THE RAILROAD WEEK IN REVIEW

February 4, 2011

"We need to own a substantial portion of our coal car fleet for things like the export coal traffic and some of the utility business." -- NS President and CEO Wick Moorman

After the shocker of theQ4 reports with CSX operating ratio 300 basis points better than NS, I wanted to compare each railroad's annual results to see where the outliers were. Turns out there aren't that many.

To begin, CSX states in its "Notes Consolidated Financial Statements" that "CSX follows a 52/53 week fiscal reporting calendar. The fourth quarter of 2010 includes an extra week, making the fourth quarter 14 weeks and the year 53 weeks." They then compare volume, revenue and revenue per-unit for a 13-week period ending December 24, 2010 with a 13-week period ending Dec 25, 2009.

The fourth-quarter 2009 numbers are the same as reported a year ago. The non-GAAP 13-week numbers for 2010 reduce the total revenue for the period to $2,645 million from the $2,816 million reported, making the year-over-year revenue increase 14 percent as opposed to the 21 percent in the GAAP numbers based on the 14-week quarter. Similarly, year-over-year revenue units for the 13-week periods increased just seven percent as opposed to the reported 13 percent.

CSX does not provide an income statement for the equivalent 13-week period. All we know is "expenses increased $229 million from last year's fourth quarter, including increases related to the extra week." Thus we have no way of calculating an operating ratio for the 13-week period, unless we assume all expenses accrue linearly (I'm borrowing this idea from Cherilyn Radbourne of TD Newcrest, the only analyst who really drilled down in the matter).

To do this, Cherilyn applied the full year expense line percentages of revenue to the $2,465 million non-GAAP revenue line. This, of course, yields an operating ratio of 71.1 but still 110 basis points less favorable than reported. See table at the end. From my point of view, it's not weeks that count but the inclusive dates of the year. Yes, AAR reports weekly car counts, but I can see no reason why the AAR and the railroads have to come out with the same car counts by the week and year. But that's another argument for another day.

Given that CSX and NS operate in generally the same territory, it's safe to say their operating metrics ought to look something alike. And they do. Each expense line item represents about the same percentage of revenue for both railroads. CSX has about five percent more route-miles and two percent more employees, generates a quarter again as many revenue ton-miles and has about the same total operating expense per ton-mile. However, NS has about a ten percent edge in revenue per revenue ton-mile. That, I think, is where the wheel meets the rail.

That NS would want to own its own cars for the export franchise is the only sane way to approach that core business. It's really a captive conveyor belt between NS local points and export tonnage is on the increase -- in 2010 they pushed 23 million tons out of the country, about equal to 2008 and a paltry one percent behind the 2007 peak.

The export coal business, is after all, a major part of Norfolk Southern's heritage. Veteran train-watcher Ed King puts it this way in his Letter to the Editor in the March, 2011 issue of *Trains*: "In the early 20th century, N&W entered into a relationship with its on-line mine owners to help them market their coal. N&W also started sales efforts to overseas and domestic customers, telling them that they could blend coal from various mines at the pier to meet the customer's exact chemical and/or metallurgical expectations."

NS handled 171 million tons of coal for all users in 2010. Coal for export, domestic metallurgical and industrial customers amounted to 30 percent of that, 51 million tons. That's north of half a million carloads. If you had that much tonnage local to your railroad, don't you think you'd want to own your own cars? Wick evidently does.

During the January 26 conference call EVP Deb Butler said the 2011 capital budget of $2.2 billion will be up 19 percent year-over-year. The number is not only one of the most aggressive in recent memory (21 percent of the 2011 revenue estimates of around $10.4 billion) but also includes "baseline freight car acquisitions and improvements that will total $155 million, most of which is due to the planned purchase of 1,500 coal cars." To which Butler adds that current plans call for "coal car replacement program at this level or higher over the next several years."

Zacks Investment Research released its Rail Industry Outlook on Wednesday. Zeroing in on shortline commodities, they say metals and energy products "are particularly well-placed as demand is particularly strong for iron ore, rolled steel, several metal scraps, oil and natural gas drilling accessories including pipe, sand and different types of clays." The coal outlook is positive for all sectors -- steam, export and industrial.

Agricultural product demand is "less cyclical in nature and is a hedge against economic uncertainty. The most revealing feature was that China, the largest emerging economy, is turning out to be a net importer of agricultural commodities." That Russia closed its wheat exports could work in favor of producers in the United States. Demand for potash fertilizer, corn and soybeans also remains healthy.

Zacks sees three growth catalysts that will reward investors. First, pricing power. Zacks refers to the seller's market for rail services, and that it is -- if you want economies of scale the railroads' batch-process offers it in spades. Second is the competitive advantage over other carriers that simply cost more per ton-mile because they're less fuel and labor efficient. Third is the rails' technical superiority: "Investments in capacity, innovations and use of several state-of-the-art technologies led to service improvements and enhanced reliability."

The note concludes, "The AAR claims that freight rail transporters together invested a significant amount of $42 billion in the previous two years for railroad ." And they did it mostly with internally-generated funds. Look at the double-track projects on the UP and BNSF transcons; the Corridor projects on CSX and NS, the "precision railroading" gambit on CN and the "Driving the Digital Railway" initiative on CP.

The states may be broke but favored short lines and industries still benefit from taxpayer largess. Iowa Interstate Railroad says it will be making capital improvements to the tune of nearly $30 million in the upcoming months. For that sum the railroad gets a modern diesel shop and logistics center in Homestead, Iowa ($14.0 million), a car repair shop, maintenance-of-way base and train crew center in Silvis, Ill. ($1.3 million), Fifteen miles of new rail ($6.4 million) and new ties and surfacing ($7.6 million).

As if that weren't enough, they're investing another $2 million on track spur improvements to a customer elevator in Atlantic, Iowa, another $1 million to pave their intermodal facility in Council Bluffs, Iowa, and yet another $1 million on yard improvements and construction of a new team track to expand the Council Bluffs transload facility. Self-funding and bank loans will provide some of the money; the rest of it will come about through the 45G tax credit program, now extended through the end of 2012.

The Ohio Railroad Development Development Commission is also spreading money around to the benefit of short lines and their communities. Cleveland Commercial Railroad gets a $170,000 loan-and-grant stipend for a rail spur to serve a new steel transload facility. RailAmerica's Indiana & Ohio got a grant worth up to $150,000 for the first phase of rehabilitating the 26-mile line segment between Lancaster and Logan. The railroad will contribute an equal amount to improve rail service for three area employers.

Finally, the Ashtabula, Jefferson & Carson Railroad has won -- subject to State Controlling Board approval -- a $125,000 grant for "emergency repairs" to two bridges. It is alleged the repairs "would benefit several major local shippers and may assist another company that desires to ship by rail." Moreover, "the project would also benefit a weekends-only tourist train on the line that brings travel and tourism dollars to the local economy."

While I recognize that industrial development grants, tax breaks, favorable loan rates and so forth help to keep some short lines and businesses alive, do these schemes not amount to subsidizing one industry, railroad or customer at the expense of another? Is there a business case for these investments? If there is, why aren't the railroads or rail users making the capital investments out of their own cash flow? If there is no business case then that cash is better left in state coffers to pay down debt and lower taxes across the board.

CY 2010 comps	CSX	Pct Revs	NS	Pct Revs	Point Spread
Revenues	**$10,636**		**$ 9,516**		
Labor & Fringe	$ 2,957	27.8%	$ 2,708	28.5%	0.7
Purchased Svcs		0.0%	$ 1,151	12.1%	12.1
Depreciation	$ 947	8.9%	$ 819	8.6%	-0.3
Fuel	$ 1,212	11.4%	$ 1,079	11.3%	-0.1
Car hire, rents	$ 374	3.5%	$ 327	3.4%	-0.1
Materials	$ 2,075	19.5%	$ 346	3.6%	-15.9
Casualty, other		0.0%	$ 410	4.3%	4.3
Operating Expense	**$ 7,565**	71.1%	**$ 6,840**	71.9%	0.8
Operating Income	**$ 3,071**		**$ 2,676**		
Operating Ratio	71.1%		71.88%		
					CSX/NS
Average # Emps	30,083		28,610		5.15%
Route Miles	21,084		20,624		2.23%
MRTM	229,000		182,000		25.82%
Rev/MRTM	**$0.046**		**$0.052**		-11.17%
Exp/MRTM	**$ 0.71**		**$ 0.72**		-1.05%
RTM/Route Mile	10.86		8.82		23.08%
RTM/emp	$7.61		$6.36		19.66%
MM Gal fuel used	489.6		440.2		11.23%
RTM/Gal	467.73		413.49		13.12%

4Q2010 Comps	13 weeks		13 weeks		
	CSX	Pct Revs	NS	Pct Revs	Point Spread
Revenues	**$2,645.00**		**$ 2,392**		
Labor & Fringe	$ 735	27.8%	$ 659	27.6%	-0.3
Purchased Svcs	$ 0	0.0%	$ 310	13.0%	13.0
Depreciation	$ 236	8.9%	$ 207	8.7%	-0.2
Fuel	$ 301	11.4%	$ 308	12.9%	1.5
Car hire, rents	$ 93	3.5%	$ 81	3.4%	-0.1
Materials	$ 516	19.5%	$ 87	3.6%	-15.9
Casualty, other	$ 0	0.0%	$ 98	4.1%	4.1
Operating Expense	**$ 1,881**	71.1%	**$ 1,750**	73.2%	2.0
Operating Income	**$ 764**		**$ 642**		
Operating Ratio	**71.1%**		**73.16%**		