THE RAILROAD WEEK IN REVIEW
JULY 25, 2008

"Productivity was the real story line for us in the quarter, as we made strong gains in virtually every category." – Dennis Duffy, EVP Operations, Union Pacific

Canadian National reported 2Q earnings late Monday followed immediately by the call. Revenues increased 4% but ops expense shot up 14% mainly due to the 60% yoy leap in fuel expense. As a result, 2Q ops income dropped 14% yoy. The combined strong Canadian dollar and weak NA economy didn't help. The OR gained six points to 66.3 from 60 even a year ago, something truly atypical for this outfit. And net income dropped 11% though eps took only a 6% hit because the aggressive share repurchase program cut the float by 6% yoy.

Merchandise carload revenue dipped two percent as autos and forest products continued their double-digit drags. Petrol/chems, mets/mins all gained albeit on meager volume deltas plus and minus. Average RPU gained 3%, though CN expects the demand for rail to remain suffciently strong to support price increases in the 4-5% range in 2H08.

The outlook for 2H08 is "positive" for all commodity groups save the usual suspects -- housing and auto. And here's a tidbit for the US short lines: CN will introduce the retail intermodal that has worked so well in Canada into the lower 48. It's a light-asset business where CN can control origin, destination, and everything in the middle. Trans-border between US and Canada has potential.

Highlights from the Q&A: A caller asked whether CN would be slowing its trains down to conserve fuel. CN said no. "Precision railroading" means *faster* trains with distributed power (DP) units in the consist (or pushing) bigger trains for more GTMs per gallon. Moreover, changing customer behavior can make some short car types long and vice versa. The faster railroad minimizes the effect.

Tony Hatch said of this performance, "Watching CN these days is like watching a baseball game with Josh Hamilton – a great hitter surrounded by a bad situation (the economy, etc) so there's more action elsewhere. CN reported "same-store" pricing up 4.5%, plus a surcharge impact of about 5%... The key will be the resumption of growth though -- curiously -- we are finding that it's the Canadians, from the land of the bulk commodities, that are facing the toughest time in this economy."

Canadian Pacific was on the phone Tuesday with a top line that barely budged (though freight sales were up 2%) against a modest ops expense gain of 7%. Somehow, CP held its fuel expense boost to just 34% and actually took ops expense before fuel down 70 basis points. The operating ratio rose 4.7 points to 79.4 though absent the effects of fuel, floods and the new regulatory-reduced grain rates the OR would have been 74 or so. Reported net income was $155 mm, down 40% on a GAAP basis, though absent the prior-year effects of FX and related items earnings dropped only 13% yoy.

Coal, industrial/consumer, and intermodal were the bright spots on the CP commodity spectrum with FX-adjusted revenue gains of 6%, 17% and 9% respectively. Price plus fuel surcharges added almost 10% (roughly half price, half fuel recovery) to total 2Q sales but the federal grain pricing decision and mix knocked that in half with FX taking out another three points, ergo freight revs up 2%. Other above-the line sales were off a third, cutting the sales delta to 40 basis points.

Revenue-unit counts came down in all the merch carload groups ex industrial products – up 9%; coal and IM loads were up 3% and 1% respectively. The grain harvest was down slightly though that may even out in 2H. Sulfur and fertilizer were off the tough comps of 2Q07. Ag and auto -- well, what can I say? The rapidly expanding Alberta oil sands infrastructure was the primary IP driver. Contract renewals average 6.5% YTD, though the outlook for 2H08 remains "muted."

No CP call would be complete without a Fred Green comment of two on customer behavior and Tuesday did not disappoint. Responding to a question on western corridor capacity, Fred talked about "rifle-shot de-bottlenecking" that would keep lines running at 70-80% capacity. "With coal at $300/ton it must mean the mine operators want to ship a lot of coal but knowing what the coal company wants to do in terms of volumes [is essential]. We want to build on long-term relationships, however we won't add capacity if we don't know what the customer is about."

CP is using this lull in the proceedings to zero in on specific efficiency initiatives: financing projects ahead of the curve, fitting track class to the intended service, yard efficiency. Then there are the Railway of the Future initiatives -- ECP, trip optimizer, and in-train repairs, among others. Fred added, "Culturally the time lag between concept and shareholder benefit is too long. We need to shrink the time frame so we see benefits before the end of 2008. This will require an action-oriented rigorous approach." Sounds solid to me.

Norfolk Southern was next up and if this were Yankee stadium the ball would be someplace on East 161st Street. That's over the left field wall, and it's a long ball outta the park. CEO Wick Moorman set the tone in his opening remarks, saying that the second quarter results "continue the momentum of the first quarter." He went on to note they're keeping service levels high and sharpening the operations focus by measuring yoy and sequential improvements.

The push to match price to perceived value of the transportation product is resulting in greater shipper demand for NS services, and that in turn supports an $80 mm capex bump for locos and rail. The goal is and will be a "broad and balanced portfolio of commodity mix" that will result in greater shareholder value. As proof, they just announced a 10% dividend increase to $1.28, three times what it was three years ago, with a goal of a 33% payout ratio.

It all begins above the line. Revenues were up 16% -- 11% in merch carloads, 34% coal and 11% intermodal. This wide swing meant carload dropped 3 points to 56% of revenue, IM slipped a point to 19% and coal rose four points to 28% of total sales. The revenue-volumes are a bit misleading, however: even though the car count rose but 2%, that metric masks the fact that the move to bigger cars continues, meaning more tonnage moved per individual car. Export coal rose 63% on strong global demand for US met and steam coal.

On the merch carload side, 20% growth in ethanol shipments to the southeastern markets helped propel a 28% revenue gain. Strong global steel demand led to higher export scrap and finished steel movements, pushing group revs up 18% even as domestic construction moves dipped further. Chem revs were up 8% against a 5% volume decline, a quarter of which was due to plant closures. Paper and forest products were the same as elsewhere – down. But selective price increases kept this group in the revenue positive column as well, up 7%. Auto was down 11%, but, hey, you can't win 'em all.

The ops guys coped with a 76% increase in fuel expense by keeping the other line items in check -- ex-fuel ops expense was up 5%. Operating income rose 16% and the yoy OR delta was a measly plus 10 basis points at 71.1, a number NS says they can bring down still further (will CN and NS cross in 2h08??). Net earnings increased 19% and eps jumped 31% thanks to a 10% share-count drop. What's really astounding – and why I say the ball is out on the street in the Bronx – is that NS managed a 9%

price increase across the board, making the 19% RPU gain a reality – this after guiding to 4% or so earlier on. Dare we look for 9% in 2H? Somebody go look for that ball.

Union Pacific came to the plate Thursday morning. The second and third bullets of the press release said it all: Revenue up 13%, operating income up 18%, indicating that ops expenses were held in check even after a quarter fraught with mud slides, fires and flooding. Ex-fuel, ops expense dropped $30 mm or one percent, fuel consumption was down 6% on a 1% drop in GTMs and a 5% gain in GTMs/gallon. Rents were down 5% thanks to better asset utilization, lower car hire payments and less leased equipment as improved system velocity has facilitated the return of some short-term leased power.

The flooding cost about 40,000 loads though UP expects to recover that in 2H. Agriculture was the bright spot with revs up 29% on an 11% volume gain (ethanol was up 25% and DDGs 14%), pushing a 16% RPU gain. It was the best-ever Q revenue for ag, chems, energy and industrial prods and a record Q2 for intermodal. Within the IP group, lumber and cement continued their southerly drift though steel and rock shipments made up about 2/3 of the shortfall. RPUs were up double-digits across all commodity groups.

Below the line, net income was $531 mm, up 19% and earnings per share grew 24% to $1.02 with the spread due strictly to the share-repurchase program. UP projects Q3 earnings in the $1.10-$1.20 Range on the lower volumes and $4.00 diesel fuel. For the year, the eps guidance is $4.00 to $4.20, implying a $90 share price.

The Q3 commercial outlook calls for continued growth in ag, coal and chems and mixed results in IP, auto parts and domestic intermodal. Finished vehicles and international intermodal remain plagued by weak demand. Core prices will be in the 5-6% range for the year on volumes that will most likely be off a point or so.

BNSF was the last of the Big Six Class Is to check in. And like the other three US Class Is, the Fort Worth gang scored points with a double-digit (16.5%, best of class) revenue gain against a 2.8% dip in revenue units (second worst before NS' 4.0%). The increase was primarily due to improved yields (6% sale-store) and FSC revs (up $400 mm yoy). Carload revenues (ag and auto included) increased 19.6% on a 1.8% revenue increase and RPU up 17.4%. Reported ops income took 15% haircut though adjusted for charges (below) it actually rose 7%.

However, there's even a stronger story buried in here. Industrial products and coal took slight volume hits but total RTMs for each was down even less – more tons per car. As a result, RPUs were up double-digits. This is a hint that short lines paid handling fees might want to look at their own commodity mixes and where the car size has increased, talk about sharing in some of this upside. Short lines play a partularly important role on the ag side, where BNSF posted record 2Q revenue and units led by ethanol, corn, wheat and beans.

Fuel led the operating expense line-item increase, up 62% yoy. BNSF did less well than its peers in getting more miles per gallon as consumption per GTM was unchanged (as were total GTMs). Ops expense ex-fuel was up 13%. During the call CFO Tom Hund said the OR (adjusted for one-time environmental charges and additional personal injury accruals) was 79.2, up 120 BP from 2Q07. (Note: If you do a classic OR as ops expense as a percentage of revenue, you get 84.1, up nearly six points.) Reported EPS dropped 17% to $1.00 but that includes the charges cited above. They came to 34 cents a share and adding them back yields $1.34 a share, up 12%.

Bill Greene of Morgan Stanly caught the essence in his note: “It was a strong pricing story , however BNSF is unlikely to outperform without volume growth. We like the BNSF story longer-term as the company should be able to produce ~20% annual EPS growth from 2009-2012. Moreover, BNSF has exposure to many key parts of the secular rail story: legacy contract renewals, strength in bulk commodities, robust organic pricing, and improving returns.

“BNSF is a railroad built for growth that can produce impressive operating leverage in positive freight environments. However, until volume growth returns, the stock will struggle to outperform peers. BNSF will need strong coal and grain volumes to continue to maximize the upside. Intermodal volumes should improve later in 3Q as BN laps the loss of Maersk. On the intermodal front, weak import demand should continue to weigh on volumes so new domestic intermodal services will be key for intermodal growth.”

Asked about the regulatory and legislative climate in Washington, CEO Matt Rose said he thinks further action on the re-regulation front will be stayed until the full impact of the DuPont-CSX Small Rate case shakes out. Moreover, the energy situation is making more aware that more rail capacity, not less, is what we need and that legislative actions that go the wrong way may be injurious to our health. I’ll drink to that.

If there were one common thread to the six Class I reports, it’s that Tom Peters is right: Relative quality in the eyes of the customer merits premium pricing and expanded market share. NS won the brass ring in this one, up 9% though the 6% same-store gains on the other three US Class Is are nothing to sneeze at. The common negative threads are that fuel is a killer, revenue unit counts remain flat to down and that the lousy housing market is a drag affecting more than building products.

But that, as Kosmo says in *Moonstruck*, is temporary. The volume lull gives everybody a chance to swap out gas guzzlers for fuel-sipping power, get more tons per train start, more train miles per track mile, and generally sharpen the operation. I’m happy to report I see many short lines taking the same tack.

WANTED: Ex-railroaders; Must Have Own Hat & Whistle. “With the CSX proxy vote moving (slowly) towards certification the takeaway for rail companies is that their owners (shareholders) want railroad experience on the Board. While TCI leveraged the “no railroad experience” argument effectively, the fact remains CSX was not an outlier in this regard. None of the other rails have any experience (ex-their CEOs) on the Board either.

“With CSX done (put a fork in it), UP is the next obvious candidate given TCI’s stake. Don’t be surprised if UP, and then the other rails, stealthily elevate some experienced guys to the board room over the NTM. We may even see yesterday’s heroes make a comeback as ex-CEOs become in-demand at the board level: Goode, Davidson, Krebs, Tellier, Ritchie. Even John Snow may catch a bid.” (courtesy of Rick Paterson at UBS)

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Class I Commodity Carload Comps
Quarter ending 6/30/2008
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 4,478	$ 2,098	$ 1,220	$ 2,907	$ 2,765	$ 4,568
YOY Pct. Change	16.5%	3.5%	0.4%	14.9%	16.3%	12.9%
Revenue Units (000)	2,509	1,188	683	1,775	1,828	2,371
YOY Pct. Change	-2.8%	-1.3%	-1.6%	-2.8%	-4.0%	-2.5%
Carload revs (2)	$ 2,017	$ 1,376	$ 671	$ 1,637	$ 1,458	$ 2,661
YOY Pct. Change	19.6%	-1.9%	-2.7%	9.8%	10.5%	12.2%
System RPU Pct Chg.	19.7%	2.9%	3.3%	18.3%	19.0%	15.8%
Pct carload	45.0%	65.6%	56.3%	56.3%	52.7%	58.3%
Pct Intermodal	31.9%	18.7%	29.3%	13.2%	19.2%	16.8%
Pct Coal	20.1%	4.9%	14.4%	28.3%	28.0%	20.1%
Mdse Carloads (000)	714	750	291	768	661	999
YOY Pct. Change	1.8%	-3.7%	-5.4%	-6.6%	-2.8%	-2.2%
Rev/CL x coal, IM	$ 2,774	$ 1,835	$ 2,309	$ 2,132	$ 2,207	$ 2,664
YOY Pct. Change	17.4%	1.9%	2.8%	17.5%	13.7%	14.7%
Operating Expense	$ 3,764	$ 1,391	$ 969	$ 2,190	$ 1,966	$ 3,637
YOY Pct. Change	25.4%	14.4%	6.8%	14.2%	16.5%	11.6%
RR Operating Income	$ 714	$ 707	$ 251	$ 717	$ 799	$ 931
YOY Pct. Change	-15.1%	-12.8%	-18.4%	17.2%	15.8%	18.3%
RR Operating Ratio	84.1%	66.3%	79.4%	75.3%	71.1%	79.6%
YOY Point change	5.94	6.31	4.74	(0.47)	0.12	(0.93)

Class I Commodity Carload Comps
YTD through 6/30/2008
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 8,739	$ 4,025	$ 2,367	$ 5,620	$ 5,265	$ 8,838
YOY Pct. Change	16.7%	2.3%	1.5%	13.5%	13.8%	11.9%
Revenue Units	4,995	2,320	1,331	3,492	3,729	4,706
YOY Pct. Change	-1.8%	-0.6%	0.2%	-2.5%	-2.2%	-1.3%
Avg RPU change		1.6%		16.7%	16.4%	13.4%
Mdse Carload revs (2)	$ 3,951	$ 2,686	$ 1,332	$ 3,181	$ 2,810	$ 5,156
YOY Pct. Change	20.6%	-2.5%	-3.0%	9.6%	-3.8%	11.6%
MGTM	531,878	171,614	122,258	229,800	185,000	514,373
YOY Pct. Change	-3.2%	0.9%	0.2%	-1.0%	-0.6%	-0.2%
Pct carload	45.2%	66.7%	56.3%	56.6%	53.4%	58.3%
Pct Intermodal	30.7%	18.5%	29.0%	13.0%	19.3%	16.7%
Pct Coal	21.2%	5.1%	13.5%	28.2%	27.3%	20.1%
Mdse Carloads (000)	1,453	1,468	577	1,514	1,350	1,956
YOY Pct. Change	4.3%	-3.1%	-3.0%	-5.7%	-3.8%	-1.4%
Rev/CL x coal, IM	$ 2,719	$ 1,830	$ 2,308	$ 2,101	$ 2,081	$ 2,636
YOY Pct. Change	15.7%	0.6%	2.6%	16.2%	14.7%	13.1%
Operating Expense	$ 7,150	$ 2,795	$ 1,918	$ 4,277	$ 3,888	$ 7,119
YOY Pct. Change	20.1%	9.1%	6.9%	10.9%	14.1%	11.4%
RR Operating Income	$ 1,589	$ 1,230	$ 449	$ 1,343	$ 1,377	$ 1,719
YOY Pct. Change	3.5%	-10.3%	-16.3%	22.4%	13.1%	14.1%
RR Operating Ratio	81.8%	69.4%	81.0%	76.1%	73.8%	80.5%

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
Source: company financials
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Big Six Class I Operating Efficiency						
Quarter Ending 6/30/2008						
Revenue and income in $millions						
Metric	**BNSF**	**CN**	**CP**	**CSX**	**NS**	**UP**
Railroad revs	$ 4,478	$ 2,098	$ 1,220	$ 2,907	$ 2,765	$ 4,568
RR Operating Expense	$ 3,764	$ 1,391	$ 969	$ 2,190	$ 1,966	$ 3,637
RR Operating Income	$ 714	$ 707	$ 251	$ 717	$ 799	$ 931
GTM in millions	279,060	87,287	62,397	116,200	93,800	257,199
RTM in millions	164,373	45,264	34,479	64,200	51,100	140,939
Fuel Consumed (mm gals	355	96	74	138	130	313
Fuel Expense	1,245	399	260	537	491	1,159
Ops Exp ex-fuel	2,519	992	709	1,653	1,475	2,478
Capex	(1,042)	(529)	(557)	(912)	(676)	(1,482)
Measures	**BNSF**	**CN**	**CP**	**CSX**	**NS**	**UP**
Operating Ratio	84.1	66.3	79.4	75.3	71.1	79.6
Capex as % of Revs	23.3%	25.2%	45.7%	31.4%	24.4%	32.4%
Ops exp chg ex-fuel	12.9%	2.6%	-0.7%	3.9%	4.7%	-1.1%
Ops exp/Thousand GTM	$ 13.49	$ 15.94	$ 15.53	$ 18.85	$ 20.96	$ 14.14
Ops exp/Thousand RTM	$ 22.90	$ 30.73	$ 28.11	$ 34.11	$ 38.47	$ 25.81
Rev/Thousand RTM	$ 27.24	$ 46.35	$ 35.39	$ 45.28	$ 54.11	$ 32.41
MRTM/MGTM	0.59	0.52	0.55	0.55	0.54	0.55
MGTMs/gallon	786.08	909.24	847.79	844.48	720.61	821.72
CN, CP in $C						
MG/RTM = Millions of Gross/Revene Ton-Miles						
Revene line includes freight revs plus other ops rev.						
Returns and Ratios						
YTD Ending 3/31/2008						
Metric/Name	**BNSF**	**CN**	**CP**	**CSX**	**NS**	**UP**
FCF*	663	45	(214)	431	382	354
FCF/Revs	14.8%	2.1%	-17.6%	14.8%	13.8%	7.7%
Operating Ratio	84.06	66.30	79.42	75.34	71.10	79.62
Net margin	7.8%	21.9%	12.7%	13.2%	16.4%	11.6%
Current Ratio	0.80	0.96	0.67	1.32	0.95	1.09
Working Capital	$ (694)	$ (58)	$ (508)	$ 799	$ (102)	$ 301
Debt/equity	74.0%	62.4%	73.7%	71.4%	60.4%	49.4%
interest coverage	5.10	8.13	3.99	5.39	7.13	7.27
*** Free Cash Flow = cash from ops less capex**						
Source: Company financials						
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