THE RAILROAD WEEK IN REVIEW

May 14, 2010

"Focus on 'where it's happening.' Be nimble in your approach to new business opportunities." Canadian National CEO Claude Mongeau at the CN Shortline Conference, May 13, 2010

Week in Review is late this trip as some of us were out were out riding Amtrak locomotive cabs and hanging out with CN and its short lines in Montreal. As for the cab ride, it was over CP's Schenectady-Rouse's Point line of the former D&H. There are a lot of slow orders for track upgrades now, but when it's done it'll be a much better railroad.

As for the 2010 CN shortline meeting, it was the first under the Mongeau-Ruest regime and it was welcoming to say the least. Starting with the theme,"Partners for Growth," one got the feeling that CN really means it and has opened the doors to a new level of cooperation on the commercial side, building on the the operational excellence put in place by the Hunter Harrison team. The presentation slides are already on the website. You are invited to sing along.

CEO Claude Mongeau opened the session by admonishing the short lines there assembled to "be nimble" in their approach to developing new lines of business. He noted that customer behaviors change during economic downturns and as they begin to see recovery they also take a closer look at their vendor relationships. What an ideal time to walk in and show how your short line in combination with CN can create and deliver transportation products with supply-chain benefits customers never even dreamed of in the past.

He sounded a cautionary note, too, saying business may be coming back *in toto*, but it's not coming back to what it was in the past. Commodity strengths are shifting with leaders becoming laggards and vice versa. Take forest products: Lumber to Asia is on the upswing and newsprint is finished as a growth business. Steel demand is propelling iron ore gains; every carload of finished vehicles represents three carloads of raw materials.

Mongeau concluded with an admonishment to those assembled to focus on "where it's happening." The CN short line with a fact-based approach to new business in terms of carload potential, car management and yield will be the soonest winner. And this of course squares with what was said during the April 26 first quarter conference call: "CN is committed to staying ahead of the game through leveraging the recovery, protecting the legacy of operational excellence and pursuing strategic growth opportunities." The rest of the morning built on this theme.

To give you a flavor of what CN is experiencing in commodity carload growth, I thought it might be helpful to attach Chief Marketing Officer Jean-Jacques ("JJ" for short) Ruest's commodity revenue slide from the first quarter 2010 analyst call. Every commodity group was up year-over-year in constant dollars, without the effects of foreign exchange. I should also add that in the first quarter merchandise units increased 17.5 percent, with particular strength in metals and minerals including iron ore. JJ's shortline presentation Thursday morning reinforces the message.

The afternoon was devoted to what really amounted to a pair of regional sandhouse sessions to which short lines, CN staffers and suppliers were invited. The nonsensical vitriol so often heard at Class I and ASLRRA shortlines-only sandhouse sessions was noticeably absent and instead the dialog was devoted to finding solutions. One thread of particular note had to do with data exchange and visibility. Though RMI and other vendors collect and make available on-line car-event data to short lines, neither CN nor the mutual customers can see it. This is a serious limitation.

As it happens, IBM President and CEO Sam Palmisano addressed the Intelligent Transportation Society of America May 5 saying, "Our transportation system is not a system at all; it's a collection of related industries operating in close proximity to one another." He said the transportation system must be "traveler-centric" across all modes and in real time. As is, nobody -- customer, CN, short line -- can see the goods in transit in real time in the same format in the same place, nor can they act on it the way they could on, say, a Google Docs spreadsheet.

Happily, the afternoon sessions brought out the need for better information sharing between and among customers, CN and short lines. This is the first time to my knowledge that this level of connectivity and customer benefit has ever been broached at any shortline meeting, whether sponsored by the Class Is or the ASLRRA.

To go back to Mongeau's point, information is one critical area "where it is happening" and it's crying out for solutions. Clearly CN and its short lines are poised for being better "Partners for Progress." We have the operational excellence and all we need to do now is convert it into transportation products that are, as Palmisano says, "traveler-centric." Comments?

Genesee & Wyoming April 2010 revenue units increased to 72,023 units, up 16.1 percent year-over-year with double-digit increases in all but the aggregates, paper-related and petroleum commodity groups. The New York/Ohio/Pennsylvania region contributed most of the increases thanks to steel-making (raw materials, coal and finished steel). These results exclude 826 Huron Central carloads from April 2009 as the railroad went under discontinued operations in August 2009. Year-to-date loads were essentially unchanged, up 0.6 percent, while April loads were down 3.9 percent from the preceding month.

The April 2010 carload story shows how just one large strategic acquisition can change the fortunes of the whole company. The revenue-unit delta year-over-year was 9,979 carloads of which the Ohio Central/Buffalo & Pittsburgh region accounted for nearly 80 percent. Moreover "farm & food" was up 17 percent and that includes Australia. AAR total agriculture carloads for the trailing four weeks through April increased just 6.3 percent. I'm not convinced GWR did all that well in April ex-Australia and the Ohio Central acquisition.

The April 2010 RailAmerica car-count is a better proxy for the broader North American shortline community so it was heartening to learn RA's April 2010 carloads came to 73,136 units, up 10.7 percent year-over-year, excluding the discontinued Ottawa Valley Railway operation. Particular strength is seen in agriculture (grains and grain products), chemicals, waste & scrap, metallic ores and finished metals. Aggregates, paper-related commodities and auto slipped slightly. Year-to-date carloads increased 6.4 percent while April carloads came down 2.9 percent from the March number.

Going back six months, I see RA as basically a 65-70,000 cars-per-month railroad. Going back to the 2005 first quarter I still see RA in the same range or perhaps slightly more. The difference is that back then the RA portfolio of railroad names was constantly changing as some railroads were sloughed off and others added with the ease of a day-trader buying and selling stocks.

It pleases me that the Giles team has turned his predecessors' basket-cases into functioning railroads and other than OVR there has been little change in the lineup. Looking at the map of North America and where the RA properties are located, I get a very strong sense that there is a lot of business that could originate on one and terminate on another, using the Class Is as overhead carriers. This is a much stronger position to be in.

The AAR's John Gray, late of UP and before that the Alaska Railroad, writes, "Ever since seeing the article on the North Carolina installation of grade crossing signals that are solar powered I have been just a tad amazed at how primitive technology can be in this neck of the woods (the east).

"On the Alaska Railroad we had 100 percent of our grade crossings outside of Anchorage and Fairbanks powered by solar installations by 1980. It was far cheaper than running power lines into the right-of-way. I believe that today much of their CTC installation is similarly powered. Back in the 80's we also had 100 percent of our microwave system units powered by solar panels. Again, much cheaper and more reliable than traditional power sources (even during the Alaska winter nights they worked better!!).

"I do not believe we had a crossings unit or microwave failure due to power interruption during the entire time I worked at the railroad and keep in mind, this was technology that was more than 30 years older than what is available now. Apparently, since we had no basic infrastructure to start with, we were in a position to skip a generation, or two, versus what you have back here." Thanks, John. It just goes to show how entrenched interests can prevent progress.

Morgan Stanley's May 10 note on KCS says in part that "The railroad is firmly exposed to all of the main themes underlying our attractive view on rails (pricing, productivity, and volume rebound potential). In fact, we expect both volumes and core pricing to grow more in 2010 at KSU than at any other rail we cover."

My take: Put this together with the Street's view of shortline results from GWR and RA and it certainly looks like the Street is OK with the theme of the smaller rails hitching onto the Class I volume gains but doing it more cost-effectively and producing higher margins into the bargain. This applies mostly to the BIG short lines with economies of scale not bogged down by high-cost, low volume single-car customers. The mom-and-pops are toast, some sooner rather than later, and I wouldn't bet *my* farm on their longevity.

CN earnings call excerpt.

Q1 Revenues

millions of Canadian dollars, unless otherwise indicated

AS REPORTED

	2010	2009	% Change Favorable (Unfavorable)	% Change at constant currency[1] Favorable (Unfavorable)
Petroleum and chemicals	**$ 321**	$ 340	(6%)	6%
Metals and minerals	**210**	198	6%	22%
Forest products	**288**	302	(5%)	8%
Coal	**132**	103	28%	38%
Grain and fertilizers	**372**	357	4%	15%
Intermodal	**351**	319	10%	15%
Automotive	**114**	77	48%	69%
Total rail freight revenues	**$ 1,788**	$ 1,696	5%	17%
Other revenues	**177**	163	9%	17%
Total revenues	**$ 1,965**	$ 1,859	6%	17%

[1] *Please see website, www.cn.ca/nonGAAP, for an explanation of this non-GAAP measure.*

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