RAILROAD WEEK IN REVIEW
JULY 27, 2007

"We are confident that the structural factors that have driven our growth are still in place." – Wick Moorman, NS earnings call

Earnings calls for the Big Six Class Is plus KCS concluded this week. What follows is a summary of those calls with the usual WIR emphasis on the carload sector and operating earnings. I'm still including auto in the carload sector though that may change in Q3 because of the fall-off in auto parts shipments, specifically STCC 37147, where short lines used to have a stake. Asset turns and system velocity are increasingly critical. The table following the disclosure offers some comps.

Canadian National once again takes top honors for lowest operating ratio (60.0) and highest percentage of revenue (69.2%) from the merch carload side of the house. Yeah, I know, certain detractors say that with government health care their OR is not a straight comp with US roads, but, hey, even without what some say is a six-point advantage nobody else is within eight points. As for the merch carload side, critics say it's "a simple network" without the branch-line density of a CSX or UP. But at the end of the day running a successful merch carload franchise is *still* all about gathering and distribution.

CEO Hunter Harrison in his opening remarks said this was a "bounce-back quarter" from some unusual Q1 challenges but once again the Five Principles of Precision Railroading paid dividends. Operating income rose just 70 basis points yoy to C$811 as the 2% ops expense gain offset the meager 1.4% revenue gain to C$2027 mm. Fuel and car hire took big hits as the former was up 10% and the latter more than doubled. Higher fuel expense was mainly price as $23 mm in hedges wore off even though gallons were down 2%. The hike in car hire came mainly because the rails in the US are turning cars back faster so there are fewer credits to offset CN's organic car hire expense. Below the line eps increased 6% to C$0.95 from C$0.89 before deferred tax recoveries. Adjusted net incomes were C$486 mm vs. C$479 mm respectively.

Merch carload revenues increased 2.9% on 2.6% fewer revenue units. RTMs were down 1% and fuel surcharge recovery was down 1%, however same-store prices gained 4% yoy thanks to a combination of mix and longer lengths of haul. Pets and chems revs were up 7% on 4% more loads as gains from ethanol and new initiatives in Alberta were offset by softness in plastics. Grains and fertilizer revenues from the US and Canada jumped a combined 7% on no change in loadings as ethanol and its derivative ferts and DDG gained. Auto was a surprise as sales grew 17% on 8% more loads. Forest products continued to be biggest drag, 7% off in revs and 12% in loadings due to the continuing US hosing softness and the higher priced Loonie vs the US dollar (90 Canadian cents vs. 71 cents not that long ago).

From a shortline standpoint, CN is probably the easiest to work with because of the way they run their railroad – doing the same thing the same way every day – *and measuring* what they do. I would urge you to turn to slide six of the Q2 presentation under the investors tab at www.cn.ca. Of particular value to short line railroaders are the trailing gross tons, cars per switching-hour and GTMs per available horsepower.

Convert GTMs to carloads and see immediately whether your loco fleet – including all the stored-serviceable units -- is the right size for your base traffic load. Cars per switching hour is the number of cars moved per hour of yard work – at interchange, intermediate yards or any other place not associated with place or pull on an industry track. Like I said, CN is probably the best carload operator franchise in the business and even this quarter's modest result is laden with lessons for the short line railroad operator.

Moving on to BNSF, we have the antithesis of CN in terms of the merch carload business. Even including Auto in the merch side (which BNSF does not), and putting Ag Products in the same pot as Industrial Products, Q2 BNSF non-coal or IM business contributed just 44% of total revenues. BNSF is, by their own definition, a "high-speed, heavy-haul, high-density railroad" and the intense focus to that end can be even a bit scary at times. But it works.

Top-line revenue was up 3.8% to $3.8 bn on 3.7% lower revenue-unit count, however system RPU was up a respectable 8%. Merch revs increased 5.9% against a 0.3% unit shortfall yet merch RPU was up 6.0%. IM was the only commodity group to get dinged in revs whereas everybody but ag took a hit in revenue units. Ops expense was up 5.8% driving ops income down 2.7% with fuel the biggie as hedges ran out pushing expense up 14% even as fuel burn was 4% less on 1% fewer GTMs. The operating ratio rose 146 BP to 78.1 in the bargain.

Drilling down into Industrial products, the area with the highest BNSF concentration of short line participation, total revenue increased 4.3% to $950 mm. Construction products is the largest group with $309 mm in sales, up 7% yoy, consisting of everything to do with steel from ores to ingots to scrap as well as aggregates, clays and cement. Then comes building products at $293 mm, down 6%, not surprising as this is where BNSF puts forest prods (both STCCS) as well as government, machinery and non-met waste. Petroleum products had $121 mm in sales, up 19% on Fuel by Rail, asphalt and LPG. Chems (all STCC 28) brought in $132 mm in sales, up 15%, on pure demand. Food and beverages, a new addition to the IP group since 1Q06, brought in $71 mm and is mainly STCC 20 with other consumer goods from tires to cotton moving in boxcars.

Ag products is another strong short line contributor and rounds up the usual grain suspects – beans, wheat, corn – as well as oils, sweeteners, ferts and ethanol. Group sales were up 9% yoy to a record $610 mm with ethanol surging 58% and ferts up 23%, partially to feed the larger corn acreage to support ethanol. But actual corn shipment revs dipped 8% as more corn went short-haul to the distilleries rather than to export.

Below the line net income drifted south 8% to $433 mm from $471 mm. Diluted eps came in at $1.20 vs $1.23 (excluding a 4-cent tax benefit), down 2.5% yoy. All in all, not a bad showing and a testament to what this company can do to keep its Velocity focus in what is not particularly the best of times. Moreover, these results point out a clear direction for shortlines wishing to capitalize on the BNSF focus on the high-density, high-speed, heavy-haul environment.

Canadian Pacific was an especially telling call given last week's Private Equity noise. Though CEO Fred Green said in his opening remarks he wasn't going to talk about the recent "speculation," Bear Stearns' Ed Wolfe did manage sort of an oblique response on splitting infrastructure and railway ownership. Said Fred (and I couldn't agree more), "There is no convincing economic business case for it." He also noted that any model for doing so must consider safety and the infrastructure required for keeping train ops safe and concluded by saying that the rail industry has the best ever opportunity to build new revenues while continuing to reduce the unit cost.

Clearly he must have in mind the disastrous results in the UK when they split the train operating companies away from track ownership an gave infrastructure responsibilities to a new outfit, RailTrack, which then managed capex to meet its shareholders' best interest. Derailments and loss of life ensued. Nobody wants to chance a repeat.

CP increased freight revenues for Q2 by 8% to a record C$1.2 bn while holding the ops expense gain to less than 7% thereby bumping ops income up 9% to C$308 mm and taking the OR down 38 BP to a comfy 74.7 from 75.0 last year. Net income excluding FX gains and other below-the-line items came in at C$1.12 per ticket, up 12% yoy. The revenue drivers were sulfur and ferts, up 37% chiefly in exports and ethanol-related corn plantings; coal was up 13% and grain revs added 9% yoy.

RPU went up 4% across the merch carload board as higher rates prevailed even though some commodity-OD pair RPUs declined due to longer hauls in shipper-owner cars and volumes rose only 3%. Forest products slid 12% in loadings and 2% in revenue. Intermodal was a classic mix story as the domestic-international mix changes increased boxes handled by more than 50% while revs increased but 3% and RPU decreased 3% yoy. System RPU was off 2%.

Out on the railroad CP demonstrated its ability to recover from various Q1 challenges from strikes to weather through fluidity and execution. They've returned to the performance levels posted in 2006 and are looking for better ops balance this year. CP is going for bigger, faster trains and better yard performance. Cars-on-line dropped by 1% and car miles per day improved by 10%. In his concluding remarks, Green said that the quarter demonstrated CP's "resilience in spite of disruptive events" and that the metrics are headed in the right direction. I'll buy that.

Norfolk Southern operating income rose 2% to $690 mm on $2.4 bn in revenues, down 1% yoy. Operating expense decreased 2% and the OR came down another 70 basis points to 71 even. Net income was up 5%, helped by lower interest payments and tax rates; eps ratcheted up 10% thanks to the share buy-back program that cut diluted shares 10% yoy. Free cash flow came in at $388 mm or 16% of revs. Capex for the Q was $575 and is going up, unlike some other roads reporting this quarter. CEO Wick Moorman said they will be adding 50 more loco units at a cost of $93 mm chiefly to speed up unit grain and coal trains, continuing the NS theme of replacing freight car capital with loco capital.

Car counts were down across the board ex-chems though RPU was up in every group. Don Seale, Chief Commercial Officer, noted that "demand for transportation services has not returned to the robust levels seen in 2006. The primary constraint to GDP continues to be a weak housing market, which, along with higher gas prices, has contributed to a slowdown in consumer spending growth." In fact, the paper/clay/forest group was again the worst volume performer with units off 8.4% and sales dipped 3.6% on a 5.3% RPU improvement.

That said, NS rang up its 19th consecutive quarter of yoy RPU gains on a system basis thanks to continued strength in pricing and moving toward better yields in traffic mix. The merch carload revs hit $1.3 bn, up 1%, on a 4% decline in revenue units – autos and manufacturing again. Merch RPU gained 5% to a record $1822 per revenue unit, the best ever and the 14th consecutive quarter of increases in this commodity group. Positive traffic mix changes in the quarter, with less low-rated short-haul business, the addition of some higher-rated import volumes, and favorable pricing across the commodities helped. See www.nscorp.com/investors for a transcript of Don's comments.

The message to short lines is to become aggressive marketers of higher-yielding commodity OD pairs with low cycle times. NS, like every other road reporting this season, says it has no intention of relenting on price to increase volume for volume's sake. NS expects that merch carloads in 2H will be up in mets, aggregates and biofuel-related corn, beans and DDGs, with this last amounting to some 7,000 loads. Depressed housing-starts will continue to be a drag as will be the effects of further GM and Ford plant closures. However, said Seale, "we see improved pricing and yield across all groups as expiring contracts and quotes are re-priced in the second half."

Kansas City Southern's Q2 results reflect their continuing saga of sequentially improving returns. Total revenues increased more than 3% to $427 mm while ops expense was held to a 2.5% bump producing a 7.2% operating income gain, taking the OR down 70 basis points to 80.5 – recall it was 88.7 adjusted for comps as recently as 2Q05. Net income before preferred divs came to $30.2 mm for a net margin of 7%. Net income available to common shares was 36 cents a ticket exclusive of certain refinancing costs, a gain of 50% from the 24 cents in 2Q06.

Auto revenues grew by 17.8% over last year, a reflection of the growing importance of Mexico to the North American automotive industry. Coal revenues also experienced double-digit improvement increasing by 10.4% on strong volume. Chemical and petroleum products grew by 5.1%. Growth in grain business was a key driver leading to a 4.6% increase in agriculture & minerals, and despite a continued slow US new-homes market, paper and forest products revenues rose 1.2%. On the IM side, Q2 revenues were basically flat as BNSF and UP business on the Meridian Speedway shifted around. Excluding the impact of the haulage, Q2 sales for IM grew about 14%.

System RPU increased 9% indicating that pricing power works as well for KCS as it does with its peers. During the call CEO Mike Haverty said they expect the second half to be better than the first, which is how it usually works on KCS. We should look for 6% yoy revenue gains as well as continued OR shrinkage from higher revenues (mostly price; fuel adjustments are not expected to be material) and the cost-containment program.

The RRIF loan app for Victoria-Rosenburg is in and construction has begun; even if the RRIF loan fails, they have alternative plans and the shortcut *will be built*. The port at Lazaro Cardenas is on schedule for a late Sep 2007 opening. Thirty of the 150 new loco units are now on the property with the remaining 120 to be split between the US and Mex as they arrive. The Eyeris revenue-cost management system is fully operational across the system and there's $33 mm worth of new incremental business flowing with another $45 mm potential behind that. Sure looks like everything is up to date in Kansas City, to coin a phrase.

The thread on Amtrak performance as a mirror on Class I freight performance drew this note from a friend who's been on both sides. His remarks are based on experiences a few years ago, however we all know that the railroads' institutional cultures – especially at the Division level and below – are not quick to change. (See Fred Frailey's train ride report, page 60, Feb 2007 TRAINS, also his news item, page 8, Oct 2006 TRAINS.)

"The CSX service design group," my friend recalls, "scheduled the merchandise network of trains which included merchandise, intermodal, local and automotive. These trains were given scheduled start and finish times, traveling specific routes with specific operating instructions (pick-ups and set-outs) at various different points along the route, generally crew change points. Amtrak, Maryland Area Rail Commuter (MARC) and Virginia Railway Express (VRE) were in this same category. They were given specific slots and times along with crew allocations if required. Merchandise trains were scheduled in such a way as to provide a wide-berth around the passenger trains.

"Coal, grain and unit trains like rock-runners were slotted in by their respective desks at the Operations center in West Jax and were not given specific time of day or day of week schedules. Since they did no work along their route and their destination is what mattered, there was more flexibility as to the way they moved." However, my friend notes there were times when the local ops guys would over-ride the trip plans for their own reasons.

Fast forward to the present and another correspondent reports that on CSX the Auto Train and "silver fleet" are running much better and such delays as there are more often come from equipment failures either on Amtrak or host railroad equipment. Stay tuned.

Class I Commodity Carload Comps
Quarter ending 6/30/2007
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 3,843	$ 2,027	$ 1,215	$ 2,530	$ 427	$ 2,378	$ 4,046
YOY Pct. Change	3.8%	1.4%	7.4%	4.5%	4.7%	-0.6%	3.1%
Revenue Units (000)	2,581	1,204	694	1,827	460	1,942	2,433
YOY Pct. Change	-3.7%	-3.4%	5.7%	-2.3%	-4.0%	-4.1%	-3.1%
Carload revs (2)	$ 1,687	$ 1,403	$ 690	$ 1,491	$ 331	$ 1,320	$ 2,386
YOY Pct. Change	5.9%	2.9%	9.6%	4.3%	4.4%	0.7%	3.1%
Pct carload	43.9%	69.2%	58.8%	58.9%	80.8%	55.5%	59.0%
Pct Intermodal	33.1%	17.1%	27.4%	13.6%	8.2%	20.1%	17.7%
Pct Coal	20.2%	5.0%	13.8%	25.2%	11.1%	24.3%	18.8%
Mdse Carloads (000)	716	779	307	822	261	724	1,021
YOY Pct. Change	-0.3%	-2.6%	5.0%	-3.6%	-3.3%	-4.1%	-4.6%
Rev/CL x coal, IM	$ 2,363	$ 1,801	$ 2,245	$ 1,814	$ 1,268	$ 1,822	$ 2,337
YOY Pct. Change	6.2%	5.6%	4.4%	8.2%	8.0%	4.9%	8.1%
Operating Expense	$ 3,002	$ 1,216	$ 907	$ 1,927	$ 344	$ 1,688	$ 3,259
YOY Pct. Change	5.8%	1.8%	6.8%	8.5%	2.5%	-1.6%	1.7%
RR Operating Income	$ 841	$ 811	$ 308	$ 603	$ 83	$ 690	$ 787
YOY Pct. Change	-2.7%	0.7%	9.0%	-6.5%	7.2%	1.9%	9.8%
RR Operating Ratio	78.1%	60.0%	74.7%	76.2%	80.5%	71.0%	80.5%
YOY Point change	1.46	0.24	(0.38)	2.81	(0.70)	(0.71)	(1.17)

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
Source: company financials
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