THE RAILROAD WEEK IN REVIEW

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“As the prior year comparables become more difficult in the second half of 2010, operating leverage should be a function of the type of traffic returning and where that traffic falls on the network.” Cherilyn Radbourne, TD Newcrest

As we start the second half of 2010, we have to ask ourselves how much of the first half’s revenue-unit gains are sustainable. Says Radbourne, “Key topics of discussion on the Q2/10 conference calls will likely include: 1) volume visibility for the second half of the year; 2) pricing trends, which should have improved versus Q1/10; 3) operating leverage, in particular the extent to which railroads still have capacity to add incremental volume to existing train starts; and 4) the probability that U.S. rail legislation resurfaces prior to the August recess. We expect earnings estimate revisions to remain positive, but more modest this quarter.

“The Big Five Public Class I railroads achieved strong operating leverage in Q1/10, with RTMs up as much as 17 percent year-over-year and operating costs per GTM down as much as 10 percent for the period. As the prior year comps become more difficult in 2010’s second half, operating leverage should be a function of the type of traffic returning (i.e., bulk, merchandise, or intermodal) and where that traffic falls on the network.” In other words, the rails have been very selective in taking on new O-D commodity pairs and where margins are wanting the rails are less apt to accede. Not everything works as it used to when margins were less tightly controlled.

The 90-percent economy thread posited here last week has sparked some helpful comment. A fellow railroad watcher (who BTW has been watching the rails as long as I have but who also has had a highly successful career actually drawing railroad paychecks) picks up the idea thus: “Roy: you nailed it. Something very profound is going on and we ain't going to back to where it was. Your 90-percent image is, unfortunately, probably right on. I have hypothesized that we have really been in a 90-percent economy for a long time, just disguised by the housing bubble.

“If you consider that we got unemployment down to five or six percent by building millions of houses that no one could pay for, might not we conclude that our unemployment rate for the past decade might just have been 10 percent all along? The trough right now actually might have been the norm except for the noise that was made from this housing boom.

“What you see is what you get. I am sticking with the very shallow "U" prognosis that you and I have discussed before. Think of just treading water for year after year while the guy next to you disappears. The railroads will do OK, but I wonder about the rest of the country. Political tensions will be intense after a few more years of this [uncertainty] -- which I now see as a likely scenario. The problem is that no one really knows what to do; government credit cards are maxed out and economists are really out of ideas, me included.

“I really think that technology is accelerating and wiping out lots and lots of jobs. Consider the railroads; all of those automated line-side monitors have eliminated lots of jobs, ditto for belt

packs. And the ability to run really big trains (we are talking two miles long here, folks) means that we will need less T&E folks. With a significant shift now underway to IM, there go a lot of over-the-road truck drivers -- folks with a skill that, like day-labor construction, does not require an advanced degree. I just rode an intermodal train for nearly 1,000 miles and mostly, I saw very few people. And our train was carrying about 300 domestic boxes. So three hundred over the road drivers get replaced with eight folks (four crew districts times two).

"There's also a broader issue to be pondered here. I picked an iPad last week and am blown away. Significance; I will not by buying hard copy books anymore and I suspect I will get the WSJ on line, etc. Nibble, nibble, nibble -- but the internet does deliver a lot of things with a minimum of physical assets and people.

"And note where auto sales have stalled. We have built cars so well that they actually can last and last. Perhaps we had a society based on waste-McMansions and cars that fail -- and by doing things smarter and better we will need fewer people to run things. Is the new economic model based on college grads serving retirees at upscale bars or providing end-of-life care at the hospital? That, from observation, seems to be the evolving model. None of this is based on any analysis but hey, Greenspan and Bernanke did analysis and missed everything. Maybe a forecast based on looking out the window and to see if it's raining makes more sense.

"Happily, the railroads have learned to live with lower traffic volumes. Unhappily, the rest of the country has lived on the hype of housing and using their houses as ATMs. One estimate I saw said that those two factors alone contributed $1 trillion to the GDP back in 2007. So, without that stuff, we would have had a 9-10 percent unemployment rate back then.

"But I do not see a doomsday scenario. Far from it -- we will still need stuff, just a little less of it. Hopes to throttle coal will die with a less than robust economy. Remain with my thesis that over the long term, a society that has been wedded to convenience is going to have to make some adjustments toward economic efficiency. Wanting windmills is not the same as paying for them. Does anybody in DC have a clue about what is going on or how to deal with it?"

If the carload sector -- industrial products, mainly - is any indication, probably not. As Cherilyn Radbourne notes above, "Operating leverage should be a function of the type of traffic returning and where that traffic falls on the network." In other words, the more it looks like a batch process the better. That ten percent housing over-reach added a lot of carloads; take them away and see where it gets you.

Short lines are particularly at risk -- especially the smaller, independent properties. New federal mandates from hours of service to bridge inspection to PTC come close to forcing marginal lines to increase staffing levels. Yet, a page from Dennis Gartman's Tuesday note says accurately, "For any small business that is on the verge of employing more than 25 people -- the level of employees that triggers a huge increase in government oversight and new, expensive mandates -- the propensity to expand to 26 employees becomes close to nil.

"Rather than face these new, expensive mandates businesses logically chose to stand steady and not expand. Or at best chose to work their current employees just a bit harder and for just a few

more hours. Now, they are choosing to work their employees fewer hours and are prone to cutting wages." As a result, that new business development that wants rail may not get it and instead of taking more trucks from the highways the rails become complicit in adding more trucks to the highways.

Don Phillips, *Trains* columnist and good friend of many years, writes, "Most of you probably have heard Homeland Security Secretary Janet Napolitano's announcement that Amtrak is joining her department in an effort she called "See something, say something." Among most of us, the first reaction was NOT "Oh boy, now we're safe." It was more like "OK, what's she trying to do to us now?" I have received many e-mails asking some version of that question.

"Napolitano, and in fact most of the government, seem to think that as train riders, our greatest fear is that we'll be attacked by terrorists as we relax and look out the window at the passing scenery. This is quite similar to what the government has done to those who use U.S. airports.

"Sorry, Ms. Napolitano, but a very large number of train riders have greater fears. The least of these fears is: Will we be put through the nastiness of airline-style "security"? The extreme fear is: Will we be placed on watch lists that may drag us away just as we are ready to board our trains? (Don't chuckle. That has happened to innocents on airplanes. And such a list, which has failed terribly in aviation, is part of the new plan.) " Thanks, Don.

There is a perception in some circles (this one included) that Class II and III railroad revenue units are not recovering their numbers as fast as the Class Is. The Week 26 reports are now starting to come in and at first view that perception appears to have some merit. RMI's RailConnect Index shows total revenue units up 8.8 percent through Week 26 (July 2). Notes from RW Baird and TD Newcrest have graphs that show large -- albeit shrinking -- gaps in total industry unit numbers Jan-June and NS Jan-June (I pick on NS because their annual shortline meeting starts Sunday in Roanoke) when you put the first-half 2010 curve against 2008's.

JP Morgan's note says total year-to-date North American Class I revenue units increased 11.4 percent through Week 26, some 260 basis points better than the short lines. Drilling down to key commodities, Class I coal was up 0.7 percent to the smaller roads' down 15.0 percent. Class I chems were up 15.5 percent to the short lines' 5.9 percent. Could it be the 90-percent economy is hitting the Class IIs and IIIs hardest? Stay tuned.

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