RAILROAD WEEK IN REVIEW
SEPTEMBER 15, 2006

"How gas prices affect the average Wal-mart or Target customer is of keen interest to us." – Patrick Casey, AVP for planning and forecasting, TTX.

Schwab Chief Investment Strategist Liz Ann Sonders recommends overweighting consumer staples – soup, soap, cereal, and suds (BUD) – and underweighting consumer discretionary items – cars, coats, computers. The signs of an economic slow-down are upon us and, says Sonders, the continuing short-and long-term treasury yield curve inversion points almost invariably to recession.

The reasoning is that a normal yield curve tends to slope up as investors believe that the economy will grow as usual. Short-term money is less risky and so earns interest at a lower rate than longer term instruments – more time into the future means more uncertainty. Curves invert when investors believe the economy is contracting and bonds with longer maturity dates will yield less and less the longer out. Thus investors seek to lock in higher rates today because future rates may be even lower.

The link to TTX is this: consumer discretionary items increasingly come from off-shore sources whereas soup, suds, cereal and soaps come from places like Camden, St Louis, Cincinnati and Grand Rapids. That's why Patrick Casey cares about the behavior of the Wal-Mart and Target (Tar-*zhay* if you want to sound upscale) shoppers more than whether Crest or Special-K sales are up.

In other words, the commodity carload side of the railroads' house is apt to get hurt less in a consumer-driven down-turn than the intermodal side. Shortlines, being mainly carload businesses, ought to weather a softening economy as long as they are not tied to lumber and residential building materials. And to the extent they are, it's a good time to start developing a traffic base more aligned to soup, cereal, soap and suds. (Disclosure: I own K and PG in my retirement account.)

RMI's RailConnect Index of Short Line Traffic through Week 34 (8/26) has the shortlines up 3.6% YTD with strengths in coal (6.3%), petroleum and coke (10.9%), metals (11%), farm and food ex-grain (7.4%). Lumber and primary forest products fell 6.2%, ores were off 2.8% and paper was down 2.4%. For the week, shortline loadings were off 1.6% with commodities continuing to behave as they have YTD. Class Is for Week 34 were up 2.4% led by intermodal, coal and metals; lumber, paper and autos all declined, so the shortlines seem to be tracking the larger roads for better or worse.

Genesee & Wyoming reported August 2006 revenue units up 13.4% yoy. Excluding Australia and the recent Chattahoochie Bay acquisition, loads were off by less than 2%. US and Canada business was essentially even with losses in forest products offset by gains in STCCs 01 and 20. YTD volumes thru August 31 increased 17.7% though ex-Australia and Chattahoochie Bay loads declined by 2.2%. Mexico still lags, so net-net US and Canada loads were off less than a percent.

RailAmerica's August 2006 revenue units decreased 2.1% as line sales accounted for three-quarters of the short-fall. Same-railroad units were essentially unchanged, off less than 500 units on a base of 104,000 units. Losses were heaviest in forest products and intermodal with offsets in overhead traffic mets and petroleum products. YTD units ex-line sales and acquisitions were down 1.4% yoy.

Liquidity and transparency in reporting are essential for any company to enjoy a positive ranking among serious investors. Among the Class I rails liquidity (the ability of the market to accommodate buyers and sellers at or near the buy or ask) are never a problem however transparency (the ability to see quickly what a company is up to) is uneven.

Part of the homework that goes with owning any equity is studying the press releases, analyst reports and listening to the conference calls, including the Q&A. That's important because how questions are fielded can affect one's perception of how well the CEO knows his own company. And reading the call transcript after the fact helps one fill in the blanks on the things one misses while one is scribbling. Trouble is, Class I conference call transcripts are scarce.

In fact, only Norfolk Southern has 'em. You'll see the slides, hand-outs and scripts for Hank Wolf and Don Seale before the call even starts. Wick Moorman's remarks go up a few days later and the Q&A shortly after that. These excerpts from the July call provide, I think, an invaluable window on what NSC is thinking and why they do what they do. Perpend:

Tom Wadewitz, JP Morgan: When you look at the economy right now, and you look at the pace of volume growth in first quarter, do you think it is reasonable to believe that you could continue to see that kind of 4 to 5 percent type of all-line unit growth?

Wick Moorman: We watch our volumes very closely and try and determine where any potential weaknesses are. One of the things we're sorting through for ourselves today -- and don't really have the answers for -- is the discussion as to how much of our volume growth right now is because of underlying changes in the transportation marketplace and how much is secular rather than cyclical.

So, I think it's fair to say that even if there is an economic slow-down, it's not clear to us what we're going to see in terms of potential traffic slowdown. In fact, there're some arguments that, in fact, a lot of our traffic will remain very good, regardless of some issues in the economy, but our best evaluation right now based on what we're currently seeing, and what Don and all of his people are hearing in the marketplace, is that we don't anticipate a substantial difference in volume growth in the second half than we've seen in the first half.

Don Seale: In terms of the second half, volume appears to be poised to be at a run rate of what we've seen in the second quarter. Certainly coal business will continue in terms of the utility and metallurgical market with its growth and intermodal is poised for further growth in the second half. Our metals and construction business will continue to grow; order books at the steel manufacturers look pretty good. They're telling us they're at capacity or close to capacity in terms of the run rate for the second half. So, volumes of 4 percent or in that range we feel fairly comfortable with.

Tony Hatch, Independent Analyst: Can you give us the breakdown in yield and how the fuel surcharge fits? I would also like some color on the good intermodal story that's going on, what's happening in year-over-year pricing and where you expect to see that?

Don Seale: Tony, with respect to fuel for the quarter, it was 60 percent of the revenue per unit growth. Now, that was somewhat impacted by the year-over-year comparison, again by the $55 million. As for intermodal, we continue to see strong demand; the truckload numbers that I showed you support that. Our international business continues to be very strong -- up 16 percent for the quarter and for the half. We see that continuing, and as far as demand goes, we price to the market and with the demand like that, obviously we're looking at yield improvement as we go forward.

Ken Hoexter, Merrill Lynch: Just to clarify what you're saying on that last answer, 60 percent of the 7 percent average revenue per car increase was fuel related, so pure pricing on mix was up 3 percent, and does that same 60 percent then apply to the 9.5 percent if you normalize for the coal, and you're still up then, what, 5.5, 6 percent on fuel and that means still 3 percent on pure pricing?

Don Seale: That was a very complicated question you just asked there, Ken. We had a negative mix effect in the quarter. And when we look at fuel again, we're looking at that delta between '05 and '06 quarter to quarter, in terms of RPU, so we had the volume increase, and we had that RPU increase, of which 60 percent was fuel, but mix was negative – mix was negative to the tune of about 3 percent.

[me again] The whole thing is on-line under the Investors tab at www.nscorp.com. If your shortline connects with NS, or if you're an NS customer or investor, listening too the call and studying the transcript is mandatory homework. And if you're none of these with NS but have a similar relationship with any other Class I, these are the Qs you need to be asking.

It goes without saying (but I'll say it anyway) that the general public really doesn't know much about freight railroads. Mention that you're in the rail business to your seat-mate on an airplane and the subject changes immediately to the weather. We're very good at preaching to the choir, but not so hot at getting the word out. And this failure comes at a cost.

Larry Kaufman writes in *Journal of Commerce*, "Today, the public doesn't even know what intermodal is. Computer word processors don't recognize the word and flag it as questionable (as happened in writing this column). When it comes to funding intermodal and other transportation infrastructure, it is too easy for Congress and state legislators to earmark public money for their pet projects — bridges to nowhere, museums, rainforest exhibits in Iowa, and the like. Those making a living running the various elements of the intermodal supply chain must tell their story."

Moreover, "It's fine for railroad, trucking, steamship and port terminal company executives to address seminars and other meetings where their colleagues and competitors will nod in agreement. But these audiences do not drive public policy changes." And those of us who've sat through unending presentations at short line meetings have to be wondering the same thing: why are we always preaching to the choir?

Among Class Is, NS is the only outfit telling the story in print and on TV. The AAR is moot. Other than a big push for the Railroad Day on the Hill the ASLRRA is as silent as the grave. Yes, we have Santa Claus Specials and holiday trains, but that's about entertainment, not making the case for infrastructure spending to the voting public. For example, I wish every analyst and financial writer could see RRA's New England Central the way I saw it last week: clean, well-maintained and professional. (More on my trip anon.) It's a story worth telling.

Like Larry says, "Most legislators see transportation as a vehicle for pork-barrel spending on pet projects. Some even see it as a source of new revenue for which no offsetting benefit need be offered." Happily, some states – Vermont, Virginia, NC and Penna come first to mind – see rails as an important part of their transportation infrastructure. But it's time the rest of them woke up.

RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 8/26/2006

Week Number: 34

Carloads Handled	Current Week			Year-To-Date		
	2006	2005	% Change	2006	2005	% Change
Coal	15,783	15,313	3.07%	499,347	469,941	6.26%
Grain	12,434	13,309	-6.57%	415,936	402,411	3.36%
Farm & Food (Exc. Grain)	4,408	4,089	7.80%	144,259	134,334	7.39%
Ores	8,349	8,903	-6.22%	293,023	301,562	-2.83%
Stone, Clay, Aggregates	11,610	11,253	3.17%	336,524	314,313	7.07%
Lumber & Forest products	6,502	7,631	-14.79%	213,846	228,033	-6.22%
Paper products	7,185	7,685	-6.51%	232,595	238,207	-2.36%
Waste & Scrap materials	6,225	6,104	1.98%	197,344	180,996	9.03%
Chemicals	14,643	14,144	3.53%	467,457	469,528	-0.44%
Petroleum & Coke	6,125	4,847	26.37%	191,803	173,018	10.86%
Metals & Products	11,599	10,529	10.16%	391,408	351,489	11.36%
Motor vehicles & equip.	2,273	2,365	-3.89%	74,819	73,999	1.11%
Intermodal	15,794	19,440	-18.76%	576,840	564,804	2.13%
All Other	3,597	2,983	20.58%	108,887	99,092	9.88%
Total	**126,527**	**128,595**	**-1.61%**	**4,144,088**	**4,001,727**	**3.56%**