RAILROAD WEEK IN REVIEW
AUGUST 31, 2007

"Re-regulation will cripple efforts to achieve re-investability, derail capital investment, limit capacity expansion and reduce growth." – UP's Jack Koraleski

Union Pacific held its annual short line meeting in Omaha this week. This session is always unique in that there is a minimum of speechifying from the platform and a maximum opportunity to network with other shortlines and UP managers in all disciplines from marketing to operations to joint facilities. Moreover, feedback from the shortline attendees was generally positive. And where we uncovered opportunities to improve shortline relationships UP was generally receptive to ideas and acted promptly on them.

In the formal presentations, I found the candid remarks from EVP Operations Dennis Duffy and EVP Sales and Marketing Jack Koraleski went directly to the core issues that impact the UP-shortline relationship, and more on those remarks anon. I think ASLRRA President Rich Timmons' wake-up call on what's coming down the pike from Congress framed the others' remarks beautifully. In just 20 minutes Rich bullet-pointed his way through Congress' heightened interest in the rail industry as indicated by their promising to meddle in such area as operational tests, medical standards, shortline loco inspections, roadway worker safety, CWR and bridges.

Now put all this in the framework of the STB's renewed interest in how to calculate railroads' cost of capital (WIR 8/17/2007), paper barriers and common carrier questions. And these are just for openers. Go to http://www.aslrra.org/news___publications/Speeches___Remarks/ for the full riff.

IMHO the most serious threat is re-regulation. As I wrote for the upcoming Simmons-Boardman revised edition of *The Railroad: What It Is, What It Does*, "The ICC's power grew increasingly onerous for the rails over the seventy years 1905-1975 and in that period the superior service offered by trucks and the Interstates had siphoned off much of the rails' high-rated traffic while the private auto and jet planes did in the long-haul passenger trains. As a result, the forty or so Class Is left standing were more concerned with shrinking the asset base to save money than they were with finding new business that could compete with the trucks while still making a profit and fit within the ICC's highly regulated pricing structure.

"Finally Congress began to take notice. The Penn Central imploded, the Rock and the Milwaukee had become fallen flags, and standing trains were derailing on the MKT. Thus was born the Staggers Act of 1980 which, among other things, eliminated most of the ICC activities and positions that were the root causes for the systematic economic dismemberment of this once-vital industry. Gone were the extensive and expensive litigations surrounding perceived rate and service discrimination, prohibitions against any real marketing and new business development initiatives, the inability to come even close to earning the cost of capital, and the requirement to keep branch lines open well beyond their useful life."

Limit the railroads' ability to charge enough to replace what's worn out in providing the service and there's no incentive to provide the service in the first place. That's what killed many branch lines and secondary mains, leading in part to the capacity crunch we see today. Moreover, limiting capital kills feeder lines faster because *nobody* can charge enough to maintain 'em, meaning the shortline industry will go away even more quickly.

Dennis Duffy said it costs UP nearly $30,000 to hire and train a conductor and more than double that to put a CLE in the cab. They're putting $3.2 mm into the railroad this year, two-thirds of which is for MOW and capacity expansion with another $800 mm into locos and cars. GTMs have increased at a pace of nearly 4% CAGR since 1990 and absent the present lull can be expected to continue at that rate. First Call, for example, sees UP's net income growing at a rate of 18% over the next five years and the intrinsic value of the share price stands at $176 so at today's price you can get UNP shares for 61 cents on the dollar (more on this below).

But limit UP's ability to generate the revenue to support the operating cash flow that supports capex (*and* dividends *and* share buy-backs) and that growth goes away and we return to the bad old days. The short lines have done a great job drumming up support for the tax credit program but there does not seem to be the same level of intensity on the re-reg front. Remember what my fellow Philadelphian Ben Franklin said 200+ years ago: "We must all hang together or surely we will all hang one by one." And surely 500+ shortlines ought to be able to make enough noise to beat some sense into this Congress.

Meanwhile, back at the UP short line meeting, Jack Koraleski said that in 1H07 short lines handled 14% of UP's 2.4 mm revenue units and 20% of UP's $4 bn total revenue. Do the math and get 336,000 revenue units worth $800 mm in top-line revenue or about $2380 per carload vs. the UP system average of $2337 per non-coal or intermodal revenue unit. Koraleski's theme was growth, and shortlines have met the challenge with first-half carloads down only 1% yoy compared with down 3% for UP system-wide and 7% for North American shortlines in general.

My sense from one-on-one conversations with attending short line representatives and UP staffers both is that there is a renewed commitment on the part of UP to Get It Right and the short lines have picked up on that. Union Pacific has the largest North American merchandise carload franchise (4.1 mm carloads in 2006 with CSX in second place at 3.3 mm units) generating $9.1 bn in 2006 revenues. At a 20% share, that's worth nearly $2 bn to the UP shortlines. Where do I sign up?

Berkshire Hathaway said this week it has added 10 mm more shares to its BNI position, bringing the total stake to 52 mm shares. BNI reported a diluted share count of 360 mm as of June 30 so it looks like the Oracle of Omaha owns about 14% of the company. Berkshire also has positions in NSC and UNP though in its filings has said it would not disclose the details of this positions. What we do know is on Mar 30 BRK owned 10.5 mm shares of UNP and 6.36 mm of NSC. One reason the present total has not been disclosed may well be that BRK is still buying.

As I write this Thursday afternoon NSC is trading at $50 and change, down 5% from its SMA-50, with UNP at $107-plus, down 8% from its SMA-50. The smartmoney.com Intrinsic Value Calculator says NSC is worth $84 per ticket risk-adjusted based on the forward earnings estimates and UNP is worth $176 under the same rules. Thus Buffett is following his own rules of buying good companies cheap because at today's prices both are trading at 61 cents on the dollar. These are clearly On Sale as the rest of the rails are priced from 80 cents (BNI) to a buck-five (CP) on the IV dollar.

The same rules applied to the supplier side show some good values to be had. *Barron's* writes that Trinity Rail Car's "attractive valuation and solid prospects have encouraged its largest shareholder, Tontine Capital Partners, led by respected hedge-fund manager Jeffrey Gendell, to plunk down nearly $80 mm this year as the stock fell from around $43 to $35." Though some industry observers have predicted (wrongly, as it turns out) that freight car demand has peaked and is headed for a fall, TRN's president and CEO Tim Wallace expects 2008 sales to hit $4 bn, up 25% over 2006. He cites strong replacement demand with 700,000 cars now 25 years old or more.

More to the point, the AAR says there are more than 400,000 covered hoppers (TRN's bread-an-butter) out there about evenly split between private and railroad ownership with more than half the total more than 21 years old and nearly 80,000 cars between 31 and 40. So it's not surprising that Zacks analysts see TRN earnings growing at a 22% clip going forward, implying an intrinsic value of $69 a share, meaning today's $37 lets one buy TRN at 54 cents on the dollar. By way of comparison, GBX, RAIL and ARII all sell for something north of 80 cents on the dollar while WAB remains cheap at 66 cents. Get 'em while they're hot!

Short line car counts through Week 32 (ending 8/11/2007) continue to run about 6% less than where they were at this point in 2006. STCCs 24 and 26 still lag with ores and metals also in the negative seven percent range. The good news is these four represent just a quarter of shortline traffic, though chems remain the only commodity group that is actually up. It's now a question of what's less worse. See RMI's Week 32 RailConnect chart attached.

The Class Is are pretty much in the same jam, as one might expect, off 3% YTD, and though intermodal has done a lot to mask losses in the merch carload sector even that group is showing some softness. The only significant volume gains in the entire sector continue to be from CP thanks to intermodal and chems, with particular strength in the later, good news to CP short lines that participate in that group.

So here we are half way through Q3 and when does it hit bottom? Bear Stearns' Ed Wolfe writes, "Volumes have remained weak with few signs of improvement in the near term other than easing comparisons when we get to the fourth quarter. The recent down-tick in intermodal volumes, including container volumes as well as trailers, is likely a bad sign about the US consumer." That's why I'm betting on roads with a firm grip on consumer staples – cereal (grain), household products (chems and plastics), and fertilizer – plus energy (coal) to carry the day near-term. Consumer discretionary from shoes to home furnishings may have a place in intermodal but the entire group is under-weighted by the rating services, so I'm not going there.

Watco's Stillwater Central Railroad (SLWC) in Oklahoma has begun reconstruction on its Canadian River Bridge, damaged during last week's flooding, however an embargo remains in effect for SLWC traffic. Rail traffic that would normally travel over the Canadian River Bridge has been rerouted over the BNSF. More than 90 cars stranded in Oklahoma City because of the closed bridge were interchanged at Altus for delivery to customers. More railcars are en route to the SLWC via the BNSF for interchange later this week.

By way of review, Watco operates 16 railroads in 14 states, does industrial switching and owns Millennium Rail, a fully-integrated repair and maintenance service provider with eight car repair shops.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $125. Corporate subscriptions are $500 per year. A publication of the Blanchard Company, © 2007. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned.

RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 8/11/2007

Week Number: 32

Carloads Handled	Current Week			Year-To-Date		
	2007	2006	% Change	2007	2006	% Change
Coal	15,193	14,539	4.50%	456,539	466,821	-2.20%
Grain	14,790	12,349	19.77%	421,256	426,548	-1.24%
Farm & Food (Exc. Grain)	4,707	4,679	0.60%	141,484	147,834	-4.30%
Ores	3,169	2,938	7.86%	83,567	93,916	-11.02%
Stone, Clay, Aggregates	12,531	12,483	0.38%	344,620	363,437	-5.18%
Lumber & Forest products	5,691	6,417	-11.31%	190,923	232,532	-17.89%
Paper products	8,055	8,718	-7.60%	259,068	281,792	-8.06%
Waste & Scrap materials	5,600	6,492	-13.74%	190,861	198,272	-3.74%
Chemicals	16,873	15,153	11.35%	529,246	488,681	8.30%
Petroleum & Coke	5,602	5,766	-2.84%	177,359	187,059	-5.19%
Metals & Products	9,890	11,959	-17.30%	357,442	384,973	-7.15%
Motor vehicles & equip.	2,052	1,930	6.32%	67,833	72,166	-6.00%
Intermodal	14,761	18,416	-19.85%	458,411	569,797	-19.55%
All Other	2,994	3,304	-9.38%	95,047	108,508	-12.41%
Total	**121,908**	**125,143**	**-2.59%**	**3,773,656**	**4,022,336**	**-6.18%**