RAILROAD WEEK IN REVIEW
JANUARY 25, 2007

"Customers are willing to pay premium prices for premium service." Jim Young, CEO, Union Pacific, during the Fourth Quarter Conference Call Q&A

CSX was first up for Earnings Week, reporting after the bell Monday. Revenues increased 8% to \$2.4 bn on 1.8 mm revenue units, off four-tenths of a percent. Merch carload revenues were \$1.4 bn, up 6% though merch revenue units declined 4% on double-digit losses in phos and ferts (we expected that given what's going on in Florida's Bone Valley), forest products, and auto. Ag products were up 14%, the only positive commodity group in the entire merch book.

Clearly what CEO Michael Ward calls "pricing momentum" is alive and well, and that's good because it supports a theme heard throughout the week: better service begets better prices even as it takes costs out. Chief Commercial Officer Clarence Gooden notes (slide 8) that price gains in same-store commodity lanes – same STCC, same OD Pairs, same car type – averaged better than 6% over the past eight quarters.

Ops expense increased 6% excluding a \$27 mm Katrina-related insurance adjustment taking the OR down another 120 BP to 80.1 and operating income up 15% to \$478 mm. COO Tony Ingram said during the call that on-time departures and arrivals have contributed to a four-hour drop in average dwell to 25.6 hours and reducing cars-on-line by 20,000 units to 225,000 since 4Q05. Bottom line, CSX net income increased 46% to \$347 mm. However, EPS after one-time items came in at 57 cents up just 10% yoy.

Gooden said 1Q07 looks good for ag, chems, metals and phos & ferts in the merch group. Coal and IM also are favorable. Emerging markets, food & consumer and forest products are neutral and auto is still gloomy as the increased transplant biz can't make up for the Big Three downturn. The take-away for shortlines is concentrating on cycle times, reducing dwell at interchange and customers, and looking for the high-yield business.

BNSF began Tuesday with a stellar performance: revenues up 9% to \$3.9 bn, revenue units up 4% to 2.7 mm, merch revs and carloads up 8% and 2% respectively, the highest merch RPU for the week (\$2390), ops income up 18% and the OR down 173 BP yoy to 75.7. In fact BNSF completely blew away the others in terms of positive numbers in all areas, even if we are supposed to be in a "softening economy." Independent analyst Tony Hatch summed it up nicely in his note on the call: "Nothing is clearer than BNSF's reconfirmation of the 'railroad renaissance'; in the face of slowing volumes and cyclical headwinds, the secular changes show in stark contrast."

The merch carload trade is about as secular as it gets, dominated as it is by chems, food and ag. These are the raw materials for such consumer staples as soap, soup, cereal, and suds (beer). Moreover, in a financial presentation at the Union League this week, Phila Fed First VP Bill Stone said that they expect business investment in equipment to grow in 2007 at about a 6% pace, double what they expect for the economy as a whole. Good for the merch carload trade.

BNSF ag revenues were up 9% on 6% more loads while industrial products revenue went up 6% for about the same number of loads. Every group but building products was up: food and beverage 7%, chems 17%, construction products 13%, and petroleum products 22%. And *that's* not cyclical business. Average carload RPU was up 6.3 with IP posting a 7% gain.

Net income grew 21% yoy and the 4% reduction in shares pushed diluted EPS up 26%. The velocity mantra is paying off because, said Rose, "We can run the railroad better if we get the congestion costs out." Backing him up, Chief Commercial Office John Lanigan added, "We're open for business with no constraints."

Special Rant Section. BNSF is the only carrier to come right out and say what it collects in fuel surcharges (slide 17). I know it's a sensitive subject, but it must be addressed. Couching it in terms of "two points of the nine percent revenue increase" or "30% of the RPU gain" obfuscates and creates extra work for the analyst, shareholder or shipper. They're going to find out sooner or later and the deeper they have to dig to get at the number the madder they'll get. Let John Lanigan be your guide: say what the number is and give some background. In this way *he* controls the dialog, shapes the story as best suits the purpose, and can strafe the survivors in the Q&A.

Canadian National held its call after the bell Tuesday. Total sales increased 3% yoy even as revenue units slipped 5% on declines in forest products, US coal (ex-IC Illinois basin), auto and a short-haul taconite move. CEO Hunter Harrison said that severe weather in the west also impacted intermodal and a slower economy, chiefly in auto and forest products, didn't help. The good news is that even as merch loads skidded 8% RPU was up 11%, further supporting the theme this earnings season that higher quality service in the eyes of the beneficial owner begets better revenue.

Operating expenses held at up 2% for an OR of 61.1, down 75 BP yoy, and operating income gained 5% to $C756 mm including a 5% foreign exchange adjustment. Net income gained 16% including a one-time tax benefit and EPS increased 22% on the same basis. That six-point spread is the shareholder benefit of CN's aggressive share repurchase program, $C1.5 bn worth in 2006.

Bear Stearns' Ed Wolfe sums up the call thus: "Reiterate Outperform. CNI [ticker symbol] continues to trade at the low end of the rail sector despite high-end margins, free cash flow, and returns. We have gained confidence that rail pricing remains firm to date through the first half of reports and CNI's yields, net of fuel, are at the high-end of the group. We expect volumes to gradually re-accelerate into improved weather, stabilized lumber and increasing intermodal business throughout 07." Specifically, Chief Comm'l Officer Jim Foote said that in 2H07 there will be an up-tick in paper and "some rebound" in lumber and panel products.

Lesson for shortlines: CN's merch carload business contributes 72% of total revenues, more than any other Big Six Class I road, and a dozen percentage points ahead of the number two in this regard, CP. Recall that it was Jim Foote who said several quarters ago that the carload business is where the money is but to earn that money one must pay strict attention. Proof of that pudding is CN's perennial lowest OR by at least ten points. This is HH's "precision railroading" at its best and the soonest shortline winner is the one that can fully embrace its Five Guiding Principles.

Norfolk Southern flat disappointed, especially when compared with archrival CSX operating in pretty much the same geographic space. The 2.7% revenue gain was the smallest of the five Class Is reporting to date and the 2.8% decrease in revenue unit count was the largest decline of the lot. Merch loads declined 6%, second only to CN's 4% and merch revs gained but 1.6%, again barely besting CN's 1.4% gain. Everybody else ran six to nine percent gains. Merch RPU gain was 8.0% beating only BNSF's 6.3% whereas the others saw merch RPU up 10% or more.

JPM's Tom Wadewitz summed it up well. "NSC's earnings [using the ticker symbol] were well below our expectations as yield growth slowed meaningfully to 5.7% compared to our 7.8% forecast while margin expansion was a slight 15 BP yoy vs. our 250 BP expectation. NSC's reported 4Q of

$0.95 was only modestly below our $0.97 forecast and Street Consensus of $0.96 due to a boost from low tax rate ($0.08) and better other expense ($0.02)."

Tom continues, "We believe that softness in industrial demand (automotive, home building), increased modal competition, and potential slowing in coal demand are likely to limit volume growth in 1H07 for NSC. With few legacy contracts left to re-price and increased truck competition limiting price increases in domestic intermodal, we suspect that NSC's pace of yield growth is likely to be more modest in 2007 compared to the pace of the last few years."

With that, NS gapped down $2 at Wed's open from the previous day's $53.65 close and was still drifting south below $49 as I write this at 1100 Friday morning. I own NSC for my IRA but used this opportunity to by back the short Feb 50 calls I'd sold for less than I paid thus lowering my cost basis another notch. The tech signs point toward further declines however this event signals a broken stock, not a broken company. See *The Trade* below.

NS is clearly building for a stronger tomorrow with increased capex for 2007 that, as CEO Wick Moorman explained in his wrap to the call, will expand capacity not only for intermodal but also will speed up the entire railroad for all shippers." For proof, see what's happened to velocity on BNSF's transcon as it closes the few remaining single-track gaps.

Union Pacific brought up the markers for the week with a very powerful story. In his opening remarks CEO Jim Young cited a number of Q4 records including a 62% eps gain to $1.78, ops income up 52% to $810 mm, freight sales of a tad under $4 bn, a six-point OR improvement to a Q4 best of 79.6, the lowest in four years. It all starts with freight sales, up 9.42%, edging out BNSF's 9.35% revenue gain. Revenue units increased one percent while merch carload revs gained 7.6% yoy, 30 BP behind first-place BNSF. Merch carloads skidded 3.4% in volume however merch RPU gained a league-leading 11.3% yoy. Merch RPU ran to double-digits in all but auto.

As usual, Chief Comm'l Officer Jack Koraleski's slides (www.up.com/investors/index.shtml) give a dynamic overview of the sales and marketing picture and I'd recommend you follow along as I run some highlights for the shortline readership. Ag revenues were up 20% on 4% more units with ethanol, DDGs, and Mex the big drivers. Chems revs up 9% on 1% fewer units, though RPU was up 11%. The Industrial Products group really took it in the shorts across all STCCs. Still, RPU went up 12% as UP zeroed in on commodity lanes with the best returns.

Look too at COO Dennis Duffy's slides and see that his team held the yoy expense increase to a mere 2% to create the out-size deltas in ops income and OR cited above. Shortliners please see Slide 19 in particular and strive to match those records. The theme is one of driving ops improvements so as to support the quality product-quality-price initiative.

The trade: The UNP turnaround has gathered the expected momentum and though the stock has enjoyed some heady gains of late I'd wait for a pull-back to the $90 level. The 2007 estimate is for $6.71 and at $94 this represents a PE of 14. By comparison CNI at $44 is under 12x the 2007 estimate and NSC at $48 a ticket is right at 12x.

Big Six Class I Commodity Carload Comps
Quarter ending 12/31/2006
Revenue and income in $millions

Metric	BNSF	CN	CSX	NS	UP*
Railroad revs (1)	$ 3,882	$ 1,942	$ 2,396	$ 2,319	$ 3,962
YOY Pct. Change	9.35%	2.97%	7.98%	2.75%	9.42%
Revenue Units (000)	2,677	1,146	1,810	1,928	2,440
YOY Pct. Change	3.7%	-5.1%	-0.4%	-2.8%	0.9%
Carload revs (2)	$ 1,659	$ 1,402	$ 1,382	$ 1,234	$ 2,293
YOY Pct. Change	7.9%	1.4%	5.9%	1.6%	7.6%
Pct carload	42.7%	72.2%	57.7%	53.2%	57.9%
Pct Intermodal	34.4%	18.4%	14.9%	21.3%	18.3%
Pct Coal	20.0%	4.0%	25.2%	25.5%	19.1%
Mdse Carloads (000)	684	720	787	678	988
YOY Pct. Change	1.5%	-8.3%	-3.8%	-5.9%	-3.4%
Rev/CL x coal, IM	$ 2,390	$ 1,947	$ 1,756	$ 1,820	$ 2,322
YOY Pct. Change	6.3%	10.5%	10.1%	8.0%	11.3%
Operating Expense	$ 2,940	$ 1,186	$ 1,918	$ 1,705	$ 3,152
YOY Pct. Change	6.9%	1.7%	6.3%	2.5%	2.1%
RR Operating Income	$ 942	$ 756	$ 478	$ 614	$ 810
YOY Pct. Change	17.8%	5.0%	15.2%	3.4%	52.0%
RR Operating Ratio	75.7%	61.1%	80.1%	73.5%	79.6%
YOY Point change	(1.73)	(0.75)	(1.25)	(0.16)	(5.72)

Full Year Ending 12/31/2006
Revenue and income in $millions

Metric	BNSF	CN	CSX	NS	UP
Railroad revs (1)	$ 14,985	$ 7,716	$ 9,566	$ 9,407	$ 15,578
YOY Pct. Change	15.4%	6.6%	11.0%	10.3%	14.7%
Revenue Units	10,637	4,824	7,358	7,901	9,852
YOY Pct. Change	6.1%	-0.4%	0.1%	1.5%	3.2%
Carload revs (2)	$ 6,489	$ 5,576	$ 5,595	$ 5,106	$ 9,104
YOY Pct. Change	14.5%	5.1%	10.3%	11.3%	15.1%
Pct carload	43.3%	72.3%	58.5%	54.3%	58.4%
Pct Intermodal	34.3%	18.4%	14.8%	21.0%	18.0%
Pct Coal	19.5%	4.9%	24.9%	24.8%	19.0%
Mdse Carloads (000)	2,833	3,087	3,287	2,884	4,104
YOY Pct. Change	3.1%	-1.8%	-2.6%	-0.4%	0.1%
Rev/CL x coal, IM	$ 2,291	$ 1,806	$ 1,702	$ 1,770	$ 2,218
YOY Pct. Change	11.1%	7.1%	13.3%	11.8%	14.9%
Operating Expense	$ 11,468	$ 4,686	$ 7,608	$ 6,850	$ 12,694
YOY Pct. Change	13.9%	1.5%	7.6%	6.9%	7.7%
RR Operating Income	$ 3,517	$ 3,030	$ 1,958	$ 2,557	$ 2,884
YOY Pct. Change	20.4%	15.5%	26.4%	20.8%	60.7%
RR Operating Ratio	76.5%	**60.7%**	79.5%	**72.8%**	81.5%

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal

Source: company financials
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