RAILROAD WEEK IN REVIEW
APRIL 27, 2007

"Weakness in the housing and automotive sectors had the greatest impact on volume for the quarter and accounted for over half of our decline. Losses were experienced across the board in all of our business groups." – Don Seale, Norfolk Southern

The ASLRRA Annual Meeting in Baltimore earlier this week was by all measures a resounding success. With some 1500 souls in attendance it set all kinds of records. The theme was "Railroad U," a theme most appropriate given the educational opportunities afforded. After lunch on Monday, the meeting broke out into seven educational tracks and 40 different sessions covering Engineering, Finance & Administration, Legal, Legislative, Marketing & Emerging Markets, Operating & Maintenance, and Technology.

The three I went to -- Shortlines as Investments (see Hatch-Zwillinger below), Sources of Untapped Revenue, and Equipment Buy vs. Lease -- were all excellent and well-attended, My only quibble is that there were no sessions at all on three key areas where many short lines fall short: the nurturing of Class I commercial relationships (see "panel" below), what companies are looking for from transportation vendors in supply chain management, and the importance of enhancing customers' competitive advantage *vis a vis* their customers.

Suffice for the nonce to say that it was most encouraging to see so many shortline railroad owners, operators and marketers plus a huge gallery of suppliers hawking everything from insurance to software to crossing gates and rolling stock, all plunking down $250-350 a head to register and $200 a night for the hotel. It was a grand testament to the health of the shortline industry and to the leadership the ASLRRA has brought to this space.

As good as the meeting was, however, a cautionary note is in order. You can see from the attached table of Class I results that merch carloads were all down. This commodity sector is the shortlines' bread and butter, and that's borne out by the Week 14 chart from RMI. Thus it behooves shortline owners and operators to keep abreast of Class I merch carload trends and one of the best tools is tuning in on quarterly earnings conference calls of one's connecting Class Is. Yet not one of the shortliners I interviewed in Baltimore does.

Those who attended the Tony Hatch-David Zwillinger Show Monday afternoon learned there's a lot of money looking for homes in the shortline space. That money seeks robust properties with forward earnings potential. And the strength of the merch carload business is going to be in agriculture (grains, grain prods and ferts), mining, aggregates and coal. Check these earnings call reports and see how well your Class I expects to do in 2007 and see hour your line fits.

The common theme among all calls was revenues up and revenue units down. Merch carload revs were mostly up though NS took a 4% hit and there was not one Class I with any increase in merch carload numbers. To be sure, merch carload RPU was up across the board though CP alone was off a tad. Ops income gained significantly for UP as they held ops expense to a tiny gain against their 4% revenue gain. BNSF was at the opposite end of the scale with ops expense up 11% against a 5% revenue gain pushing ops income down 13%. The **black** numbers in the table below are the category leaders; the **red** ones are the laggards.

In short, shortline owners need to pay close attention to what works and does not. The message from Monday's Class I Market Managers' panel was clear: go out and sell competitive advantage in terms of customer supply chains and Class I equipment and capacity guidelines. Better to look for moves that turn cars quickly and with attractive contribution than onsey-twoseys at the other end of the scale.

Canadian National reported essentially no change in revenue in a quarter fraught with strikes, rotten weather, avalanches, mudslides and a slowing economy. Merch revenues (ex-coal and IM) were flat on 5% fewer revenue units though grains and ferts vols were unchanged yoy and RPU was up 5% in the commodity group. CN continues to hold its Big Six leadership position in merch revs as a percentage of total revs, 71%, though KCS wins the Class I category at 77%. The outlook is positive for all but – you guessed it – forest products.

The big surprise was seeing CN *increase* its operating ratio, up 3.5 points and breaking 70 in the process. During the call CEO Hunter Harrison said that it was the "most challenging of [his] 40-year career." But, said Harrison, it was a learning experience and they all came out ahead. CFO Claude Mongeau said the strikes and weather cost about $80mm in ops income. Another piece of the ops income downside was fuel-driven as the hedge ran out. Car hire and casualty expense were also pushed northward by weather and strikes.

Chief Commercial Officer Jim Foote said that the combined strike and weather effects cost CN some $90 mm in lost revenues split roughly 2/3 strike 1/3 weather. All-in ops income was off 10% and diluted EPS dropped 6% to 63 cents Canadian as the diluted share count dropped 6%. The strike and weather cost about a dime in EPS, without which CN would have reported 73 cents, up11%.

On the labor front Harrison said that turmoil in UTU leadership and the lock-out have not made for particularly smooth sailing in the negotiations. That said, they expect some resolution in 90 days and that in turn will "let us get on with our lives again." The operating model continues to be a low-cost one and he expects the benefits will be forthcoming as 2007 progresses as the daily metrics continue to set new records.

BNSF was next up and the theme of softening volumes and moderate revenue increases continued. Total revenues increased 5% but ops expenses rose 11% pushing ops income down 13% and EPS down 12% even after a 4% decrease in diluted share-count. Absent GAAP accounting adjustments EPS would have been $1.10, up 5% yoy, which means you can't always tell how a railroad is really performing for shareholders until you get behind the "official" numbers.

Total revs increased 6% to $3.5 bn, a Q1 record, on a point-six percent decline in total revenue units and a 6% gain in system RPU. Merch carload revenues increased 2% in a 3% dip in car-count. Ag products revenue increased 5% on double-digit gains in beans, ferts, bulk foods and ethanol partially offset by a 19% drop in wheat revs. Industrial products commodity revs were mixed as building products revs slid 14% on the decline in housing starts, petroleum products jumped 25% on "Fuel by Rail," asphalt and LPG, chems and plastics grew 14% on stronger demand, and strong steel and minerals revenue growth offset taconite declines.

Looking ahead, Chief Commercial Officer John Lanigan said they expect to see continued growth in coal and grain/grain products while the future for the Industrial Products group depends largely on the state of the economy. Consumer demand will keep international intermodal healthy though flat demand in the domestic IM segment may mute revenue gains going forward.

This last is significant because, as Bear Stearns' Ed Wolfe writes, "Weaker vols are leading to negative mix and, because BNSF has the biggest intermodal mix, we view them as susceptible to near term truck pricing pressure." In other words, the hungry OOs out there are going to take share from the JB Hunts and Schneiders who ride the rail a lot. That in turn is going to put pressure on shortlines' ability to load more merch cars even absent the general economic softening.

Canadian Pacific rang up an 8% yoy EPS gain on ops income, up only 1% as a $13 mm swing in foreign exchange on LTD accounted for two-thirds of the gain. Diluted share count dropped 2% on buy-backs so EPS was up 20% yoy to 82 cents Canadian. CEO Fred Green put it this way: "Our disciplined execution of the integrated operating plan, in addition to the investments in network capacity we've made in our Western corridor, paid major dividends for us this quarter. We were able to recover from each event as it occurred and keep our customers' shipments moving."

SVP marketing and Sales Marcella Szell (I wonder if she's any relation to former Cleveland Symphony Conductor George Szell) said freight revs rose 2% on moderate gains across the merchandise sector with the 32% bump in sulfur and ferts sales more than offsetting the 14% drop in forest products revs. Coal was off 18% on a yoy drop of 20,000 carloads largely due to the recent sale of the 92-mile Latta Sub to Tom Hoback's Indiana Southern (see *TRAINS* for Nov 2006).

Winter disruptions and the CN strike increased network congestion which resulted in reduced shipments in coal and other commodities. Other Q1 revenue declined $18 mm reflecting a significant 1Q06 land sale. Operating expenses were essentially flat, up 0.3% yoy despite the challenging winter operating conditions. Fuel, inflation and winter-related expense increases were partially offset by a drop in compensation and benefits expense. SVP Operations Brock Winter (what a coincidence!) said weather-related events degraded train speed and yard dwell while car miles/day, cars on-line and the 7-day rolling average GTMs improved however slightly.

Green concluded, "Our operational focus on network fluidity has increased our resilience and allowed our operations to rebound effectively. With the recent return to more normal operating conditions, we expect to move freight volumes with increasing efficiency and improved service levels through the balance of the year."

Norfolk Southern had Wednesday to itself and had a nice turnout at the Chase building in NYC to wish departing CFO Hank Wolf Happy Trails on his June 30 retirement after 67 consecutive earnings calls and 34 years with NS and its predecessor roads. Recently-tapped SVP Financial Planning Jim Squires did the honors with the financial portion which, in a change from past practice, followed Don Seale's marketing and sales remarks.

Said Seale (read his remarks *verbatim* at www.necorp.com/investors), "The 1Q07 economic headwinds and operational issues from severe weather conditions in our service area drove declines across all of our business groups with total volume down 86,000 carloads or 4%. [Merch carloads including auto were down 57,000 units, 8%.) We also faced a very strong comparison from the first quarter of last year which was our best first quarter ever in both volume and revenue. As a point of comparison, first quarter 2006 volume was up 94,000 units, or 5% over 2005. Our first quarter 2006 volume actually exceeded fourth quarter 2006 peak season traffic by 2% and was within 2% of third quarter totals as well.

In fact, NS suffered the *only* yoy percentage revenue drop of all seven Class Is as auto and metals/construction accounted for roughly 2/3 of the decline in revenue units. After the formal presentation Seale told me that for 1H07 NS revenue units to meet last year's, he'll need to see an additional 153,000 loads just to match the 2Q06 record levels. Even the yoy delta in RPU was nothing to holler about – just 2%.

The ops side held its own however as ops expense came down 2% yoy on significant cuts in compensation and fuel. Trouble is, 2% here against revs down by as much doesn't do much for ops income, down 4% yoy as a result. Net income dropped 7% to $402 mm but EPS dipped just 2% as the share buy-back program decreased shares out by 5%. NS continues to buy on the dips (see Moorman's slide 4) and that's a good sign.

Kansas City Southern brought the Class I earnings season to a close Thurs with a resounding bang as net income after preferred divs more than doubled to $17 mm from $8 mm yoy. Unfortunately, diluted share count was up 19% largely on the Mexican transaction (call it a one-time shot) so EPS gained just (!) 91%. Working backwards, ops income increased 18% yoy as ops expense was held to a gain of less than 4% against a 6% revenue increase.

The merch carload sector remains KCS' bread-and-butter, accounting for 77% of revenues and 55% of revenue units. (That's what $1249 per merch carload and a fifth of that per intermodal box will do to the averages.) Every commodity group but auto (Mexican production down 13%-plus) saw increased yoy sales even as vols slid less than 2%. RPU was up 8% with pure price contributing 8% of the revenue increase offsetting a negative 2.3% in revenue mix. Fuel surcharge gains and volume losses were a wash.

We've often remarked in these pages that any company can expect a certain amount of churn in its customer base and the RRs are no different. Thus it is encouraging to see a strong new business pipeline, and KCS has $173 mm in its pipeline as of this month. The 1Q07 conversion rate was 85%, putting $17 mm in incremental business into the KCS revenue stream. New opportunities expected to be converted within 12 months add another $18 mm in sales.

Bringing on this amount of new business requires a more nimble, faster RR and capex is the answer. Highlights for 2007 include more than 400,000 ties in the US and Mexico, 50 miles of rail, 12 new main line side tracks, 150 new locos (replacing 225 older units), 1400 new freight cars and – on the Meridian speedway alone – 130,000 ties, 40 miles of 136# CWR, five run-arounds and completing CTC for the entire 250 miles.

For dessert COO Art Shoener says they'll have Victoria to Rosenbrg done in 2008 and are filing for a RRIF loan next month. My suspicion is the FRA will go along given its prior favorable experience on the Tex Mex and the fact that KCS is certainly in better financial shape than the DME.

RailConnect Index of Short Line Traffic

Traffic Type: All

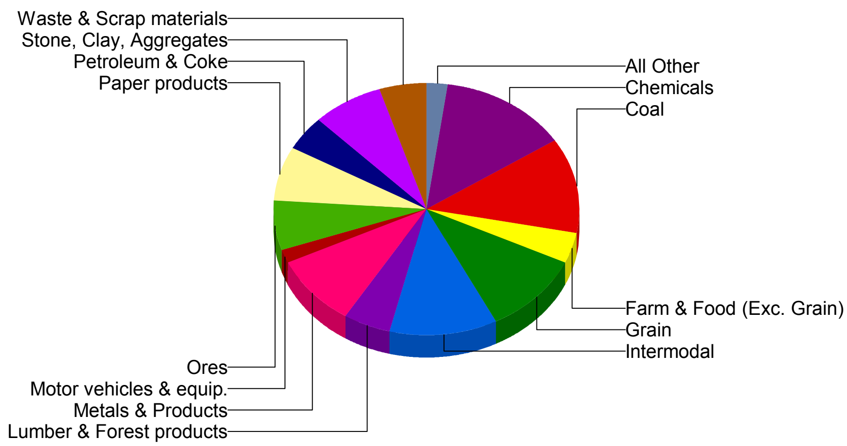
For the week ending: 4/7/2007

Week Number: 14

Carloads Handled	Current Week 2007	Current Week 2006	Current Week % Change	Year-To-Date 2007	Year-To-Date 2006	Year-To-Date % Change
Coal	12,923	17,052	-24.21%	207,062	224,584	-7.80%
Grain	12,064	13,238	-8.87%	180,070	193,189	-6.79%
Farm & Food (Exc. Grain)	4,478	4,742	-5.57%	62,734	67,618	-7.22%
Ores	5,628	8,928	-36.96%	106,044	116,902	-9.29%
Stone, Clay, Aggregates	10,927	11,501	-4.99%	129,491	143,241	-9.60%
Lumber & Forest products	6,382	8,067	-20.89%	85,950	111,872	-23.17%
Paper products	8,268	8,838	-6.45%	117,618	126,312	-6.88%
Waste & Scrap materials	6,213	6,244	-0.50%	82,344	83,982	-1.95%
Chemicals	16,334	14,877	9.79%	230,370	216,179	6.56%
Petroleum & Coke	5,793	5,662	2.31%	76,147	79,773	-4.55%
Metals & Products	11,127	12,735	-12.63%	153,083	166,169	-7.88%
Motor vehicles & equip.	2,384	2,586	-7.81%	30,505	32,458	-6.02%
Intermodal	13,937	17,250	-19.21%	190,871	241,528	-20.97%
All Other	3,137	3,444	-8.91%	39,060	45,991	-15.07%
Total	**119,595**	**135,164**	**-11.52%**	**1,691,349**	**1,849,798**	**-8.57%**

RailConnect Index

Year-To-Date



All Other	2.3%
Chemicals	13.6%
Coal	12.2%
Farm & Food (Exc. Grain)	3.7%
Grain	10.6%
Intermodal	11.3%
Lumber & Forest products	5.1%
Metals & Products	9.1%
Motor vehicles & equip.	1.8%
Ores	6.3%
Paper products	7.0%
Petroleum & Coke	4.5%
Stone, Clay, Aggregates	7.7%
Waste & Scrap materials	4.9%
Total:	100.0%

Class I Commodity Carload Comps

Quarter ending 3/31/2007

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 3,645	$ 1,906	$ 1,116	$ 2,422	$ 411	$ 2,247	$ 3,849
YOY Pct. Change	5.26%	0.47%	0.49%	3.90%	**5.90%**	**-2.43%**	3.75%
Revenue Units (000)	2,507	1,131	634	1,755	457	1,872	2,334
YOY Pct. Change	**-0.6%**	**-5.0%**	-2.7%	-3.9%	-1.5%	-4.3%	-2.5%
Carload revs (2)	$ 1,588	$ 1,352	$ 648	$ 1,412	$ 315	$ 1,228	$ 2,253
YOY Pct. Change	2.3%	-0.1%	**5.5%**	2.3%	4.9%	**-3.9%**	2.5%
Pct carload	43.6%	70.9%	58.1%	58.3%	76.7%	54.7%	58.5%
Pct Intermodal	32.8%	16.4%	28.6%	13.1%	8.0%	20.6%	17.4%
Pct Coal	20.9%	4.5%	12.0%	26.1%	11.0%	24.8%	19.0%
Mdse Carloads (000)	697	736	288	784	252	681	962
YOY Pct. Change	-2.7%	-4.8%	**-1.1%**	-6.0%	-6.4%	**-7.8%**	-6.3%
Rev/CL x coal, IM	$ 2,342	$ 1,837	$ 2,252	$ 1,801	$ 1,249	$ 1,804	$ 2,342
YOY Pct. Change	5.1%	4.9%	**-1.1%**	8.8%	12.1%	4.2%	**9.4%**
Operating Expense	$ 2,951	$ 1,345	$ 887	$ 1,935	$ 339	$ 1,719	$ 3,130
YOY Pct. Change	**10.5%**	5.7%	0.3%	4.9%	3.6%	**-1.9%**	0.8%
RR Operating Income	$ 694	$ 561	$ 229	$ 487	$ 72	$ 528	$ 719
YOY Pct. Change	**-12.5%**	-10.2%	1.1%	0.0%	18.1%	-4.2%	**18.8%**
RR Operating Ratio	81.0%	70.6%	79.5%	79.9%	82.4%	76.5%	81.3%
YOY Point change	3.86	3.51	(0.13)	0.78	(1.82)	0.43	(2.37)

(1) CN, CP in $Canadian

(2) Excludes coal, intermodal

Source: company financials

Week in Review for April 27, 2007