THE RAILROAD WEEK IN REVIEW
FEBRUARY 1, 2008

"The theme in Q4 was strong core pricing." – Rick Paterson, UBS

The Big Six Class I rails concluded their earnings reports this week so we have KCS (Feb 5) and GWR (Feb 13) still to go. As usual, WIR earnings commentary will focus on the carload side of the house looking at such metrics as revenue units, revenue by commodity group, RPU, the operating ratio and what the particular road is doing to run a more customer-oriented more efficient railroad. My thesis is that the successful short lines are those that can capitalize on their connecting class Is' commercial and operational strategies.

Clearly, strong operating results have a lot to do with earnings. UBS' Rick Paterson has ranked the Big Six by upside earnings surprises based on 4Q07 earnings-per-share ex-items and there is a strong correlation between the yoy changes in operating income and eps. CSX was in first place with a 34% eps surprise and ops income up 21%. NS was second with a positive 8% surprise and ops income up 11%. And so on down to CP with its 4% eps surprise against a 5% operating income drop. Rick continues, "The average upside surprise was 11%, with all rails surpassing their expectations. The theme in Q4 was strong core pricing for all rails, partially offset by the run-up in fuel prices."

Class I revenue unit counts, as expected, were nothing to write home about with the average delta running a negative 1% yoy. Shortlines revenue unit counts dropped 4.4% yoy with the biggest drop in – you guessed it – forest products. The only significant upside was in chems, up 7% with plastics and ferts the likely drivers as seen on the Class Is. And the fact that the "all other" commodity group was down by 11% is yet another indication that more and more of the short lines' universe is made up of commodity groups that mean less and less to the Class Is.

I am also noticing that RMI shows coal representing 12% of short line carloads and auto less than 2%. I suspect this has a lot to do with the fact that the Big Three automakers' practice of having many parts suppliers spread all over the place has come to an end. The transplants either make what they need on site or a truck-ride away or they import parts via container. Class I auto traffic is increasingly finished vehicles and hardly any of this ever touches a short line. And so, starting in 1Q08, I'm changing my definition of merch carloads to all but IM and auto, and my new all-inclusive shortline metric becomes "merch and coal."

Turning now to BNSF, the revenues-up-carloads-down story continues. Total sales increased 9% in the Q and 6% for the year against 3% fewer revenue units for both the Q and year. Yet RPU gained 13% in the Q and 9% for the year. During the call, Chief Marketing Officer John Lanigan said that the combination of more RTMs and price drove a 10% revenue gain yoy though "mix/other" took that down 3% for the reported 7% freight revenue gain.

Though Lanigan did not break out the revenue-dollar fuel surcharge amount, he did say that BNSF took in $120 mm more in FSC than in 4Q06 thanks to higher fuel costs and increased customer participation in the FSC program. Lanigan's mix chart (slide 17, if you have the music on your stand) shows the 7% freight revenue gain (the 9% above includes "other" operating revenues) comes on top of an unspecified pre-FSC number for 4Q06.

The 10K for 2006 says BNSF took in $1.7 bn in FSC; call it an average of $425 a quarter. This implies 4Q07 FSC of $545 mm. To sanity-check this number I started with reported 4Q06 freight revenues of $3.8 bn and backed out the estimated $425 FSC. To that number I added Lanigan's 4% gain in RTMs, 6% gain in price, took the 3% dip in "mix/other" and got a pre-FSC freight revenue number of $3.6 bn. Subtract this from the reported $4.1 bn 4Q07 freight revenues for an implied $543 mm FSC revenue amount for the Q. Now take out the $120 mm FSC gain above and get 4Q06 FSC intake of $423 mm, certainly in the ballpark of our starting estimate of $425 mm.

Against 10.3 mm revenue units, this implies an average per-unit FSC of 41 smackers a car. The question to short lines thus becomes how much of this are *you* seeing? Yes, I know BNSF has tied FSC participation to car-cycle time, and since they had not been successful in getting all short lines' attention in this regard, that was only fitting. So assuming your short line is playing by the rules and getting 20% of the negotiated or tariff freight rate, are you also getting $8 a car in FSC? If you do 10,000 cars a year with BNSF, that's 80 grand, enough to keep the FRA man happy on 16 miles of Class 2 track.

Getting back to BNSF results, only auto and IM posted negative deltas in revenue units. Merch (including auto, ex coal for now) loads were actually up 6% in vols and 12% in revs garnering a hefty 10% RPU gain. The ag products group raked in 25% more revenue yoy with double-digit gains in wheat, ethanol, bulk foods, ferts, beans and other with corn unchanged. The Industrial Products gang saw double-digit jumps in petro and construction prods with chems up 9% offset by food & beverages down 4% and building prods off 9%.

Operating expense rose 12% leaving ops income essentially unchanged yoy. Fuel was the big killer, up 37%, as it was on each of the Big Six. And though there was a great noise across the board about ops expense pre-fuel, I say diesel fuel is a cost of doing business so get over it. BNSF actually cut fuel use by 5 mm gallons in the Q and at an average of $2.68 a gallon. That's not exactly chump change.

I'm certain that COO Carl Ice's velocity-service-productivity mantra will continue to give Lanigan the service quality he needs to keep the price story going. We all know that a faster safer railroad is a cheaper railroad to operate. Therefore, Mr. Shortline operator, when you see cars laying at customers' docks or at interchange, get on the horn and do something about it. There will be more money in your jeans as a result.

Canadian Pacific this quarter provides an object lesson why we ignore earnings deltas at our peril if we really want to know what's going on with the core business. Reported net income more than doubled yoy thanks to a C$146 mm income tax credit, quite coincidentally equal to the net income reported for 4Q06. Share count was virtually unchanged yoy and the eps delta without the tax thing rose just 4% to C$1.20 on flat revenues and a 5% operating income drop.

Out on the railroad, though, they're heading in the right direction. COO Kathryn McQuade said during the call that reportable incidents are down while train sped, terminal dwell, cars-on-line and car miles per day all improved yoy. Marcella Szel, EVP Marketing and Sales, emphasized FX-adjusted amounts however, to keep yoy continuity, I'm going with reported numbers. Freight revenues for the Q were up a point while revenue units gained three points. System RPU actually dropped 4% with negative deltas predominating across the commodity spectrum. Looking ahead, Szel sees a brighter future for bulk and merch traffic, less so for IM.

On velocity and capacity, CEO Fred Green said that CP "has the capacity to move more product" and a big reason is the steps they're taking to speed up the railroad. They've added more horsepower to the coal trains cutting cycle times an increasing carrying capacity by half again. Customers are stepping up by shortening load/unload times (shades of the grain story we heard two years ago). The

Integrated Operating Plan (IOP) will deliver incremental benefits of C$25-30 mm in 2008 and running faster coal trains is part of it because doing so speeds up *all* trains. (Recall during the NS call Steve Tobias said they're putting unit trains in the TOP to get everything moving faster. Hmmm.)

Once again, the message to shippers and short lines is better turns equals more tons per individual car and increased yield per asset dollar. Ferts are going to 100% privates, for example, and better turn times make this investment more attractive. Similarly, converting the last of the steel coal hoppers to aluminum depends on customer the outlook and how many loads per car per year CP can get.

It's always good to step back from the numbers and take the wider view. Fellow pundit, analyst and rail-watcher Tony Hatch penned a rather thoughtful note on the Big Six earnings season wrap the other day. Herewith some excerpts:

"*UP beat its reduced guidance* – which itself caused a bit of consternation amongst the conference call listeners – but given the moving parts – the dramatic swings UP saw in volume (in large part due to December weather, volume was flat after running up), fuel, and continued productivity improvements, the UP team ought to be more rewarded than castigated. Yield growth (6%, same as revenues – and as *price!)* and ops improvement summarized by 4% fewer crew-starts on the 1% volume drop, and therefore a 3% comp drop.

"*There was no announced 2008 capex budget* -- highly unusual, which I sense eventually will be in line with the industry trend. In the end, UP delivered the goods with a better-than-expected quarter, better then expected outlook, better then expected pricing and a well-known path to improved operating efficiency. The story could be clearer, but there are reasons why it's everybody's All-American, as it were, once again.

"BNSF is viewed as a growth story – or not. I think the intermodal story still is not well understood on the Street. On other fronts, coal should also grow around 4-5%, and Ag also has a very positive, export-driven outlook. Overall, price will be firm, if not quite at '07 levels. BNSF gave a very good '08 outlook – low double digit EPS and high single digit revenue growth (ahead of consensus), and a resumption of improvement in the ROIC trend line."

Greenbrier has announced what Bear Stearns' Peer Nesvold calls a "tuck-in" acquisition to its Meridian unit: wheel-maker American Railway Equipment Co. The $83 mm cash price will be paid from Greenbrier's existing cash balances and credit facilities. Says Nesvold, "Wheels are one of the components with the tightest supply throughout this rail capex cycle; wheel demand is driven not only by railcar builds, but also by the aftermarket, as wheels are among the most frequently changed parts of a railcar after brakes." A good move on GBX'part.

Correction: Last week I spaced and called CN's recent acquisition the Alberta Northern. I shoulda known better. I actually wrote it up just three weeks prior as the lead item in WIR for Jan 4. It's really the ***Athabasca &*** Northern or ANY. Sheesh.

Class I Commodity Carload Comps

Quarter ending 12/31/2007

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 4,245	$ 1,941	$ 1,188	$ 2,577	$ 2,454	$ 4,197
YOY Pct. Change	9.4%	-3.0%	-0.2%	7.6%	5.8%	5.9%
Revenue Units (000)	2,600	1,205	683	1,761	1,870	2,444
YOY Pct. Change	-2.9%	5.1%	3.0%	-2.7%	-4.0%	0.2%
Carload revs (2)	$ 1,863	$ 1,303	$ 675	$ 1,470	$ 1,357	$ 2,430
YOY Pct. Change	12.3%	-5.4%	-0.5%	6.4%	10.0%	6.0%
System RPU Pct Chg.	12.6%	-8.1%	-3.6%	10.5%	9.1%	5.9%
Pct carload	43.9%	67.1%	59.1%	57.0%	55.3%	57.9%
Pct Intermodal	32.1%	18.7%	29.4%	13.9%	20.2%	18.0%
Pct Coal	21.1%	4.7%	11.5%	26.5%	24.5%	19.5%
Mdse Carloads (000)	694	773	303	759	677	988
YOY Pct. Change	6.1%	7.4%	0.4%	-3.6%	-0.1%	0.2%
Rev/CL x coal, IM	$ 2,531	$ 1,686	$ 2,232	$ 1,937	$ 2,004	$ 2,460
YOY Pct. Change	5.9%	-11.9%	-0.8%	10.3%	10.1%	5.8%
Operating Expense	$ 3,295	$ 1,205	$ 883	$ 1,968	$ 1,768	$ 3,333
YOY Pct. Change	12.1%	-3.1%	1.4%	4.1%	3.7%	5.7%
RR Operating Income	$ 950	$ 736	$ 306	$ 609	$ 686	$ 864
YOY Pct. Change	0.7%	-2.6%	-4.6%	20.6%	11.7%	6.7%
RR Operating Ratio	77.6%	62.1%	74.3%	76.4%	72.0%	79.4%
YOY Point change	1.91	(0.12)	1.18	(2.56)	(1.48)	(0.14)

Class I Commodity Carload Comps

YTD through 12/31/2007

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 15,802	$ 7,897	$ 4,708	$ 10,030	$ 9,432	$ 16,283
YOY Pct. Change	5.5%	-0.4%	2.7%	4.9%	0.3%	4.5%
Revenue Units	10,318	4,744	2,698	7,116	7,593	9,733
YOY Pct. Change	-3.0%	-1.7%	3.0%	-3.3%	-3.9%	-1.2%
Avg RPU change		0.7%		7.8%	4.3%	5.7%
Mdse Carload revs (2)	$ 6,902	$ 5,419	$ 2,664	$ 5,829	$ 5,196	$ 9,469
YOY Pct. Change	6.4%	-1.3%	1.1%	4.2%	-3.9%	4.1%
MGTM	1,121,255	347,898	246,322	458,500	384,000	1,052,300
YOY Pct. Change	0.1%	-1.4%	4.2%	-3.4%	-4.6%	-1.9%
Pct carload	43.7%	68.6%	56.6%	58.1%	55.1%	58.2%
Pct Intermodal	32.7%	17.5%	28.9%	13.5%	20.4%	17.9%
Pct Coal	20.8%	4.9%	12.6%	26.0%	24.5%	19.3%
Mdse Carloads (000)	2,863	3,059	1,191	3,143	2,773	3,981
YOY Pct. Change	1.1%	-0.9%	1.1%	-4.4%	-3.9%	-2.9%
Rev/CL x coal, IM	$ 2,411	$ 1,771	$ 2,237	$ 1,855	$ 1,874	$ 2,379
YOY Pct. Change	5.3%	-0.4%	2.1%	9.0%	5.9%	7.2%
Operating Expense	$ 12,316	$ 5,021	$ 3,543	$ 7,779	$ 6,847	$ 12,908
YOY Pct. Change	7.4%	2.5%	2.6%	4.6%	0.0%	1.7%
RR Operating Income	$ 3,486	$ 2,876	$ 1,164	$ 2,251	$ 2,585	$ 3,375
YOY Pct. Change	-1.0%	-5.1%	3.2%	5.9%	1.1%	17.0%
RR Operating Ratio	77.9%	63.6%	75.3%	77.6%	72.6%	79.3%

(1) CN, CP in $Canadian

(2) Excludes coal, intermodal

Source: company financials

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