RAILROAD WEEK IN REVIEW

JUNE 9, 2006

"Record YTD coal volumes were made possible by Norfolk Southern's commitment to invest in the infrastructure, equipment, manpower and technology needed to serve the coal industry efficiently." – Don Seale, EVP and Chief Marketing Officer

Watching rail stocks come back from the dead Thursday afternoon was quite an experience. It was almost as if Jim Cramer had predicted Thursday's Rally. The night before on his Mad Money show he talked about how to tell when a mid-session rally has legs. Said he, "Only the rallies that start around 2:45 p.m. tend to be successful. That way the sellers don't have time to put orders out before then and the bell. Next, wait for the margin players to be cleared out, and finally, wait for the shorts to cover."

My first clue that we might have a sustainable rally came at about 1:50 when BTU broke back into the black for the day. Half an hour later BNI and CP turned positive, followed shortly thereafter by UNP. Then came GWR and KSU with CSX and NSC bringing up the markers. CNI, RRA and FLA never got into the black and they finished the day still in the red. By the end of the day BNI and CSX had lost some of their momentum and so finished slightly down.

As this downturn progressed I was becoming concerned that as interest rates ratcheted up earnings estimates would drift south, taking PE multiples with them and further dampening any chance for rail stocks to get out of their funk. But even though at Thursday's close the trading week still had a day to go it was most encouraging to see the turn, and as it happened, Friday was more of the previous.

Meanwhile, an AP piece time-lined 2:51 crowed, "Fears of Economic Spur Profit-taking in Railroad Shares." Lord knows there were profits to take, and the bears have been taking them repeatedly for weeks. BNI was 17% off its 52-week high hit April 19. UNP hit $97.26 on 5/10 and was down to $83.83 on 6/8, a decline of 14%. GWR hit a high of $36.50 on 4/24 and had plummeted 25% to $27.60 before Thursday's rally. So it's not like all of a sudden rail investors are heading for the door. In fact, they had already started to come back in when the AP headline hit.

There remains one serious disconnect. I've been looking for plain-Jane 30,000 gallon tank cars for an ethanol client. There aren't any. GATX, TRN, GE Rail Car and ARI have all said that everything they have is spoken for and, in the case of TRN, they're taking orders for cars to be built in *2009!* And yet all four builders – TRN, ARII, RAIL, GBX -- are still 20% or so off their highs. The fundamentals are simply not that bad, and all but RAIL are cheap with PEG ratios right around one-point-oh. As for ethanol loadings, NS' Dave Lawson told the shortline group on Monday that his ethanol business is up 34% YTD. The disconnect is that cars are scarce yet the guys who build them are getting beat up.

And speaking of NS, this year's shortline gathering in Roanoke was particularly notable for several reasons. There were in attendance more than 250 shortliners representing 134 shortlines out of NS' 250 or so. Coincidentally, 134 NS shortlines are 286-compatable. Now I'm not saying those were the only shortliners there, but there was a dearth of representation from the really small guys.

Perhaps it was just as well. NS, like BNSF and CN, has been fairly emphatic over the years that they are moving ahead with technology and capital investments to speed up and add value to the entire supply chain process. And they expect their shortline partners to do likewise. It was almost an embarrassment to learn that there are still 21 shortlines that do not report car data over the internet, relying on hard-copy faxes that somebody else has to re-key. Or that only 53% of NS shortlines' event reporting is up to snuff. The laggards are the guys that will be the fallen flag class of 2010, and that's too bad. However, that there are 134 NS shortlines that ***get it*** and took the time to come to Roanoke to see what's new is a good sign in deed.

The main takeaway for me is that NS is getting quite comfortable with the concept of being in a growth industry. They are not shy about saying that they know what works and what does not work; there are only so many assets to go round. Yes, NS took on 8,000 new hires over four years, bought 500 new locos and rebuilt untold others, is spending $2.1 bn to replace 28,000 freight cars, and is bring on-line state of the art operating tools like UTDC and LEADER that provide greater visibility of and control over train dynamics.

It also says that NS at fifty bucks a share is a steal. I can see where NS will continue to be able to command premium rates and push operating expenses still lower. We know that NS has a track record of leveraging operating income gains north of 30% every quarter and I suspect these tools will only accelerate the process. So, Mr. Shortline Operator, here is a great opportunity to leverage your future with some of the best and the brightest in the industry. Paper faxes just won't cut it any more.

The late Wall Street unpleasantness has been particularly hard on the home builders (DHR, Pulte, Toll, KB Homes, Ryland, e.g.), raw materials (PD, FRK to name two) and agriculture (ANDE, PEIX ADM, BG) as the bloom has come off the ethanol rose. As we've noted before, shortlines' futures are closely tied to ag, forest products and raw materials.

For proof, look no further than the NS breakout sessions where individual shortline reps meet with various NS commercial and ops managers on matters of mutual importance. There were 248 scheduled sessions in 15 categories from accounting through transportation. Just four groups -- agriculture, chemicals, metals/construction and forest products -- accounted for 122 of the 248 sessions. As the economy goes, so go these sectors and the shortlines that depend on them.

Railfans Unite! BNSF has officially invited the foamer community to help keep BNSF properties safe by reporting suspicious activities and to help prevent possible security breaches. This is an excellent move. As a rule, railfans notice stuff and can quickly tell when something's wrong with this picture. Train crews talk like train crews, have radios, sometimes wear reflectorized vests and always safety shoes. Track guys have hard hats and look like track guys. Turnouts on the main are always lined for the main unless a diverging move is imminent (either the train is there or the home signal so indicates). And so on.

In its press release BNSF asks fans to register at the website for Citizens United for rail security http://newdomino.bnsf.com/website/crs.nsf/request?open). CRS participants will receive an official identification card along with access to news and information on the BNSF CRS Web site. To report suspicious activity, CRS members and the public can call (800) 832-5452. The information will be taken by a BNSF representative and routed for appropriate response.

The CRS program is an outgrowth of another BNSF grassroots program, called BNSF ON GUARD, which encourages employees to report suspicious activities, trespassers or individuals to BNSF's Resource Operations Call Center (ROCC). The BNSF ON GUARD program, which started in 2003, has received reports on theft, vandalism, arson, attempted suicide, and other criminal violations, threats to safety, or unusual events on or near railway properties.

DME Extension Rankles. To begin, I lost a few zeroes when I reported the expected cost of the PRB build-in as $250 mm. (WIR 6/2/2006). Wrong. It's $2.5 billion! Put in context, that's $700 mm more than Amtrak's FY 2005 grant request to Congress. Now I ask you, if given a choice of one or the other, which creates the better benefit for the common weal? But then, it's really not about public good – take the recently approved bill to spend $700 mm to relocate the CSX main in southern Mississippi to accommodate casino owners and a new highway.

The DME expedition has not been universally hailed as a good use of taxpayer money, either. Take this sampling from last week's e-mail box: "Maybe there should be a taxpayer lawsuit filed against using Federal $ for **new** private freight railroad investments. Bailing CR out and doling out low interest loans to improve extant infrastructure is one thing but investing in a new railroad (non-transit) that will compete with private enterprise I believe is quiet another. If the utilities are so all wrapped up in it why don't they fund it? Or am I missing something somewhere?"

RMI's RailConnect sample of 269 shortlines shows revenue unit volumes increased 5% yoy in Week 20 (ending 5/20/2006) and 3.6% YTD. Double-digit gainers for the week included coal, farm and food ex-grain (mainly STCC 20), petroleum and coke as well as metals. YTD the winners were this group less pet/coke plus aggregates. (Coincidentally, NS mets business was up 11% YTD, surpassing IM gains by four percentage points).

The larger picture as painted by Bear Stearns shows "total reported carloads and intermodal units increased 6.8% yoy in Week 20, driven largely by a very easy year ago coal comparison resulting from last year's derailments in the Powder River Basin, though absolute volumes were also strong, up 0.5% sequentially versus the prior week. Excluding coal, overall volumes were up 2.7% yoy."

Elsewhere, BSC reiterated its Outpeform rating on BNSF and included some positive comments of interest to shortlines. Reporting from this week's analysts' meeting in Denver, Ed Wolfe writes, "We believe there is the most opportunity for operating and margin improvement in BNSF's coal and carload franchises. Management noted that its coal business, surprisingly, is its least profitable segment. Longer term, we believe coal should likely be one of BNSF's highest margin businesses segment once all legacy coal contracts have been re-priced to market levels with fuel surcharges."

He also reminds us that 30% of BNSF's 2006 incentive plan is tied to velocity improvements (see also my May 2006 *Railway Age* story on my transcon trip). The faster railroad is the more efficient railroad and that "will allow for continued volume growth and support further margin improvement." Personally, I see the present stock price downturn as another buying opportunity. BSC has a target price of $88 for six months out, a 12% gain if you buy here and an APR of 24%. Not too shabby.

Railmark Holdings has purchased Coe Rail (CRLE) from founder Laurence Coe. The CRLE is in the metro Detroit area and operates the former GT line between Wixom and West Bloomfield. It was one of the first lines formed after Staggars and today hauls plastics, lumber and aggregates.

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RailConnect Index of Short Line Traffic

Traffic Type: All

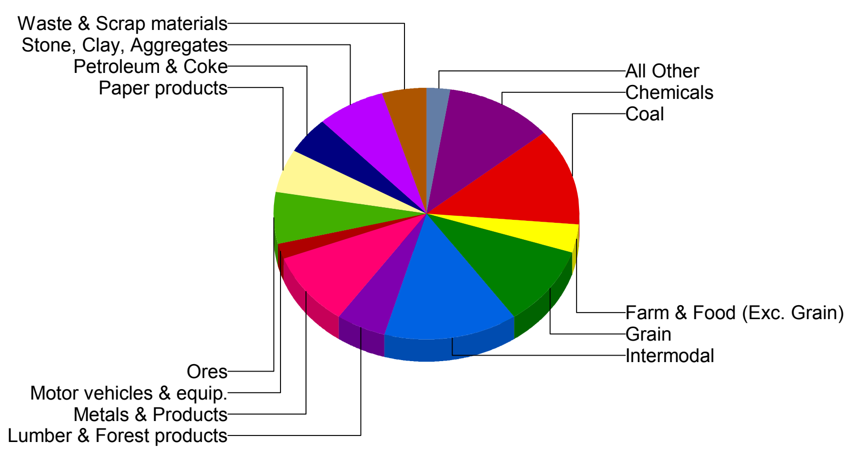
For the week ending: 5/20/2006

Week Number: 20

Carloads Handled	Current Week 2006	Current Week 2005	Current Week % Change	Year-To-Date 2006	Year-To-Date 2005	Year-To-Date % Change
Coal	14,840	12,880	15.22%	302,951	282,135	7.38%
Grain	12,599	12,430	1.36%	245,099	233,206	5.10%
Farm & Food (Exc. Grain)	4,355	3,932	10.76%	85,250	78,288	8.89%
Ores	9,336	10,096	-7.53%	162,527	177,039	-8.20%
Stone, Clay, Aggregates	10,930	10,456	4.53%	177,577	164,927	7.67%
Lumber & Forest products	6,451	6,877	-6.19%	123,942	121,679	1.86%
Paper products	6,963	7,199	-3.28%	132,335	136,015	-2.71%
Waste & Scrap materials	6,253	5,749	8.77%	111,688	106,812	4.57%
Chemicals	13,504	14,356	-5.93%	271,002	274,175	-1.16%
Petroleum & Coke	5,821	5,165	12.70%	110,460	107,858	2.41%
Metals & Products	11,961	10,321	15.89%	231,058	220,419	4.83%
Motor vehicles & equip.	2,588	2,453	5.50%	45,359	44,955	0.90%
Intermodal	17,964	16,045	11.96%	344,903	314,196	9.77%
All Other	3,276	2,820	16.17%	62,042	61,906	0.22%
Total	**126,841**	**120,779**	**5.02%**	**2,406,193**	**2,323,610**	**3.55%**

RailConnect Index

Year-To-Date



All Other	2.6%
Chemicals	11.3%
Coal	12.6%
Farm & Food (Exc. Grain)	3.5%
Grain	10.2%
Intermodal	14.3%
Lumber & Forest products	5.2%
Metals & Products	9.6%
Motor vehicles & equip.	1.9%
Ores	6.8%
Paper products	5.5%
Petroleum & Coke	4.6%
Stone, Clay, Aggregates	7.4%
Waste & Scrap materials	4.6%
Total:	100.0%