RAILROAD WEEK IN REVIEW
SEPTEMBER 8, 2006

"As the wave of incoming containers turns tidal, the question becomes whether the nation's transportation system can handle the flood." – Tom Murray, Rail StockWatch, Sep 2006

Norfolk Southern has finalized a funding agreement with the states of Ohio, West Virginia, Virginia and the Federal Highway Administration (FHWA) for $95 mm toward the Heartland Corridor rail double-stack clearance project. The project will open up clearances for double-stack train service between Norfolk and Columbus. Through mutual agreement among all the parties, the FHWA's Eastern Federal Lands Highway Division will serve as project leader.

The Heartland Corridor Project is a public-private partnership whose purpose is to expand capacity, improve service consistency and cut a day off the present routing via Harrisburg and Pittsburg. The Heartland Corridor was designated as a Project of National and Regional Significance under the recently enacted SAFETEA LU legislation. Now that funding has been nailed down the requisite engineering and environmental studies can be completed. Completion is scheduled for 2009.

Meanwhile, Bear Stearns on Tuesday advised clients that they are lowering their Q3 eps NSC estimate to 80 cents from 85 cents and CY 2006 to $3.28 from $3.35. The argument is that Q3 to-date volumes are less robust (+1.0%) than expected and trail both 2Q06 (+3.9%) and 3Q05 (+4.6%). Analyst Ed Wolf writes, "We have not made any offsetting adjustments to pricing or margins and now we believe that there is cushion in our model for a re-acceleration in vols or better margins."

Bear has also taken down the CY 2007 estimate by a dime to $3.80. NSC retains its Outperform rating "given NSC's high-end returns and cash flow, consistency of network operations and current low end valuation. NSC also has the most upside in the group on a price-to-past peak basis." This in spite of the fact that "near-term earnings expectations appear difficult to achieve." Target price for year-end 2006 remains $49.

You want Mayo on that? Holman Jenkins Jr, *Business World* writer for the WSJ, penned a pensive piece on the DM&E extension Tuesday. Titled "Train in Vain?" Jenkins points out that SD Senator John Thune, supporter of the earmark legislation behind the FRA loan, is a former lobbyist for the DM&E. But wait – it gets better. Thune now sits in the Senate seat until recently occupied by one Tom Daschle. Having lost that seat to Thune, Daschle found another seat: on the board of the Mayo Clinic, leader of the opposition to the DM&E project.

In an interesting twist to an old argument, Jenkins cites the long conflict between utilities and railroads over "captive" rates on the one hand and the need for the rails to add infrastructure to handle more coal, containers, autos and food. Recall that for a while rails held rates down to keep the delivered cost of a mm BTUs of coal under the cost of a mm BTUs of natural gas. Yeah, gas is down to $6 per mmcf or so, but who knows how long that'll last?

Jenkins concludes that there are 124 new coal-fired plants on the boards around the country and rail capacity has to be built ahead of them. The clinic, says Jenkins, "is the largest user of electricity for miles around. Maybe they need to ask what's on the other side of the outlet."

Shortline carloads as measured by RMI's RailConnect Index ©, attached, increased 1.8% in Week 33 ending Aug 19. YTD shortline cars were up 3.74% over the first 33 weeks of 2005. Intermodal and coal continue to be major contributors to the mix at 14% and 12% respectively, however these commodities actually show up in any significant volumes on just a handful of shortlines.

The real story is in grain, stone/clay/aggregates, metals and chemicals which account for nearly 40% of all shortline revenue units in about equal amounts. Lumber and paper combine to add another 10% of loads. Of these, mets were up the most at 11.4% yoy followed by the aggregates group at 7.2%. Grain loads increased 3.7% while chems were off 0.6% with STCCs 24 and 26 bringing up the markers, off a combined 7.9% for the year vs. 2005.

North American Class I revenue units increased 3.3% in Week 33, nearly double the shortline growth rate, and 3.1% YTD, slightly behind the shortline rate of increase. Metals increased 6.2% and grain was up 10.4%. Class I forest products and paper declined 6.2%. I find it instructive that in the lower-rated commodities (STCCs 01, 24, 26) where both the shortlines and Class Is were up, the larger roads were up more. And where both were down, the shortlines were down more. That may be a function of unit trains for the grains and transloads for paper and lumber.

The rails' cyclical headwinds continue to blow. You and I know the rails are in better shape than they have been for a ling time, but Wall Street still doesn't get it. Just this week, Jim Cramer recalled his earlier and very positive interview with CSX CEO Michael Ward (WIR 7/21/2006) and added, "The stock is just dirt cheap, and when the Fed cuts, it will be a buy. But for now, don't buy. Don't buy." Ditto for NSC: "Until the Fed cuts interest rates, you are dwelling in the House of Pain. And there are no exits." And as the sector goes, so go the stocks in it.

Also this week Merrill Lynch cut its ratings on NSC and CNI to neutral from buy citing a "slowing economy" and relative exposure to auto and forest products (9% and 12% of 2Q06 revs for NS, 14% and 7% for CNI). The Merrill report notes that NS serves eight of the ten Ford assembly plants targeted for closure. Target prices for buy-rated BNI, CSX and UNP were taken down as well, to $43, $84 and $100.

Tom Murray (*Rail StockWatch*, Sep 2006) asks, "How cyclical are the rails? That's the question *du jour*, but it's really two separate issues: how sensitive are the railroads themselves to fluctuations in the economy, and how sensitive do investors think they are? The decline in rail stocks in recent months answers the second question: the market is anticipating a weaker economy in 2007, and it has rushed to get out of rail (and other transportation) stocks while there were [still gains] to be had."

He then suggests that the railroads "have a price and productivity story outside the economy." I think he has a point. The rails have been competing on price for seeming ever because the only way to win *any* business was to price below trucks. Doing so shrinks margins, reduces operating income, net income and cash flow to the point you have no choice but to put yourself out of business bit by bit.

Fast forward to 2006 and the highways are jammed – been on I-40 across NM lately?? – truck fuel prices are triple what they were not that long ago, hours-of-service regs are taking big bites out of already-thin margins and drivers are getting scarce. Now the rails have more business than they can handle *if* they use the old ops model of move a train only when there are enough cars. If they act like a growth industry, though, they *can* handle it. Quarterly double-digit gains say they are right now.

Asset management is the key, and that includes crews, locos, cars and track. Getting rates up to a point where they will support more and better assets means you've got to provide a better product. Interstate transportation is a $500+ bn industry and a housing slow-down or a cooling of the consumer discretionary goods market isn't going to affect it that much. Tom Murray wraps his rant with this Matt Rose quote which is very much to the point: “If there is an economic slowdown we should see an improvement in the import business as people will be looking for lower-cost goods.”

Coal remains a major rail earner but Dangerfield-like it’s getting little respect these days. The S&P stock report for Peabody (BTU) says, “Our risk assessment for Peabody Energy reflects extensive industry regulation, narrow customer focus, the potential for geological difficulties with mines, transportation problems, and volatility in prices of competing fuels, offset by the company's leading market position, and well diversified (geographically) coal holdings.”

For its part, BTU has cited equipment problems and transportation constraints combined will “keep third-quarter earnings at the low end of its targeted range,” which I read to be in the range of 39-44 cents a share vs. 42 cents in 3Q05, with annual production of about 230 mm tons. Prices have come down by a third, forcing the closure of low-margin mines. Moreover, more coal from Australia is helping to take down world coal prices after China’s surging demand had punched them up.

Industry sources say App coal now fetches $46 a ton, down from $58 in Dec and PRB product has been cut from $20 to $10 a ton, an “aberration” according to some. Part of the reason is that utility stockpiles of coal, which were critically low in 2005, are now in surplus. However, this may be short-term as more new coal-fired generating plants are built, along with emerging markets for converting coal into liquid or gas. In the last four years, the utility coal burn is 23% consumption is expected to double by 2030. By comparison, natural gas and hydro-electric power have grown 12%, oil by 8%percent and nuclear (NOOK-u-lar to some) by 4%.

So I’m not selling my BTU just yet even though I am down double-digits. And as coal use regains its former leadership in the scheme of things, previously marginal producers – some located on shortlines -- will find new opportunities and – who knows – maybe I’ll have to start including coal in my shortline carload comps.

Chinese steam may have left China, but it’s now running in Iowa. The TRAINS magazine *News Wire* reports that on Sep 6 “Chinese class QJ 2-10-2 No. 6988 led a freight train on the Iowa Interstate Railroad . The locomotive, one of two purchased by the owners of Iowa Interstate, Railroad Development Corporation, led train BICB (Blue Island, Ill. to Council Bluffs, Iowa) for approximately 20 miles from Iowa City to Homestead, Iowa. There, the engine uncoupled to let the freight train head west, then ran backwards light to Iowa City. The trip was made to break in the locomotive prior to four days of excursions that will operate out of Rock Island September 14-17. RDC's other QJ, No. 7081, has not made a break-in trip yet.” Thanks, Henry.

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RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 8/19/2006

Week Number: 33

Carloads Handled	Current Week			Year-To-Date		
	2006	2005	% Change	2006	2005	% Change
Coal	16,210	14,000	15.79%	483,564	454,628	6.36%
Grain	12,943	12,182	6.25%	403,546	389,148	3.70%
Farm & Food (Exc. Grain)	4,481	4,191	6.92%	140,255	130,928	7.12%
Ores	8,837	9,433	-6.32%	284,674	292,659	-2.73%
Stone, Clay, Aggregates	11,645	11,394	2.20%	325,056	303,198	7.21%
Lumber & Forest products	6,592	7,295	-9.64%	207,559	220,516	-5.88%
Paper products	7,504	7,530	-0.35%	225,792	230,732	-2.14%
Waste & Scrap materials	6,237	5,891	5.87%	192,071	175,499	9.44%
Chemicals	14,766	14,242	3.68%	452,931	455,471	-0.56%
Petroleum & Coke	5,637	4,777	18.00%	185,678	168,172	10.41%
Metals & Products	10,684	9,306	14.81%	379,864	341,048	11.38%
Motor vehicles & equip.	2,060	2,308	-10.75%	72,546	71,634	1.27%
Intermodal	16,528	19,468	-15.10%	561,046	545,364	2.88%
All Other	3,149	3,000	4.97%	105,299	96,140	9.53%
Total	**127,273**	**125,017**	**1.80%**	**4,019,881**	**3,875,137**	**3.74%**