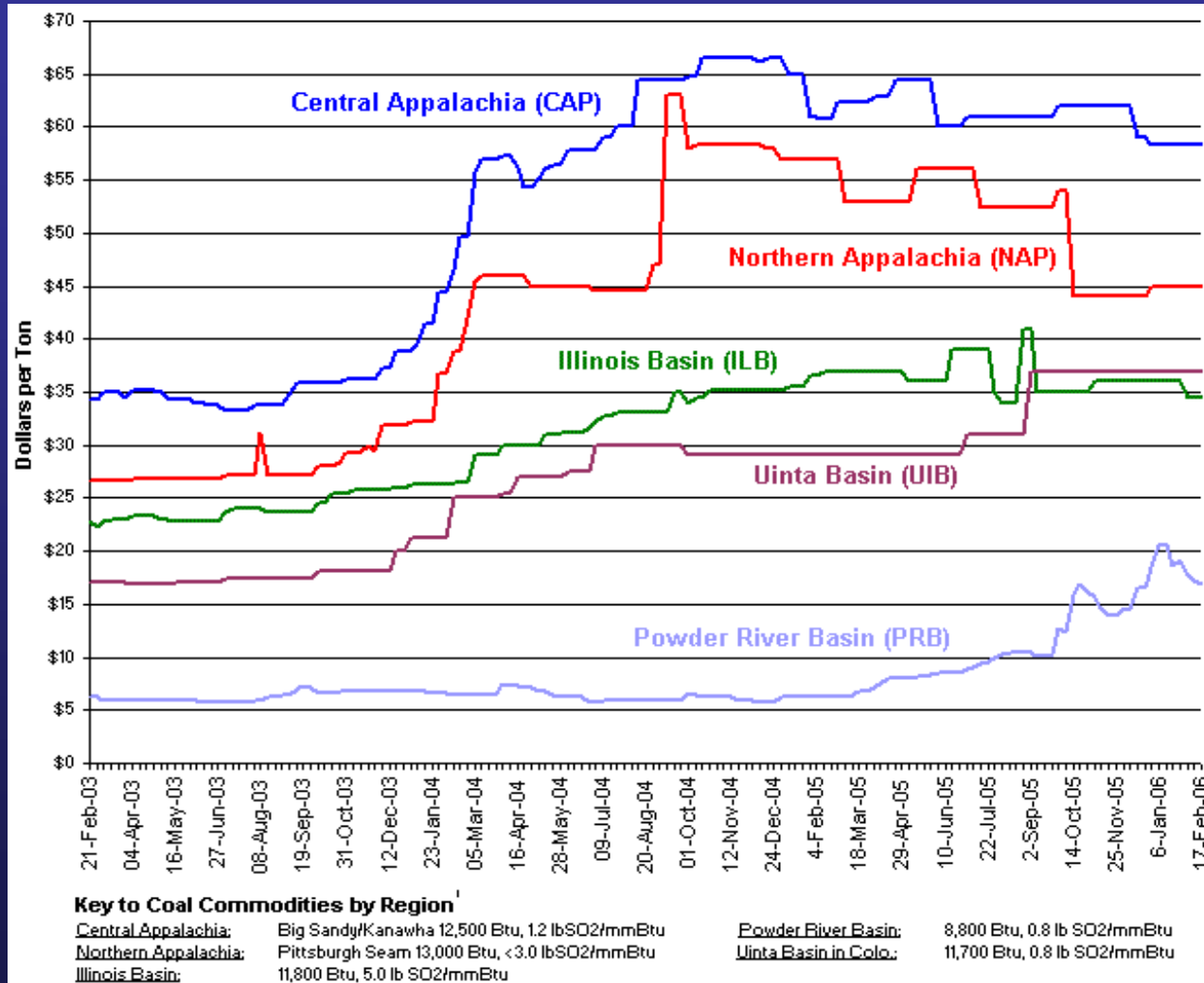
**Powder River Basin (WY)
Production Market Shares (2004)**



- Coal customers' market concerns
 - Tripling of PRB spot coal prices in 2005
 - Several Governmental Investigations in Recent Years
 - DOJ 2001 Price Spike Investigation
 - FTC 2004 Challenge to Arch/Triton Merger (concerns of market consolidation and producer market “discipline”)

WESTERN COAL SUPPLY ISSUES (con't)

- 2005 run-up in Western coal prices (anomaly or trend)?



(EIA: Average Weekly Coal Commodity Spot Prices Business Week Ended February 17, 2006)

CONCLUSION

- Coal Remains the Electric Generation Dominant Fuel
- Recently, Significant Market Price Pressures on the Delivered Cost of Coal have Arisen
- Even with Price Increases, Price Differentials Between Coal and other Substitute Fuel Choices (e.g., Natural Gas) May Continue to Keep Coal Demand Strong (as Recognized in EIA's 2006 Annual Energy Outlook)
- Who Pays?