RAILROAD WEEK IN REVIEW

NOVEMBER 16, 2007

"CSX is likely making up for past under-spending when its capex pockets weren't so deep." -- *Rick Paterson, UBS*

UBS Rail Analyst Rick Paterson picks up the capex theme in his November 8 note. He takes the unique and I think effective theme of matching capex and traffic volumes, one of the points in the TCI letter re CSX. Rick takes a four-year snapshot of the Big Six Class Is showing the capex per revenue unit starting in 2004 through 3Q07. All but CP increased yoy capex even as average volume deltas have been drifting southward from plus 7.1% in 2004 to minus 4.7% 2007 YTD.

He writes, "Note the step-up up in 2007 as capex has gone up despite negative volume growth, with BNSF the best example [up 22% to $230 from $189 capex per RU]. The real story, however, is in the East. CSX and NS have similar traffic density, running 253 and 266 loads per mile of track, respectively, in 2006. While both spent around $140 in capex per load in 2004, YTD CSX has surged to $223/load while NS is only at $156/load.

"The takeaways here are: i) NS has superior infrastructure; ii) CSX appears to be buying rather than leasing a greater proportion of rolling stock, with the recent decision to buy 100 new locomotives and return 150 leased units[1] a good example; iii) CSX may be spending capital to unlock efficiency gains to help drive the OR lower; and iv) CSX is likely making up for past under-spending when its capex pockets weren't so deep."

The TCI letter specifically chides CSX for spending capital on capacity ahead of volume expansion. But it wasn't that long ago that both NS and BNSF were taking the heat of the Street for the same behavior while CSX and UP were praised for not putting any money in infrastructure expansion. Then came the volume surges both Rob Krebs and David Goode said would come and their railroads were ready. In some regards both CSX and UP are still catching up. The CSX decision to put $5 bn into the track over the next three years seems the prudent action given the traffic growth predictions we're seeing from places such as the AAR and AASHTO.

The folks at Bear Stearns have been out talking to customers again. This week's report looks into recent customer demand trends and service/pricing issues with the Class Is with particular emphasis on the single-carload sector. Bear's admittedly small sample says the rate of price increases is slowing down and that "2008 will be 'The Year of the Shipper', characterized by lower rate increases and a willingness by the rails to engage with shippers on pricing discussions as part of an overall positive 'attitude shift'". For one steel shipper in particular, "rail moves are currently 15%-20% cheaper than comparable truck moves."

The Bear Stearns note found indications that service on UP has seen the best improvement over the past twelve-month, particularly in equipment management, while BNSF service has actually gone the other way. Price still reigns, though, and the lower price wins the day. [No mention of what added internal costs the lower price brings, like the added demurrage expense when loads stack up due to

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[1] TCI takes exception: "The $200 mm project to replace leased with owned locomotives illustrates this point. There are two effects from this that improve the operating ratio. First, it will move the financing component of lease expense (currently an operating cost) to interest expense. Second, the lease term is typically shorter than the depreciable life, so lease expense is being replaced by a smaller depreciation expense.

service inconsistencies.] Last, and hardly least, Bear concludes, “We spoke briefly about some of the regulatory issues facing the rails. This shipper does not support rail re-regulation as he believes a regulated environment would be a disincentive for infrastructure investment.” Sounds familiar. One has to wonder why the pols continue on this populist tear.

On the carload side of the Bear Stearns household, equipment analyst Peter Nesvold may have discovered an opportunity for short lines to pick up cars cheap. He writes, “We spoke to one of our contacts at a small private railcar leasing company to get his thoughts on the current environment for railcar lessors — particularly his thoughts on utilization and lease rates going forward. Our contact told us that he believes leasing utilization rates are often deceiving because they can mask weak end-user demand.”

Here’s where it gets interesting for roads like Dan Sabin’s Iowa Northern where they get good lease rates on unpopular covered hopper sizes and make a decent buck turning them quickly. “Specifically, our contact noted that in tough markets many leasing companies would rather cut lease rates than pay to store excess railcars [and pay short lines to store ‘em]. In fact, our contact says he has several contacts that have told him that they are leasing railcars at rates that aren’t profitable, but they view the rates as an attractive alternative to paying to store the railcars.”

Nesvold found that high utilization rates, even at reduced rates, are to be preferred and that there are “declining lease rates across-the-board” and there isn’t “any reason to be optimistic in the foreseeable future. The plastics business, one that has saved many a short line, could be in for a hard time. It seems that “the feedstock for plastic pellets is natural gas and in many instances plants will switch to selling natural gas in the open market as opposed to producing plastic pellets.” Moreover, that may be one reason imported pellets in containers are winning share from domestic pellets in covered hoppers.

To sanity-check Nesvold’s argument we’ve been watching car-builders’ stock prices and analyst ratings over the past month, quarter and year. They’ve all (ARII, GBX, GMT, TRN) been trading in a range since Nov 2006 except for a brief rally May-July and a sudden drop these last few weeks. There are two reinforcing factors at work here. There are declining volumes across a broad base of commodities and better car management for the carload traffic that remains. Car inventories and yard dwells are down while train speeds are increasing.

Bottom line: more revenue loads per year per individual freight car, ergo fewer cars to carry the same traffic. Currently excess equipment is going into storage. The questions now become how long it will take the inevitable up-tick in freight loadings to bring all stored-serviceable cars back into service and how long a lead-time is there to build new cars. Judging from Mr. Market’s reaction, it could be quite a while yet.

Freight traffic volumes for Week 43 (Oct 27) continued their southward drift. Credit Suisse’ Jason Seidl sums it up this way: Overall traffic fell 0.1% year-over-year on the heels of weakness in Forest Products (-13.3%), Non-metallic Minerals (-3.2%) and Intermodal (-3.1%). BNSF posted the largest decline in traffic of the Class Is (-7.1%), primarily due to large losses in Coal (-4.1%), Intermodal (-11.9%) and Forest Products (-19.6%).

In contrast, UP posted a 2.2% increase in traffic on mixed results — strength in Coal (+8.8%) and Agricultural Products (+8.3%) offset slight declines in Motor Vehicles and Equipment (-2.2%) and Intermodal (-1.8%). Traffic declined 4.0% at CSX via losses in Metallic Ores & Minerals (11.7%), Intermodal (-4.1%) and Forest Products (-13.6%). NS fared slightly better with just a 2.7% decrease

in carloads driven by weakness in Forest Products (-12.1%), Coal (-1.5%) and Intermodal (-7.5%). The Canadian rails reported a collective increase of 4.7% -- CN +5.5% and CP +3.4%.

The short lines didn't have it much better. The RMI RailConnect Index with 302 names reporting show total revenue units dropped another 5.1% as continuing weakness in lumber (STCC 24) and paper (STCC 26), pets and coke, coal and metals offset gains in grain, auto and chems. The carload sector (everything that isn't intermodal or coal) accounts for 40% of the Class I volume and 76% of short line volume; it's easy to see the shortlines bar the brunt of the effect of the carload softness.

However, there's a silver lining. We all know the shortlines largely excel at sales coverage of *all* their customers. We know they can tailor operating plans to fit the customer's supply-chain processes and we know they depend on volume more than price increases to make their numbers. From that it follows that every short line ought to have a pipeline of some dollar amount of new business that they are targeting. Marcella Szel showed us last week how they do it and WIR (11/9/2007) showed how the CP process could work in the short line environment.

There's no reason the shortlines should be down in revenue units just because the Class Is are. I've often suspected that short line traffic gains can be masked by Class I downturns in business from their Major Accounts. Maybe now's the time to start documenting it. What are we waiting for?

GWR October traffic in October 2007 from continuing operations was down 7.4% yoy with 75% of the drop as the direct result of the discontinuation of haulage traffic on its Meridian & Bigbee, a 147-mile line in Mississippi and Alabama. The haulage arrangement dated from 2005 when the M&B became a Katrina-related re-route for rail traffic to and from the Gulf Coast. Excluding haulage traffic, GWR's traffic in October 2007 was off 2.0% yoy, with the 2500-car drop in AUS grain the major hit after haulage.

Lumber and forest (STCC 24 only) was actually up a few cars – six to be exact – but at least it wasn't down. Paper was, though, by 4% thanks largely to the shrinkage in the Northern Maine Paper market, with yet another plant closing on the SLR scheduled for next month. At 26% of total GWR volume forest products and paper are the single largest commodity group handled by GWR, so a hit here hurts badly. Good to see the STCC 24s on the mend. YTD loads are off 6.4% yoy however the month-to-month trend has turned positive: up 5.7% over Sep.

Mexico is finally off the books. As previously reported, GWR initiated the liquidation of its hurricane-damaged operations in Mexico on June 25, 2007, and had no remaining employees in Mexico as of September 30, 2007. Traffic from GWR's Mexican operations was 2,109 carloads in October 2006. GWR's former Mexican operations are accounted for as discontinued operations and are not included in this report.

Reminder: No Week in Review Thanksgiving Week. WIR resumes week ending 11/30/2007

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RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 10/27/2007

Week Number: 43

Carloads Handled	Current Week			Year-To-Date		
	2007	2006	% Change	2007	2006	% Change
Coal	15,345	16,550	-7.28%	634,191	641,731	-1.17%
Grain	15,228	14,191	7.31%	582,135	577,491	0.80%
Farm & Food (Exc. Grain)	4,944	4,714	4.88%	192,874	197,871	-2.53%
Ores	3,431	2,367	44.95%	115,936	127,463	-9.04%
Stone, Clay, Aggregates	12,981	11,598	11.92%	477,414	488,065	-2.18%
Lumber & Forest products	5,386	6,352	-15.21%	251,495	303,546	-17.15%
Paper products	7,646	8,406	-9.04%	343,414	376,345	-8.75%
Waste & Scrap materials	6,711	6,236	7.62%	260,287	267,125	-2.56%
Chemicals	16,502	15,169	8.79%	712,695	661,275	7.78%
Petroleum & Coke	5,412	5,780	-6.37%	239,490	254,058	-5.73%
Metals & Products	10,507	10,896	-3.57%	475,096	511,555	-7.13%
Motor vehicles & equip.	2,459	2,230	10.27%	92,607	95,474	-3.00%
Intermodal	15,814	16,768	-5.69%	625,376	759,764	-17.69%
All Other	2,758	2,959	-6.79%	128,627	145,165	-11.39%
Total	**125,124**	**124,216**	**0.73%**	**5,131,637**	**5,406,928**	**-5.09%**