RAILROAD WEEK IN REVIEW
OCTOBER 12, 2007

"Consumers United for Rail Equity (C.U.R.E.) is pushing legislation that could…force railroads to open their privately-owned tracks (that is, their 'factories') to use by others, at rates ultimately to be established by federal courts." Cato Institute Policy Analysis No. 98

Railroads, happily, are not there just yet. However, the mere fact that they could be there in our lifetimes is a strong motivator for railroad operating companies to maximize ROIC while they can. WIR readers are well aware that profits start with revenue, and the fewer dollars used creating the core service the more dollars available for capex and shareholder dividends alike.

Yes, volumes are down this year though revenues and earnings are up because railroads are zeroing in on the commodity-OD pairs that improve system yield and are shunning those that do not. Two years ago lower-than-average RPU commodities like aggregates, wood chips and a lot of STCC 01s and 20s accounted for 18.6% of total revenue units (one trailer or container is a unit). Fast-forward to the present and they are down to 18.3% of the total while coal increased to 31.4% from 30.9% and intermodal went to 25.4% from 24.9%. At the same time, cars were getting bigger (286 vs. 263) and operating ratios were going down. Best of all, the rails are finally on the road to earning their cost of capital as calculated using the present STB formula.

Now consider the same low-rated commodities on the shortline side of the house. Two years ago they comprised 37.3% of the short line traffic base reported by RMI's RailConnect Index. By the time mid-2007 rolled around these commodities accounted for 38.6% of shortline revenue units. Since most shortline traffic shows up on the Class Is some place, it's clear that the short line share of low-rated commodities is increasing, contrary to the higher-yield goals of the Class I roads.

As the major trunk lines are forced by the forces of re-regulation to manage by yield, they will move away from the single-carload lanes with low revenues and revenue-cost ratios that are lower still, precisely those groups that are shrinking on the Class Is and increasing on the short lines. This is not a message the short lines want to hear.

Two weeks ago I gave a short talk on "Understanding Your Connecting Class Is" at the recent Eastern Region ASLRRA meeting (PPT slides are on my home page). The argument is that the more a short line's business development efforts mirror its Class I's the stronger the relationship. I showed how the Class Is' quarterly financial reports can help short lines in this regard and asked for a show of hands from those who follow these reports. Only a handful of hands went up.

I've often written here and elsewhere that short line owners who don't try to understand why their connecting Class Is do what they do "don't get it." I guess I hit a nerve because one of those in my audience writes, "Instead of saying the members 'don't get it' maybe you should find out what is important to them." Well, judging from the fact that most of the meeting program was devoted to understanding the government (WIR 9/28), I guess *that's* what's important to them and *I'm* the one who doesn't get it. I'll not be sending that message to that group again.

Turning now to CURE, take this hypothetical situation. Here comes the Fallen Flag & Eastern, a short line saddled with a commodity base consisting mainly of trash, aggregates and offal (see STCC 20 149 83). They see a plastics maker (Pellets-Plus, Inc.) on a branch line off their connecting class I five miles down the road from the interchange point. The FF&E decides, given the passage of the

CURE-sponsored legislation, that they want access to Pellets-Plus and they want to interchange that business with another Class I at the opposite end of the FF&E.

But the thick plottens, as my dear-departed friend Ben Friedland was wont to say. Paradox Plastics, a major competitor to Plastics-Plus, cites the competitive access provisions of the new railroad law and petitions Justice to extend the law to all industries, not just railroads, and force Plastics-Plus to let Paradox use the Plastics-Plus plant to make the Paradox product.

Meanwhile, HR 2125 has become law. The language not only prohibits new paper barriers but also declares paper barriers more than five years old null and void, thus encouraging the FF&E to open the interchange to the second Class I, never mind that the price it paid to buy the line was based on the guarantee that all traffic would be routed over the seller.

The Class I now serving Plastics-Plus now stands to lose a chunk of that business to a short line it had created plus a competitor and finds that this being the case no longer can serve Plastics-Plus and make its margins. First Class I withdraws from the market. Meanwhile, Plastics-Plus, finding it has to turn some of its production capacity over to a competitor, can no longer maintain the facility, turns the whole thing over the Paradox Plastics and moves to Indonesia.

And so we're back at Square One. Paradox Plastics is captive to the short line and the Other Class I and the plastics industry is down one more facility. At this point it's conceivable that some Member will launch yet more legislation, call it Son of HR 2125. In the meantime, no Class I is building any more track to access new markets lest it be forced to let the competition use the same track to access the market. There are no new short line spin-offs because nobody can afford to pay the dual-access premium. Is this the cure CURE and the legislators it has bought and paid for really want?

Back the real world, Norfolk Southern (NSC) has cut its 3Q07 earnings estimate to 97 cents, a nickel below reported eps for 3Q06. Illinois tax legislation enacted in Q3 changes the way transportation companies apportion their taxable income to the state and will result in a non-cash charge of about $19 mm. In addition, Norfolk's synfuels investment returns will be les than previously expected due to rising oil prices. Both are below-the-line effects and have nothing to do with railroad operating returns.

Morgan Stanley's Bill Greene puts it this way: "NSC's operations have performed in line with our above consensus estimates, which gives us more confidence in our bullish 2008 estimates. We rate NSC's stock Overweight in what is primarily a valuation call. The shares are trading at a meaningful discount to the rest of the rail group and look cheapest on a PE basis (despite historically trading in-line with peers). NSC has historically shown discipline with pricing and has been an industry-leading steward of capital."

S&P cites the tax and synfuels items above for maintaining its HOLD rating on NSC but is hedging its longer-term bets saying "Still, we keep our 12-month $57 target price, believing investors are focused on shipment volumes, which we see rising in 2008. Lehman Brothers has upgraded NSC as "the consistently most profitable railroad we follow and the best cash generator in the group."

Meanwhile, NSC ran its first -- and the first in the country – revenue train equipped exclusively with electronically-controlled pneumatic (ECP) brakes. The train consists of three new locos (at the June Investors Day forum VP-Mechanical Tim Heilig spoke of new 4000-HP DC power) and 115 of the new hybrid "eastern" coal hoppers (also introduced by Heilig). It will operate between the SW Penna mines and the Keystone Generating Station in Shelocta, PA over a new 11-mile track segment completed a year ago. This $44 mm project was four years in planning and permitting and one year in actual construction (see VP-Engineering Tim Drake's opening slides from June) and replaced a circuitous 51-mile haul through some of the toughest terrain in that part of the world.

By Way of review, ECP brakes have the potential to reduce train stopping distances by as much as 60% over conventional air brake systems. ECP brakes utilize electronic signals to simultaneously apply and release throughout the length of a freight train. Over the next several months, Norfolk Southern will equip 30 locomotives, 210 quick-drop coal hoppers and 230 hybrid gondolas with ECP brakes for use in dedicated coal train service.

Class I railroad revenue unit volumes ytd through Week 39 (9/29) continued to drift south, down 2.2% yoy, though the cumulative four-week count was off but a point and for the quarter down 1.7%. Intermodal, ag (including STCC 20) and coal all show improvement over the shorter terms. The 302 short lines reporting through the RMI RailConnect Index are gaining some ground in ag (also including STCC 20), aggregates, and even forest products. One must recall, however, that much of the shortline volume in these STCCs is stuff the Class Is are finding least attractive.

Moreover, as noted above, shortlines lag in commodity groups that the Class Is are building, notably intermodal, ag unit trains and coal. The Class I trend to trainload service as opposed to single-car shipments has not gone unnoticed elsewhere, either. Tony Hatch, in his "Ten Reasons to Keep the Faith in the Railroad Renaissance," (JOC 9/21), writes, "Manifest may be shrinking as a percentage of the total as intermodal (etc.) grows, but it's still a huge business and as rail reliability, cooperation (and information sharing) and technological capability improves, 'solving the carload problem' is actually within sight."

Two keys to "solving the carload problem" are better asset turns and revenue adequacy, matters of life and death to carload-driven short lines. Multiple handlings – short line to Class I serving yard to another yard to delivering local – kill transit times and asset turns. The FASB requirement that shortlines be paid out of revenue means there is less revenue to cover the Class I cost of the move so slow shortline turns decrease margins and harm revenue adequacy.

Kansas City Southern was ranked number 20 in *Fortune's* "100 Fastest Growing Companies 2007" published in the Sept. 24 edition. *Fortune* determines the rankings with data from Zacks Investment Research and considers factors such as revenue, profit growth, and total return over three years. My good friend Bill Galligan, AVP for Investor Relations at KCS, says that what differentiates KCS from most other North American railroads is that 'we have opportunities to significantly increase our value and our average length of haul in the years ahead. Much of this is tied to the emergence of Lazaro Cardenas as a Pacific port option and the expected growth of cross border traffic."

Meanwhile, Scott Arvidson moves to COO of the Railway Company as well as CIO of the corporation, Warren Erdman is named EVP for Corporate Affairs, and Larry Lawrence is promoted to EVP and Assistant to the Chairman. Art Shoener remains President and COO of KCS and CEO of the railway. Excellent and well-earned moves all.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $125. Corporate subscriptions are $500 per year. A publication of the Blanchard Company, © 2007. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned.

RailConnect Index of Short Line Traffic

Traffic Type: All

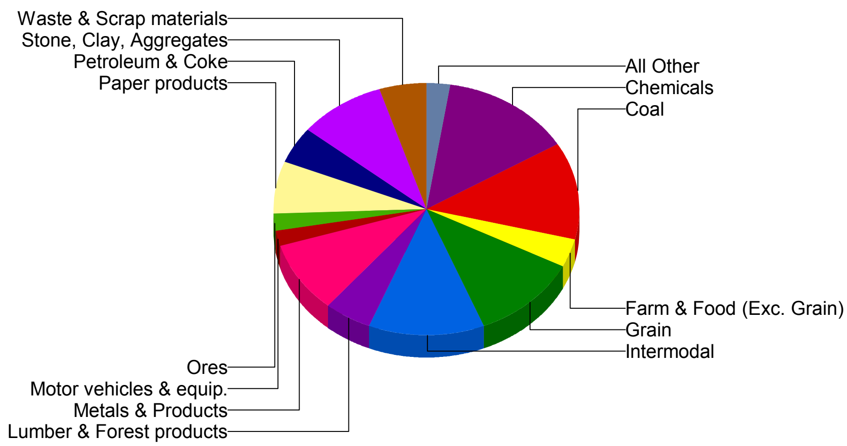
For the week ending: 9/29/2007

Week Number: 39

Carloads Handled	Current Week			Year-To-Date		
	2007	**2006**	**% Change**	**2007**	**2006**	**% Change**
Coal	15,712	15,546	1.07%	570,335	578,580	-1.43%
Grain	14,103	13,972	0.94%	524,053	523,565	0.09%
Farm & Food (Exc. Grain)	4,936	4,599	7.33%	173,938	179,341	-3.01%
Ores	3,075	3,438	-10.56%	103,235	116,941	-11.72%
Stone, Clay, Aggregates	13,557	12,121	11.85%	426,012	438,994	-2.96%
Lumber & Forest products	5,760	7,041	-18.19%	230,055	278,327	-17.34%
Paper products	7,868	8,911	-11.70%	313,445	343,111	-8.65%
Waste & Scrap materials	6,739	7,070	-4.68%	234,123	242,331	-3.39%
Chemicals	16,888	15,572	8.45%	646,378	599,871	7.75%
Petroleum & Coke	5,819	6,233	-6.64%	217,169	230,202	-5.66%
Metals & Products	11,933	12,905	-7.53%	432,303	466,954	-7.42%
Motor vehicles & equip.	2,047	1,843	11.07%	83,063	86,914	-4.43%
Intermodal	15,608	16,438	-5.05%	565,227	692,462	-18.37%
All Other	3,194	3,165	0.92%	116,728	132,798	-12.10%
Total	**127,239**	**128,854**	**-1.25%**	**4,636,064**	**4,910,391**	**-5.59%**

RailConnect Index

Year-To-Date



All Other	2.5%
Chemicals	13.9%
Coal	12.3%
Farm & Food (Exc. Grain)	3.8%
Grain	11.3%
Intermodal	12.2%
Lumber & Forest products	5.0%
Metals & Products	9.3%
Motor vehicles & equip.	1.8%
Ores	2.2%
Paper products	6.8%
Petroleum & Coke	4.7%
Stone, Clay, Aggregates	9.2%
Waste & Scrap materials	5.1%
Total:	100.0%