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Taking Lumps

As Utilities Seek More Coal, Railroads Struggle to Deliver

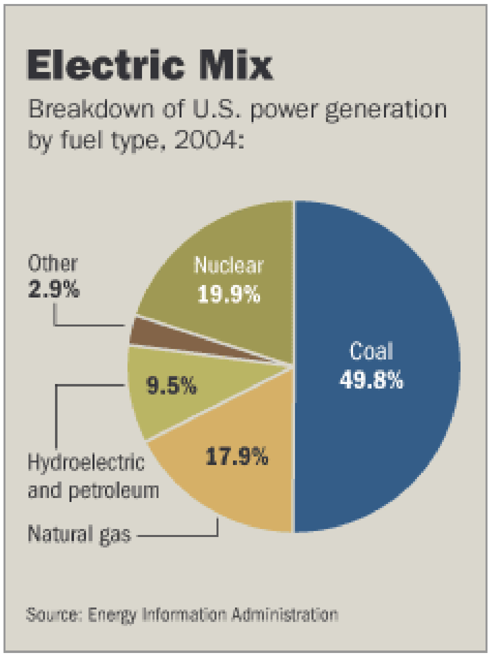
Snags in Wyoming Ripple Through Taxed Network; Power Plants Run Short

A 5,833-Hopper-Car Deficit

By REBECCA SMITH and DANIEL MACHALABA
March 15, 2006; Page A1

During the past 10 months, Arkansas Electric Cooperative Corp. has been forced to do things that power generators hate to do: It cut electricity production at plants that are the cheapest to operate and ran its costliest units harder than ever. At times, it even bought electricity on the open market at top prices.

The electricity co-op made these moves because it is afraid of running out of coal. That's surprising in a country with such vast domestic reserves that some dub it the "Saudi Arabia of coal." But Arkansas Electric has a problem that is a growing concern for many U.S. utilities: It can't get enough coal to run its power plants because the trains that serve as its supply line aren't running on time. Delays in coal shipments to the Arkansas generator began last May with rail disruptions in Wyoming and forced the utility to burn more natural gas, lifting its 2005 power-generation costs by 21%, or $100 million.



Nearly a year after problems began, "coal deliveries still aren't back to normal," says Steve Sharp, head of fuel procurement for Arkansas Electric, which furnishes power to 17 utilities. That, in turn, inflated power bills by about $20 a month for residential electricity consumers across much of Arkansas. For big industrial energy users, the hit was even greater. Matt Szymanski, general manager of Green Bay Packaging Inc., which operates a paper mill in Morrilton, Ark., says he "freaked out when I saw the power bill for December," which was double that from a year ago.

At a time of surging prices for petroleum and natural gas and rising anxiety about U.S. reliance on overseas energy sources, coal more than ever is seen as the U.S.'s dirty, but reliable, ace in the hole. With 27% of the world's proven reserves, the U.S. in recent years has seen stable coal prices relative to other fuels used for power generation. But the ability of railroads to get coal to power plants when it's needed is suddenly no sure thing.

Consolidation has left the rail industry with just a half-dozen major operators, which have been cutting rail routes and costs since the industry was deregulated in 1980. That can cause paralyzing bottlenecks when something goes wrong. Last year, a series of derailments dramatically delayed coal shipments from the Powder River Basin in Wyoming, one of the nation's most important coal-producing regions. The delays have cut into fuel supplies at many coal-fired power plants around the country. In some cases, supplies are perilously low.

Now, the utilities are pouncing on the delays and a longstanding beef over concentrated ownership of rail routes, which crimps competition. Major utilities are asking members of Congress to hold hearings on the coal-delivery problems. They may ask Congress to direct the federal regulator, the Surface Transportation Board, to establish reliability standards for railroad deliveries and enforce them if necessary. In the past, Congress hasn't shown much interest in imposing new regulations on the railroads. But the fact that coal-delivery problems in some cases could threaten the reliability of power supplies pushes the contest to a new level. Meanwhile, the railroads are seeking a 25% federal tax credit on investments that expand railroad capacity.

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COMPANIES

Dow Jones, Reuters

CSX Corp. (CSX)

PRICE	59.56
CHANGE	3.01
	3/15

Burlington Northern Santa Fe Corp. (BNI)

PRICE	81.30
CHANGE	4.80
	3/15

American Electric Power Co. Inc. (AEP)

PRICE	35.75
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PRICE	90.25
CHANGE	5.04
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For decades, coal was the No. 1 commodity moved over the rails. Lately it has been displaced in the rankings by consumer goods, with much of that cargo pouring into West Coast ports from Asia. The utilities recently have been required to pay sharply higher rail rates. As their old negotiated contracts expire, the utilities are forced to pay the railroads' standard rates, pushing up fees by 20% to 100%.

Railroads are strained by a surge in freight of all types -- from coal to containers -- and rail rates are going up across the board. But the utility industry is complaining loudest. Snags in railroad service are fueling fears that railroads won't be able to meet the growing demand for coal, casting a cloud over a goal set by President Bush and key members of Congress to make America "energy independent."

The big rail carriers stress that the industry, after years of overcapacity and dismal profits, finally is in good enough shape to invest heavily. Meddling by the government now, says Chris Jenkins, a vice president of CSX Corp.'s railroad subsidiary, is "the surest way to wreck the railroad system and prevent us from making the types of investments that are necessary."

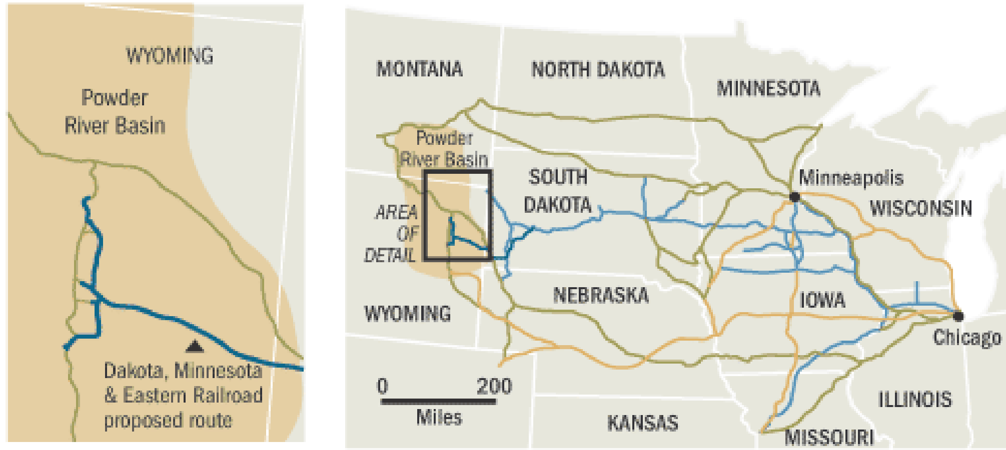
Matthew Rose, chairman, president and chief executive of Burlington Northern Santa Fe Corp., estimates that the railroad has spent about $2.7 billion since 1994 to maintain and expand capacity for moving Powder River Basin coal. He says that when the Clean Air Act of 1990 kicked off the demand for low-sulfur Western coal, the railroads stepped up. They have increased the amount of coal hauled from the Basin, including a section in Montana, to about 400 million tons a year from half that in 1990. The area now accounts for about 40% of the U.S. coal mined.

"We have provided just incredibly reliable transportation and have allowed tremendous growth of the basin since 1990," he says, calling the problems in Wyoming last year an "episodic event" that's unlikely to be repeated.

Big utilities, until recently, have shied away from a public confrontation. But Michael Morris, chief executive of American Electric Power Co., Columbus, Ohio, warned Congress in mid-February that "railroads have put the electric industry in a potential crisis situation this winter and next summer."

Bringing the matter to Congress, rather than trying to work things out quietly, shows how much the level of frustration has grown. Some utilities, backed by state regulators, are clamoring for more federal review of rail rates and the creation of national service-quality standards, backed by penalties for infractions.

One reason for hope in the long term: Rail regulators this year approved an application of the Dakota, Minnesota & Eastern Railroad Corp. to build a new line out of the Powder River Basin. Although it would take three years or more to construct, a new line could shake up the dominance of Union Pacific Corp. and Burlington Northern by adding 25%, or 100 million tons, of new capacity. The railroad is seeking a $2.5 billion loan from the federal government and commitments from utilities to use the new route.



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

In the short run, utilities are worried that a shortage of coal this summer, when air-conditioning use pushes electricity demand to its peak, could force them to buy power on the expensive spot market. The utility industry estimates that the cost of substituting more-expensive fuels for the 20 million tons of Powder River Basin coal held up in Wyoming and Montana last year topped $3 billion.

"We're going to have a really huge problem if railroads aren't held accountable for reliable deliveries and reasonable prices," says Sandra Hochstetter, chairwoman of the Arkansas Public Service Commission, who wants the federal government to exercise more forceful control.

The deteriorating relationship comes as the power sector heads for greater reliance on coal, which long has been used to create about half the nation's electricity. For the last 10 years, the industry has been building natural-gas-fired plants almost exclusively because the fuel is cleaner and the price was attractive. As natural-gas supplies and prices have become a problem, the power industry is shifting to coal in a big way, with plans to build more than 100 coal-fired power plants in coming years at a potential cost of more than $100 billion. The federal Energy Information Administration forecasts that the electric-power industry will produce 3% more electricity from coal in 2007 than in 2005. Production from natural gas is projected to drop by 2% over the same period.

Unlike natural gas, which flows smoothly and silently through thousands of miles of underground pipelines, coal must be loaded onto trains of 100 cars or more and hauled across hundreds or thousands of miles of prairie, towns and farmland to where it's burned.

Although one unit of gas is nearly indistinguishable from another, coal types vary greatly and utilities have incentives to acquire it from more sources than in the past. One big reason is tighter air-pollution rules. Many Midwestern and Eastern utilities want more of the Western coal in their mix because it's "low sulfur" and therefore less polluting. But Eastern coal burns hotter, which means a given volume will make more electricity. The various types also carry different prices: A survey Feb. 17 by the EIA found Powder River coal selling for $16.85 a short ton versus $58.25 for Central Appalachian coal and $45 for Northern Appalachian coal. The trade-offs complicate railroad logistics since many utilities want to burn a mix of coals now.

Railroads say the power industry's sudden interest in coal over natural gas caught them by surprise. Now, the railroads are spending hundreds of millions of dollars to build new double- and triple-track stretches and buy

additional locomotives.

Wall Street investors, for the most part, want railroads to keep their capacity tight, so as not to erode their newfound pricing power.

The recent coal-delivery problem has its roots in something fairly mundane. Last spring, an accumulation of coal dust that had fallen or blown from moving cars in Wyoming prevented track beds from draining properly. Amid the spring thaw and heavy rain, the poor drainage left the water with no place to go. That resulted in derailments and track damage along stretches of the major railroad line that takes coal trains that are more than a mile long out of the Powder River Basin. As a result, the railroads sharing the line -- Union Pacific and Burlington Northern -- failed to meet their coal-delivery commitments. Shipments picked up late last year, but it takes a long time to make up for lost loads, given how taxed the rail system is already.

The consolidation has left little backup capacity and fewer options to reroute freight when there are floods, derailments or other service breakdowns. Some of the biggest bottlenecks are in major rail hubs such as Chicago. When trains get backed up in one place, the effects ripple through the system.

Consider Laramie River Station, a big power plant in southeastern Wyoming that is owned by six utilities and furnishes power to consumers in nine states. At this time of year, the plant would normally have 700,000 tons of coal on hand. But it's now down to 140,000 tons even though the plant is only 170 miles from the Powder River Basin. At 125,000 tons, which it may reach in the next few days, the plant likely will cut production. "Already, the bulldozers are scraping up dirt with the coal," says Shelly Sahling-Zart, assistant counsel of the Lincoln Electric System, a member of the consortium.

Representatives of the Laramie River consortium say the delivery problems began soon after a long-term contract with Burlington Northern -- the railroad serving the plant -- expired in late 2004 and have gotten progressively worse. Adding to the sense of injury was the fact that rates were doubled. Burlington Northern spokesman Richard Russack says the railroad committed a train of its own in February, supplementing the three trains owned by the utilities. Trains used in the area tend to have 125 to 135 coal-carrying hopper cars. But, given that the facility is short the equivalent of 5,833 hopper cars, it's doubtful the plant can catch up in its reserves very fast. The utilities say they're paying $70,000 a month for the extra train.

For utilities, the problem is that the road to relief -- either for service-quality problems or high rates -- runs through the Surface Transportation Board, the federal agency that reviews railroad mergers, rates and service. Utilities generally feel the board favors railroads over their customers. Board Chairman W. Douglas Buttrey says his tiny agency, created in 1995 to replace the once-huge Interstate Commerce Commission, has an obligation to "balance the interests." But the board's power over railroads is limited. The industry is exempt from some aspects of antitrust law and the board can only rule on whether its prices are reasonable.

Otter Tail Power Co., a small Minnesota utility, recently concluded it had had enough of rising rail rates at the hands of Burlington Northern, which provides the only rail service to Otter Tail's power plant in Big Stone City, S.D. The first step in filing its protest with the Surface Transportation Board: paying the board's $102,000 filing fee.

Under an arcane procedure required to make its case, Otter Tail created a virtual railroad on paper -- complete with hypothetical routes, equipment, freight and customers -- to show that even a brand-new rail line would be able to serve Otter Tail's coal needs at a lower cost than Burlington Northern. But in February, after a four-year case that ultimately cost $4.5 million, the board told Otter Tail that its arguments came up short and the higher rates would stand.

A growing group of members of Congress is worried about deteriorating rail service and the high cost to consumers. Sen. Conrad Burns, a Montana Republican, introduced a bill that would slash fees for rate challenges to $150, require faster action by the board and eliminate the "virtual railroad" economic modeling. Others are looking at a host of remedies, including reimposing some antitrust rules.

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