

THE
WOODSIDE
CONSULTING
GROUP

PRIVILEGED AND CONFIDENTIAL
MEMORANDUM

Date: October 13, 2005
To: Kirk Trost
Cc: Paul Chrisman
From: John Williams
Subject: Potential Abandonment of the Santa Cruz Subdivision

I. Introduction

Woodside has been asked to assess the probability that the Santa Cruz Subdivision ("SCS") could be abandoned immediately after its acquisition assuming that the line had been purchased by SCCRTC (or by another purchaser similarly situated) and, we have assumed, that it would be operated by a short line.

As an employee of the Southern Pacific, I was involved in and/or managed the abandonment of numerous SP Lines over a ten-year period in the 1960s and 1970s. As a part of my duties, I prepared and presented testimony before both the California Public Utilities Commission and the Interstate Commerce Commission. On July 18, 1975, I testified before the Subcommittee on Surface Transportation to propose changes to the economic standards that were contained in Senate Bill Number 863 for determining railroad abandonment cost calculations and the subsidies for the continued operation of unprofitable rail lines. Subsequently, my proposed economic standards were, for the most part, incorporated into the Surface Transportation Board's

("STB") regulations that today govern railroad abandonments. More recently, during 2005, I advised the Amador County Transportation Commission with regard to the abandonment of the Amador Foothills Railroad between Ione and Martell, CA.

II. Conclusions

Based on the analyses contained in this Memorandum of the public interest, as determined by the STB, the economic standards that the STB employs to weigh a railroad's losses against the public's need for continuing operations, and of the rail customers located on the SCS, it is Woodside's opinion that there is no chance that the STB would deny an application by SCCRTC and its short line operator for abandonment of the Santa Cruz Subdivision.

Further, it is Woodside's opinion that none of the rail customers, including Cemex and the connecting railroad, the Santa Cruz, Big Trees and Pacific Railway Co. ("Big Trees"), would be willing to provide the amount of financial assistance required by the STB in order to either continue operations of the SCS or to purchase it, subsequent to a STB grant of authority to abandon the line.

III. The Public Interest

As required by 49 U.S.C. § 10903, no line of railroad may be abandoned and no rail service may be discontinued unless the STB finds that the present or future public convenience and necessity require or permit the abandonment or discontinuance. As a practical matter, the STB's application of this standard under its current regulations will result in authorization of an abandonment application if continuation of rail service over a line does not permit a rail carrier to cover all of its costs, including the opportunity costs of using its physical properties for other purposes.

If authority for abandonment were granted, only an Offer of Financial Assistance (“OFA”), that would permit the rail carrier to remove the financial burden of continued operation of a line or an offer to purchase the line, would prevent abandonment. Although the carrier seeking to abandon a line and the financially responsible person providing the OFA are encouraged to reach agreement on the amount and duration of financial assistance, the STB, if requested to do so, will determine the amount and terms of the subsidy required for continued operation based on the revenues on the line, the avoidable costs of providing continued rail transportation on the line, plus a reasonable return on the value of the line. Alternatively, if requested to do so, the STB will determine the price and other terms of sale, which must be at a price not below the fair market value of the line; such fair market value is defined by the STB as the greater of the net liquidation value of the line or the going concern value of the line. For the SCS, the net liquidation value is clearly the greater of the two values.

When determining the extent to which the avoidable costs of providing continued rail transportation plus a reasonable return on the value of a line exceed the revenue generated by a line, the STB gives little consideration to hypothetical future traffic projections that are not grounded in the historic traffic base of the line. Moreover, the STB gives little if any consideration to either the environmental or highway impacts of shifting rail traffic to trucks that would occur if the line were abandoned.

IV. The STB’s Economic Standards

The standards for determining the relevant revenues, avoidable costs, and required return on value of a line in an abandonment proceeding are found in 49 C.F.R. § 1152.30 – 1152.37. This Subpart D of Part 1152 contains the methodology and the standards for presenting the abandonment submissions that are used in the STB’s determinations.

A. Revenues Attributable to the Line

The revenues attributable to a rail line are defined by the STB to be those that would cease upon the discontinuance of rail service on a line. For a short line whose operation was limited to the SCS, only the revenues (including switching charges, demurrage, etc.) that the carrier receives for the movement of traffic between Watsonville and Davenport would be relevant. As calculated in Wilbur Smith Associates' Draft *Going Concern Valuation* submitted March 15, 2004, total revenues for the short line operator of the SCS were projected to be \$1.1 million.

B. Avoidable Costs

The costs that are relevant to the STB's determination are defined to be those which are "avoidable," that is, those costs which would no longer be incurred if rail service on the SCS were halted. Such avoidable costs are categorized in the usual functional operating expense groups of:

- Maintenance of Way;
- Maintenance of Equipment;
- Transportation; and
- General And administrative.

For a short line operating only the SCS, all of its costs would be avoidable. In its Draft *Going Concern Valuation Report*, Wilbur Smith estimated the costs of a short line operator of the SCS at \$1.0 million, all of which would be avoidable.

The STB also provides rules for apportioning costs between branch lines if more than one line were operated by a short line. The relative use of the assets or personnel on the several lines is the primary basis for such apportionments. For the SCS, we doubt any apportionments would be

pertinent with the possible exception of any General and Administrative costs that might be incurred if the short line operator used the same resources to manage other lines in addition to the SCS.

In theory, according to the STB's regulations, the depreciation and return on the value of all freight cars and locomotives owned and operated on the SCS would be calculated at their depreciated current replacement costs and the short line's cost of capital. This provision does not apply to privately owned cars. Most likely, however, if the short line leases from others and pays car hire to the Union Pacific, the short line would probably calculate its avoidable freight car and locomotive ownership costs based on the amounts it actually paid in freight car hire and in lease payments for freight cars and locomotives.

The STB does allow the inclusion of any required rehabilitation expenditures as avoidable costs, and the amounts to be included are defined to be those necessary to permit efficient operations over a line. In future years, such rehabilitation costs may become relevant and significant to the SCS for the rehabilitation of one or more of its bridges and/or for portions of its track structure. Assuming for illustrative purposes only that a rehabilitation cost to the SCS of \$0.5 million was projected in an abandonment application, then the applicant's submission to the STB would increase the short line operator's avoidable costs from the \$1.0 million level projected in the Draft *Going Concern Valuation* Report by Wilbur Smith to a total of \$1.5 million, including the rehabilitation costs.

C. Return on Investment

This is an element of great importance to a SCS abandonment application because of the high value of the SCS land. In addition to an allowance for working capital, the STB's regulations require that the net liquidation value of the road properties is the relevant investment base upon which the short line is entitled to earn a reasonable return. The STB's definition of the net

liquidation value of both the land and the track and structures parallels the definitions used in the net liquidation value studies that have been performed for SCCRTC by Arthur Gimmy International for the land and by Woodside for the track and structures. For the purposes of this Memorandum, we assume the total net liquidation value of the SCS would be about \$19.0 million today, although that value will undoubtedly increase in future years as the value of the land in the SCS Corridor increases.

The owner of the road property who proposes to withdraw it from common carrier rail service is entitled to earn a reasonable return on the net liquidation value of the road properties. Although the STB provides alternative methodologies for calculating a reasonable return in accordance with a rail carrier's cost of capital, the default reasonable return is defined to be the cost of capital as calculated by the STB in its most recent *Determination of Adequate Railroad Revenues*. This is an annual calculation made by the STB that in recent years has ranged between 10% and 12%. Applying the lower end of the range, a 10% return on the current net liquidation value of the road properties on the SCS amounts to \$1.9 million, annually.

It is this single economic element, the reasonable return on the value of the road properties of some \$1.9 million annually, that we believe over-powers all of the other economic factors that the STB would consider when deciding whether or not the SCS would be permitted to be abandoned. It is why SCCRTC and its short line operator would, we believe with absolute certainty, be permitted to abandon the SCS in future years. The \$1.9 million annual return on value also creates an economic barrier that would, in our opinion, preclude an OFA by any rail customer located on the SCS, just as the \$1.9 million net liquidation value would preclude purchase of the SCS by any rail customer located on the SCS.

Even assuming hypothetically that the net liquidation value of the road properties on the SCS was substantially lower than the \$19.0 million value that we have used in this Memorandum (say only \$10.0 million), then a 10% return would amount to \$1.0 million annually. Even if the reasonable return on the value of the road properties were only \$1.0 million annually, however,

we believe that amount would still over-power all of the other factors that the STB would consider when deciding whether or not the SCS would be permitted to be abandoned. Similarly, even a \$1.0 million annual return would, in our opinion, preclude an OFA by any rail customer located on the SCS, just as a \$10.0 million net liquidation value would preclude the purchase of the SCS by any rail customer located on the SCS.

To summarize, an application to abandon the SCS would show the following economics, excluding any rehabilitation costs:

	<u>Millions</u>
Attributable Revenues	\$1.1
Avoidable Costs	(1.0)
Return on Value	<u>(1.9)</u>
Net Loss	\$(1.8)

The net loss of \$1.8 million is the economic burden which must be removed from the applicant if rail service is to be continued.

V. Rail Customers on the Santa Cruz Subdivision

According to the Draft *Santa Cruz Branch Line Business Plan* dated August 4, 2004, prepared by Systra Consulting, there are eight rail customers who are now rail served on the Santa Cruz Subdivision. Six shippers are located in Watsonville, one in Santa Cruz, and one at Davenport. In addition, Big Trees handles occasional freight shipments via an interchange at Santa Cruz.

Also according to the Draft *Business Plan*, the SCS generated 4,767 carloads annually, of which 3,550 were generated by Cemex in Davenport. Of the remaining 1,217 carloads of traffic, 852 carloads were generated in Watsonville and 365 carloads were generated in Santa Cruz.

Woodside believes, based on information provided by Cemex, that the more likely volume of traffic moving on the SCS is in the range of 3,500 to 4,000 carloads instead of the 4,767 carloads stated in Systra Consulting's Draft *Business Plan*.

Based on experience, Woodside believes that if abandonment of the SCS occurred, then all of the rail customers located in Watsonville would load and unload their perishable commodities at other rail facilities located on the Union Pacific within the Watsonville area, that the lumber customers located in Watsonville and Santa Cruz would also accept their inbound lumber traffic at transload facilities located elsewhere on Union Pacific's trackage, and that final delivery to their destination facilities would be converted to truck.

Therefore, we conclude that because of the relatively small economic impacts that abandonment of the SCS would create for the Watsonville and Santa Cruz rail customers (including Big Trees), their willingness to provide funding through an OFA for either the continued operation of the SCS or its purchase in accordance with the STB's economic standards is highly unlikely and is also probably beyond their financial capabilities. Accordingly, although several of the smaller rail customers located in Watsonville or Santa Cruz may protest before the STB a proposal to abandon the SCS, it is Woodside's opinion that none of them generate sufficient traffic in order to assure the STB that continued operation of the SCS would not be at a loss, nor would any of the same rail customers be willing to put up the large amount of hard cash required in order to continue rail service.

Unlike the smaller rail customers on the SCS, Cemex is an international company with substantial financial resources and wide-spread rail operations. Given Cemex's mix of products that are traditionally moved by rail, including coal, slag, gypsum, and cement, the added economic costs of handling the large volume of Cemex traffic through transload facilities and by truck and, therefore, the adverse impacts of the abandonment of the SCS on Cemex, are judged to be substantial. Moreover, Cemex's use permit for its Davenport Plant requires that a portion

of its outbound cement traffic move by rail. Thus, we would expect Cemex to oppose any application for abandonment of the SCS.

Despite Cemex's opposition, however, it is Woodside's opinion that the STB would authorize abandonment of the SCS in accordance with its economic standards that would show the revenues attributable to the SCS are less than the avoidable expenses plus a reasonable return on the value of the SCS by \$1.8 million annually. Given such an STB decision, Cemex would probably consider the use of an OFA to fund the continued operation of the SCS line at a cost of \$1.8 million annually. Divided by Cemex's traffic volume of 2,800 carloads annually, the funding of an OFA would increase Cemex's transportation costs by \$643 per carload, on average, an amount that we believe would be unacceptable to Cemex, given its lack of interest in operating the SCS that Cemex has stated to us in our discussions. Alternatively, Cemex could request that the STB permit it to purchase the SCS at its fair market value, which is currently estimated at about \$19.0 million. Such a large expenditure (whether \$19.0 million or, hypothetically, \$10.0 million), if made, would still require either Cemex or the short line that it selected, to operate the marginally profitable SCS. Thus, it also seems highly improbable to us that Cemex would take such an action.

It is our opinion that, faced with a STB decision authorizing abandonment of the SCS, Cemex would most likely seek to negotiate away from its use permit the mandated percentage use of rail service. Alternatively, and perhaps in combination, Cemex would seek to negotiate the continued use of the same number of outbound truck movements in future years as were used in the most recent year prior to abandonment of the SCS. Further, Cemex could adjust the Davenport Plant's production to those markets that it could continue to reach economically by truck. Thus, although the overall economic impact on Cemex of the abandonment of the SDS would be substantial because of the substitution of transload facilities and truck service for rail service, it is Woodside's opinion that neither none nor all of these economic impacts are substantial enough to cause Cemex to prevent the abandonment of the SCS either by funding an

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OFA for its continued operation or by purchasing the SCS at its fair market value and participating with its selected short line in the future operation of the SCS.