THE RAILROAD WEEK IN REVIEW
AUGUST 1, 2008

Kansas City Southern brought up the markers for the Class I Earnings Season with a very respectable 26% operating income gain. Revenues came in 14% ahead of 2Q07 and the expense line rose but 11%, even though fuel – as elsewhere – was the big drag (more on that below). The OR came down two points to 78.5, the best yoy delta of all the rails (see summary sheet attached). Net income before preferred divs nearly doubled to $55 mm from $30 mm and diluted eps before preferred was up 86% to 56 cents from 30 cents.

All business units reported revenue gains, all in double-digits but coal where there was a 12% drop in loadings. I was surprised to see car counts in ag and minerals essentially flat after the robust reports we've seen elsewhere as drops in STCCs 01 and 20 offset gains in ores and minerals. The Industrial and Consumer products group volume gain was a function of the metals and scrap sectors that added seven thousand units, up 29%. The system RPU increased 14% thanks to coal and IM gains.

KCS is predominantly a carload railroad with 79 cents out of every dollar of revenue coming from commodities that move mostly in single-car lots. As we have seen from CN and others with high concentrations of carload revenue, you've got to measure everything every day. During the call the point was made several times that KCS is "process-driven" and the same disciplines and measure in use in the US are in play South of the Border as well.

It's another reason why the Victoria-Rosenberg cutoff is so vital. Expected to open within the next twelve-month, it will improve service levels, revenue opportunities and cost savings that will generate an estimated 18-20% return on investment. The average age of the road power fleet has been cut in half, to 11 years from 22 years, and you certainly don't want that asset sitting around waiting to get over the UP south of Houston. It also brings an IRR north of 20%.

Ops expense ex-fuel rose but a paltry 4%. We also know that fuel surcharges accounted for 5 points of the 12-point price change, about a third of the $60 mm yoy revenue increase. This shows the lag between the way fuel goes up and FSC lags: the fuel expense line grew 38% or $25 mm and the fuel-related revenue stream recovered about 80% of it. Still, the 38% yoy fuel expense gain is about half to two-thirds of what we've seen elsewhere. The answer lies in Mexico, where fuel cost was up 6% compared to nearly 70% in the US.

Further, KCS is beginning to see the payoff for the newer six-axle power in fuel efficiency. Though revenue units were up only 1%, GTMs went up 4% thanks to more tons per car, bigger trains, and, I expect, fewer train starts. Even though average price per gallon was up 51%, fuel burn dropped 8% and GTMs per gallon improved 13% yoy. Suffice to say, every KCS call I attend or listen to sounds better than the one before. This is a happening place and full of great object lessons for any railroader whose livelihood is in the merchandise carload business.

Roger Nelson of the North American RailNet short line investment group, writes, "I thought your readers might be stimulated by a recent note I sent along to the folks at *Progressive Railroading* regarding their 50th Anniversary Issue. Many folks -- especially the younger ones -- assume that the interstate highway system always existed. I often remind folks that when JFK was assassinated in Dallas, he had flown in from Fort Worth that morning (no interstate freeway then). With the increasing congestion on the interstate highway system, that system is failing. People are looking at rail as an alternative, now coming full circle – kind of ironic, isn't it?

“To Editor and Publisher, *Progressive Railroading*: Having spent the past 38+ years of my life in, or associated with the railroad industry, I found your 50th Anniversary Issue to be enjoyable reading. However, after finishing the issue, I was left with the feeling that the most influential factor in railroading over the past 50 years was not explicitly addressed: the development of the interstate highway system in this country. The development of that highway system was a federal policy decision that forever changed the fundamental nature of the U.S. railroad system.

“In a few of the magazine's articles, truck competition was referenced. However, without a publicly-funded interstate highway system, there would have been little chance for the trucking industry to grow and flourish as it did. Railroads have been in a reactionary mode for most of the past 50 years due to the development and growth of the trucking industry. I would also argue that the Stagger's Act was but a reaction to the destructive forces that railroads were experiencing due to truckers' access to a publicly financed infrastructure on which to operate.

“I would also suggest that going forward, the biggest issues for the railroad industry will surround how public funds are directed to develop, maintain, decongest, or restore the transportation infrastructure in this country; and, what part the U.S. freight railroads will - or will be expected to - play in that transportation system.” Thanks, Roger.

From the *Railway Track & Structure* Newswire: “The Central Oregon & Pacific Railroad (CORP) has filed paperwork with the STB requesting permission to abandon ownership of the Coos Bay rail line. The railroad named a 37 percent decrease in traffic since 2003 and $6.7 million in repairs to compromised tunnels as reasons for the request.

”The Coos Bay line up for abandonment runs [from a point some 37 miles east Eugene to a point north of Coos Bay on the Pacific coast.] The Oregon International Port of Coos Bay has filed an OFA with the STB with the intent to buy the line for $9.8 million. The purchase hinges on the sale of an additional 17 miles at the eastern end of the line that CORP does not wish to sell.”

This ex-SP line went to RailTex acquisition in 1994. It is the west end of a 439-mile route in the shape of an inverted “J” between Black Butte CA and Eugene and thence to Coos Bay. It is the latter segment that is under discussion here. Ironically, CORP won a silver Harriman in 2006, the first RA property to be so recognized. It was about a year ago that CORP shut down most of the Coos Bay line due to weather-related tunnel failures. There are nine of them all told, each more than 100 years old and which RA deemed unsafe. (WIR 10/5/20).

From central Pennsylvania comes word that a number of steel scrap dealers are up in arms over a proposed AAR rule change. At issue is the volume of scrap that is permitted in an open-top car. It seems some shippers have been piling the stuff high enough that as the car moves along pieces on the top shift to the sides and fall off, sometimes injuring people on the ground.

A second concern was car damage that created yet other safety hazards -- broken axles, fractured truck frames, draft gear problems and so on. We're not just talking the slight overloads one sometimes sees in cars with materials of varying densities. These were serious overloads, sometimes by as much as the tare weight of the car itself. Put in context, that's 140 tons in car designed for 110 tons plus 30 tons tare weight.

My contact at the AAR says the member railroads asked the AAR to look into the matter and the resulting proposed rule change was the result. The outcry came when recyclingtoday.com reported in its webzine that the proposed rule would prohibit mounding material above the sides of the car as opposed the present rule allowing up to 18 inches above. The article goes on to say that eliminating the 18-inch chord would require one more car for every 10-12 cars loaded under the present rule.

Unfortunately, the article says, “the AAR Open Top Loading Rules Committee has passed the restrictions.” Yet sources at the ASLRRA who work specifically with the AAR on such matters, maintain that such is not the case. Its passage is not imminent, as some have suggested, and the proposed rule is going out for comment from shippers, short lines and trade groups such as the Institute of Scrap Recycling Industries (ISRI).

To be sure, not all parties are guilty, and there are solutions at hand. Scrap steel shippers often have certified scales that they use to weigh scrap coming in. Surely, these could weigh outbound loads and enter the weights on the waybills. Some short lines (Pennsylvania's Lycoming Valley, e.g.) have weigh-in-motion scales that can be used to double-check car weights in *and* out. At the end of the day, there is no need for more rules if everybody's playing by the book.

Economic Planning Associates has raised its 2008 estimate of railcar deliveries to 54,000 units, up from 51,500 units, including intermodal equipment. Based on first-half 2008 deliveries and existing backlogs, EPA said in a quarterly report demand has strengthened in the tank, covered hopper and OT hopper car segments. Q2 orders came to just over 12,000 units, up 16% yoy. There were no IM units in the mix, which bodes well for the carload sector.

“Equally impressive was the fact that there was only a minimal evaporation of orders from existing backlogs. Only 990 orders were cancelled, a mere 1.5% of the backlogs at the beginning of the second quarter. Finally, with assemblies running at the quarterly pace of 14,800 units, mid-year backlogs of 61,600 units represent almost 4.2 quarters of deliveries.”

Reminder: *Progressive Railroading* magazine will hold its Tenth Annual (fourth *consecutive* -- a couple of years were missed in the middle) RailTrends Conference September 30 through October 1, 2008, at the Affinia Manhattan in New York City. Topics on the agenda include discussions on what’s behind the trends in operations, finance and commercial matters and what effect we are likely to see going forward.

The emphasis is on how you can make more money for your firm, be it a railroad, a railroad material and equipment suppler, a bank, hedge fund or any combination of the above. Speakers include RailAmerica President John Giles, UP Intermodal VP John Kaiser, BNSF Ag VP Kevin Kaufman, CN’s VP Marketing Jean-Jacques Ruest, American Coal Council Communications Director Jason Hayes plus the AAR’s Ed Hamberger, congressional figures and other industry leaders. For more info, e-mail cory.ampe@tradepress.com .

The* Railroad Week in Review, *a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe click on the* Week in Review *tab at www.rblanchard.com. A publication of the Blanchard Company, © 2008. Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned in WIR. Specifics available on e-mail request.

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

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 4,478	$ 2,098	$ 1,220	$ 2,907	$ 486	$ 2,765	$ 4,568
YOY Pct. Change	16.5%	3.5%	0.4%	14.9%	13.8%	16.3%	12.9%
Revenue Units (000)	2,509	1,188	683	1,775	465	1,828	2,371
YOY Pct. Change	-2.8%	-1.3%	-1.6%	-2.8%	1.1%	-4.0%	-2.5%
Carload revs (2)	$ 2,017	$ 1,376	$ 671	$ 1,637	$ 384	$ 1,458	$ 2,661
YOY Pct. Change	19.6%	-1.9%	-2.7%	9.8%	15.8%	10.5%	12.2%
System RPU Pct Chg.	19.7%	2.9%	3.3%	18.3%	13.7%	19.0%	15.8%
Pct carload	45.0%	65.6%	56.3%	56.3%	78.9%	52.7%	58.3%
Pct Intermodal	31.9%	18.7%	29.3%	13.2%	8.3%	19.2%	16.8%
Pct Coal	20.1%	4.9%	14.4%	28.3%	9.9%	28.0%	20.1%
Mdse Carloads (000)	714	750	291	768	269	661	999
YOY Pct. Change	1.8%	-3.7%	-5.4%	-6.6%	3.0%	-2.8%	-2.2%
Rev/CL x coal, IM	$ 2,774	$ 1,835	$ 2,309	$ 2,132	$ 1,426	$ 2,207	$ 2,664
YOY Pct. Change	17.4%	1.9%	2.8%	17.5%	12.4%	13.7%	14.7%
Operating Expense	$ 3,764	$ 1,391	$ 969	$ 2,190	$ 382	$ 1,966	$ 3,637
YOY Pct. Change	25.4%	14.4%	6.8%	14.2%	10.9%	16.5%	11.6%
RR Operating Income	$ 714	$ 707	$ 251	$ 717	$ 105	$ 799	$ 931
YOY Pct. Change	-15.1%	-12.8%	-18.4%	17.2%	25.8%	15.8%	18.3%
RR Operating Ratio	84.1%	66.3%	79.4%	75.3%	78.5%	71.1%	79.6%
YOY Point change	5.94	6.31	4.74	(0.47)	(2.05)	0.12	(0.93)

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

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 8,739	$ 4,025	$ 2,367	$ 5,620	$ 937	$ 5,265	$ 8,838
YOY Pct. Change	16.7%	2.3%	1.5%	13.5%	11.7%	13.8%	11.9%
Revenue Units	4,995	2,320	1,331	3,492	918	3,729	4,706
YOY Pct. Change	-1.8%	-0.6%	0.2%	-2.5%	0.1%	-2.2%	-1.3%
Avg RPU change	18.8%	1.6%	2.1%	16.7%	12.2%	16.4%	13.4%
Mdse Carload revs (2)	$ 3,951	$ 2,686	$ 1,332	$ 3,181	$ 731	$ 2,810	$ 5,156
YOY Pct. Change	20.6%	-2.5%	-3.0%	9.6%	13.1%	-3.8%	11.6%
MGTM	531,878	171,614	122,258	229,800	24,273	185,000	514,373
YOY Pct. Change	-3.2%	0.9%	0.2%	-1.0%	3.6%	-0.6%	-0.2%
Pct carload	45.2%	66.7%	56.3%	56.6%	78.1%	53.4%	58.3%
Pct Intermodal	30.7%	18.5%	29.0%	13.0%	8.1%	19.3%	16.7%
Pct Coal	21.2%	5.1%	13.5%	28.2%	10.2%	27.3%	20.1%
Mdse Carloads (000)	1,453	1,468	577	1,514	525	1,350	1,956
YOY Pct. Change	4.3%	-3.1%	-3.0%	-5.7%	2.1%	-3.8%	-1.4%
Rev/CL x coal, IM	$ 2,719	$ 1,830	$ 2,308	$ 2,101	$ 1,394	$ 2,081	$ 2,636
YOY Pct. Change	15.7%	0.6%	2.6%	16.2%	10.8%	14.7%	13.1%
Operating Expense	$ 7,150	$ 2,795	$ 1,918	$ 4,277	$ 749	$ 3,888	$ 7,119
YOY Pct. Change	20.1%	9.1%	6.9%	10.9%	9.7%	14.1%	11.4%
RR Operating Income	$ 1,589	$ 1,230	$ 449	$ 1,343	$ 188	$ 1,377	$ 1,719
YOY Pct. Change	3.5%	-10.3%	-16.3%	22.4%	20.9%	13.1%	14.1%
RR Operating Ratio	81.8%	69.4%	81.0%	76.1%	79.9%	73.8%	80.5%

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
Source: company financials
Week in Review for August 1, 2008