

Transportation Research**John Larkin, CFA****jglarkin@stifel.com****(443) 224-1315****David Ross, CFA****dross@stifel.com****(443) 224-1316****Michael Baudendistel****mbauden@stifel.com****(443) 224-1357****Daniel Kallaugher****kallaugherd@stifel.com****(443) 224-1356**

The following is an edited transcription of the August 6, 2009 conference call hosted by Stifel Nicolaus featuring two guest speakers: Bill Rennie and Jeffrey Elliott. The call featured a detailed discussion of Railroad industry dynamics in the “new normal” environment. Included in the discussion was commentary on the extent to which railroads have been able to reduce cost structures amid unprecedented volume declines, and how sustainable these cost takeouts are, along with an update on the regulatory environment in the Rail industry. We have attempted to recreate the experience of listening to the call live in the ensuing pages, having placed the relevant slides referred to by the speakers throughout the document. Stifel Nicolaus expresses no opinion on, and is not responsible for, the views expressed in this transcript by participants who are not Stifel Nicolaus employees.

John Larkin:

We’re very pleased to have with us today two special guests - Bill Rennie and Jeff Elliott, both of Oliver Wyman - to lead a discussion of the impact on operating performance of Class I Railroad variable cost and productivity trends. Both of our guest speakers are very senior, well respected, railroad-oriented consultants that have been in the business a long time.

Our first speaker, Bill Rennie, is a partner in Oliver Wyman’s manufacturing, transportation, and energy unit; which specializes in transportation transactions, strategic planning management and marketing economics and operations, and is based in the Boston area. Bill has particular expertise in restructuring and organizational redesign to improve financial and operating performance in surface transportation organizations. His career has spanned four decades, including senior management and operating positions at Railways and Motor Carriers. Before joining Oliver Wyman, Bill held various senior positions at the Boston & Maine Railroad. He’s a member of the Transportation Research Forum and the Council of Supply Chain Management professionals

Our second speaker, Jeff Elliott, is also a partner in the manufacturing, transportation, and energy unit at Oliver Wyman and is based in New York. Jeff has over 25 years of experience working in the transportation industry and in transportation and logistics consulting, with a focus on corporate planning and strategy, business design, transaction support, marketing and sales strategy and operations and maintenance performance improvement. Prior to joining Oliver Wyman, Jeff was a principle with a consulting firm A.T. Kearney, which also has a very fine transportation practice. Jeff also served in executive positions in transportation and marketing with Consolidated Rail

All relevant disclosures and certifications appear on page 26 of this report.

Corp. with a focus on turning around underperforming business units. As most of you know, Con Rail was more or less bifurcated - half given to CSX and half to Norfolk Southern.

So with that as an introduction let me turn it over to Bill and Jeff.

Bill Rennie

Good morning and thank you John for the introduction. We think this is quite an interesting topic, and one that has many, many moving parts. What we've tried to do this morning is to provide some background and insights into some representative actions we think the railroads have taken, not just currently but over a prolonged period of time, to put them in the very strong position that they are in now.

Exhibit 1 is to give you a sense of what we will be discussing today. We're going to start off by just briefly looking at the breadth and depth of the current business downturn; it's the most severe that the railroads have faced since World War II. Interestingly enough, while the downturn is the worst, the industry's performance during the downturn is probably the best in any kind of recorded history, even going back to the period before World War II. The railroads have appeared to be much more nimble than some other industries in responding to the downturn, they have cut operating costs greatly to match revenue declines and have even introduced some productivity improvements during this downturn. Additionally, the railroads have been able to keep up with many of the capital

Exhibit 1: Executive Summary

- At the end of 2008, the US economy entered the most severe downturn since World War II:
 - Exacerbating a three year freight recession
 - Leading to declines in US Class I rail traffic that exceeded even the most pessimistic analysts' expectations
- Railroads, however, have been more nimble than some other industries in responding to the downturn.
 - Have cut operating costs to largely match revenue and traffic declines
 - Most Class I's have been able maintain capex at levels close to projections made prior to the downturn.
- Part of the cost control story is the result of a long-term transformation (variabilization) of the railroad cost base:
 - Improved decision tools providing more precise planning of operations, resource requirements, capex, and performance parameters
 - Outsourcing of expenses and risks where it makes financial sense
 - Sharing infrastructure and resources to improve utilization and reduce investment costs
- Additionally, railroads have progressively expanded fuel surcharges across the traffic base since 2004-2005.
 - In response to rapid fuel price run-up and increasing fuel price volatility
 - Has allowed railroads to essentially hedge one of their largest expenditures, by flowing through a significant portion of recent fuel expense increases to customers
 - Counterweight is that the carriers must “give back” the surcharge when fuel costs decline, as they have generally since Fall 2008.
- These structural changes to the industry are based on the application of best practices and rational financial management to meet the requirements of industry investors – and therefore are sustainable.
- The regulatory environment continues to be uncertain and may impact carriers' progress:
 - Recent UP SAC case continues string of recent railroad losses in the West (a precedent?)
 - Negotiations on potential reregulation and STB authority continue (antitrust, Rockefeller bill, TRACS re-introduction)
 - Hours of service changes

expenditure projections and programs that they had put in place prior to the downturn, even though traffic is so depressed.

One of the important points is to recognize that the actions that are benefiting the railroads today are not specifically a reaction to the downturn, but rather part of a much longer term transformation of the railroad cost base that Jeff and I have had experience with since the beginning of the Staggers Act. We will talk about the parts of this transformation that have come from improved decision tools, outsourcing of certain expenses and risks - where it made financial sense, and the sharing of infrastructure and resources to improve utilization.

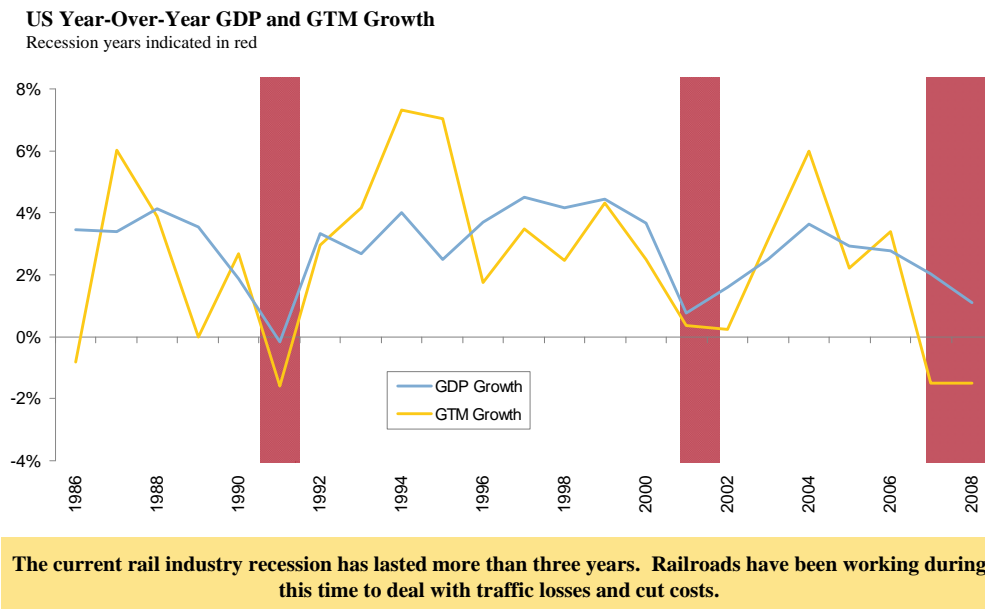
Additionally, Jeff will talk more about how the railroads have, through the use of fuel surcharges, been able to match cost increases in fuel very closely to the increase in expenses and how that has worked over time.

Finally, we will finish up with a brief update on some material we provided about five months ago on our last Stifel Nicolaus conference call on the state of the railroad regulatory environment.

Exhibit 2 illustrates, going back to 1986, where there have been downturns in the past and shows just how severe this downturn has been, based on gross ton miles measured. Many industries said the effect in this downturn is far, far greater than anything that has happened in the past.

Exhibit 2: The most severe US economic downturn in recent history

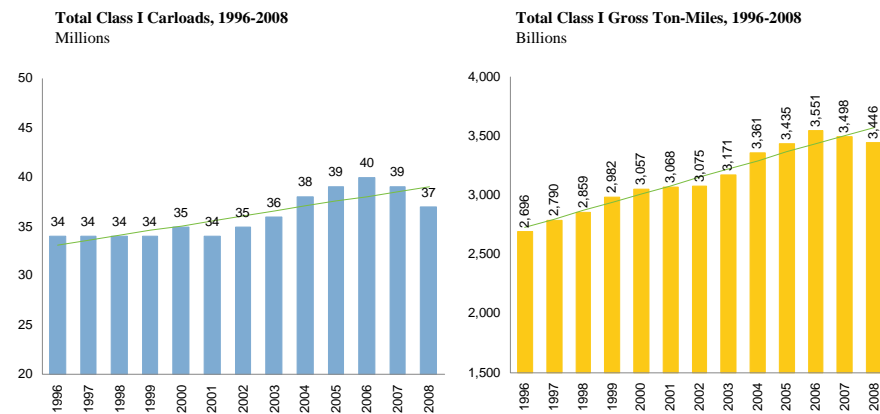
An absence of other severe US recessions post-deregulation provides little insight into how railroad performance reacts to large economic swings.



Source: Congressional Budget Office; AAR Analysis of Class I Railroads, 1996-2007; 2008 R-1's; Bureau of Economic Analysis.

Exhibit 3: Impact of customer demand

Prior to the recession, customer demand for rail services had created capacity shortages on North America’s network and increased capex required to meet demand.



Source: AAR Analysis of Class I Railroads, R-1s, Oliver Wyman analysis.

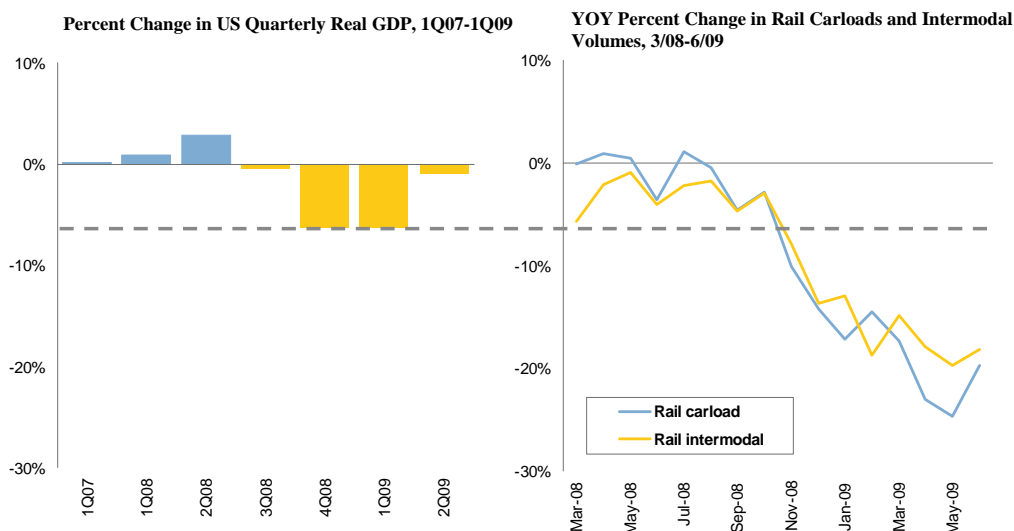
Exhibit 3 shows how this downturn occurred in a time when the railroad industry really had very strong traffic levels (in 2005, 2006, and 2007). The railroads were riding a wave of increased traffic (which came hand in hand with some congestion issues), so they were beginning to build up networks and increase CAPEX to meet this

increasing demand. So, prior to this downturn, the cost structure that was in place wasn’t geared to handle a much greater level of traffic. Given this fact, some of the rapid responses and improvements that we have witnessed many of the rails complete are even more impressive, when you consider that they were coming off a period of very high performance.

Exhibit 4 is meant to illustrate how the year-over-year decline in carloads and intermodal volumes is actually far greater than the downturn in the economy itself, and this occurs for many reasons, of which we’ll touch upon a few. The high correlation of gross ton miles and revenue ton miles to GDP and industrial production that has essentially been the underpinning of railroad forecasting and demand activity really fell apart in this environment.

Exhibit 4: A deeper recession than analysts anticipated for railroads

Rail traffic declines are outpacing economic deterioration, although both seem to have recently bottomed out.



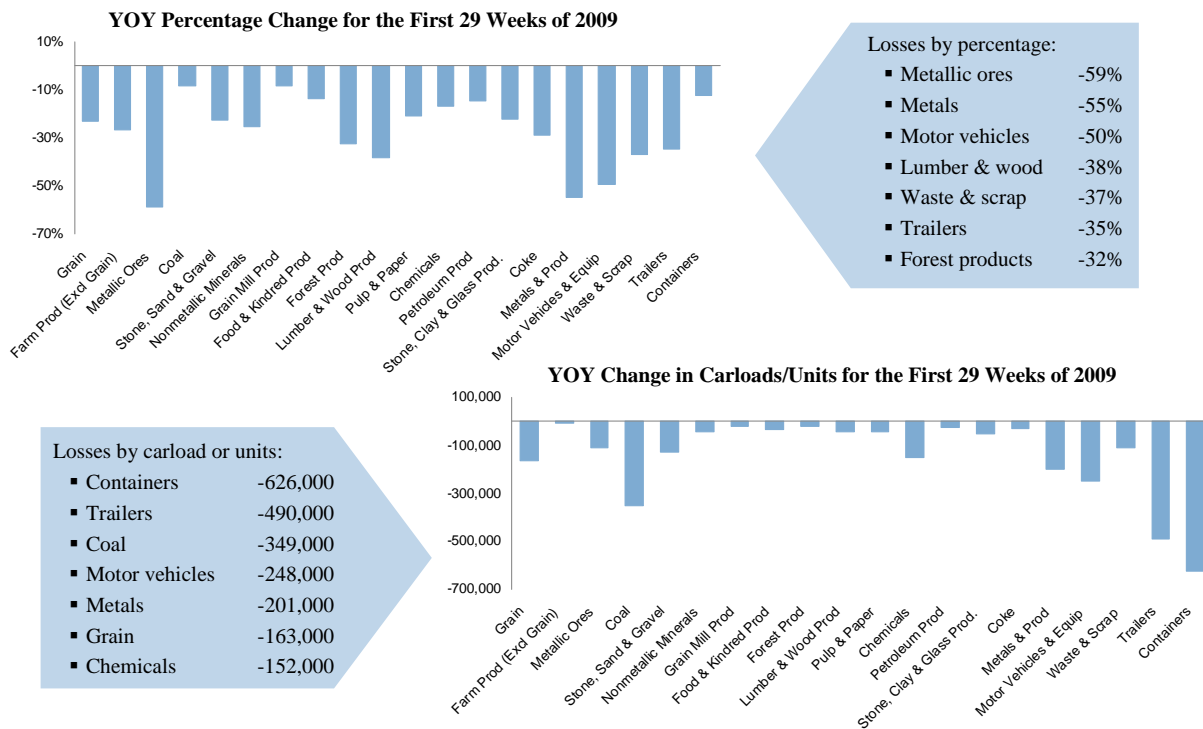
Source: US BEA; US BTS; US DOT; EIA; “GDP Fell at a 1% Annualized Rate in Second Quarter,” July 31, 2009, WSJ News Alert; AAR Weekly Rail Traffic and Carloading Report.

You can see a clear departure from that correlation, one that has not been experienced before, with the railroad activity falling much more than GDP.

Exhibit 5 shows which commodities have been the drivers of this downturn. Metallic ores fell off considerably, particularly when some of the Asian producers backed off in purchasing export ore and when the domestic producers drew down their operations. Metal products have fallen off drastically and motor vehicles have been very well publicized for their declines in this downturn. Lastly, forest products and anything related to the building industry has fallen off significantly.

Exhibit 5: Drop off in volumes across all commodities

Commodities show varying levels of sensitivity to economic conditions.



Source: AAR Weekly Railroad Traffic, week ending July 25, 2009. Cumulative change over first 29 weeks in 2009 versus first 29 weeks in 2008.

Exhibit 6 is really quite interesting. In the face of this kind of unprecedented downturn, if you look at the lower two rows, we have really seen some pretty spectacular performances. You could argue that many railroads would have been celebrating if they achieved these same performances during an upturn, let alone in this drastic downturn. Operating ratios improved pretty much across the board (Norfolk Southern has some special circumstances which Jeff will talk about later on), showing very strong operating ratios and performance during a time of unprecedented downturn and revenue loss.

Exhibit 6: Rail financials: Robust cost control in the face of historic traffic declines

Despite declining traffic and revenues, operating ratios for the most part have improved, indicating Class I railroads’ success in aggressively controlling expenses and variabilizing the cost base.

Class I Railroad Financial Metrics: Year-Over-Year Percent Change, 2Q2008 vs. 2Q2009

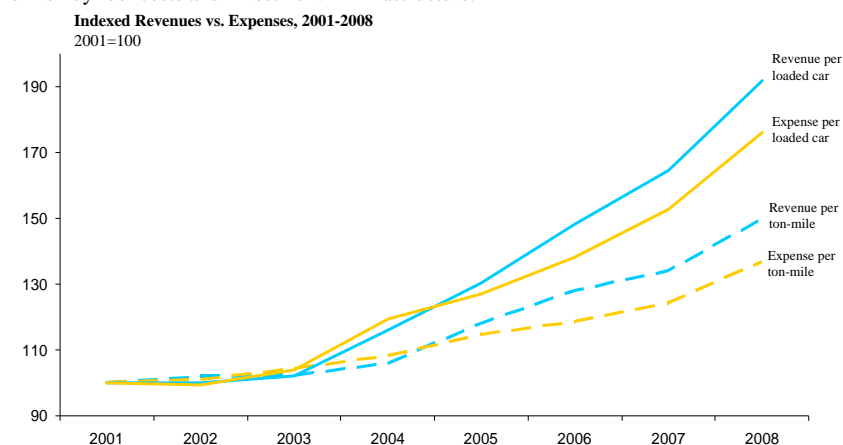
	BNSF	UP	CSX	NS	CN	CP	Average
Freight revenue (millions)	-26.0%	-28.2%	-24.8%	-32.8%	-26.4%	-30.3%	-28.1%
Operating income (millions)	-11.8%	-19.3%	-18.8%	-41.4%	-28.5%	-100.0%	-36.7%
EPS (diluted)	-11.9%	-23.5%	-22.6%	-44.1%	-27.2%	-49.5%	-29.8%
Carloads (thousands)	-18.7%	-21.9%	-20.5%	-25.7%	-21.9%	-17.4%	-21.0%
Freight revenue/car	-9.1%	-8.1%	-5.4%	-9.6%	-5.8%	-15.6%	-8.9%
Revenue ton-miles (millions)	-12.6%	-19.7%	-19.0%	-28.0%	-16.0%	-21.4%	-19.4%
Employees	-8.9%	-10.2%	-9.7%	-7.2%	-4.9%	-6.6%	-7.9%
RTM/employee	-4.0%	-10.5%	-10.3%	-22.4%	-11.7%	-15.9%	-12.5%
Operating ratio 2Q08	79.2%	79.6%	75.3%	71.1%	66.3%	79.4%	75.2%
Operating ratio 2Q09	75.2%	77.3%	73.4%	74.8%	67.3%	77.9%	74.3%
Change	-4.0	-2.3	-1.9	3.7	1.0	-1.5	-0.8

Source: Stifel Nicolaus

Exhibit 7 begins to show some of the longer term trends. This really gets back to the fact that a lot of the improvements we are witnessing are not just a recent transformation, but rather strategy that has been going on for at least the past decade. If you look at the blue and yellow lines you can see that while revenue per ton mile has increased, expense per ton mile also has increased but at a much slower rate.

Exhibit 7: Railroad revenues outpacing expenses

Revenue increases required to fund the new capex levels have been achieved by raising base revenues, legacy contract conversions, and expansion of fuel surcharges. Expenses have been driven by fuel costs and investment in infrastructure.

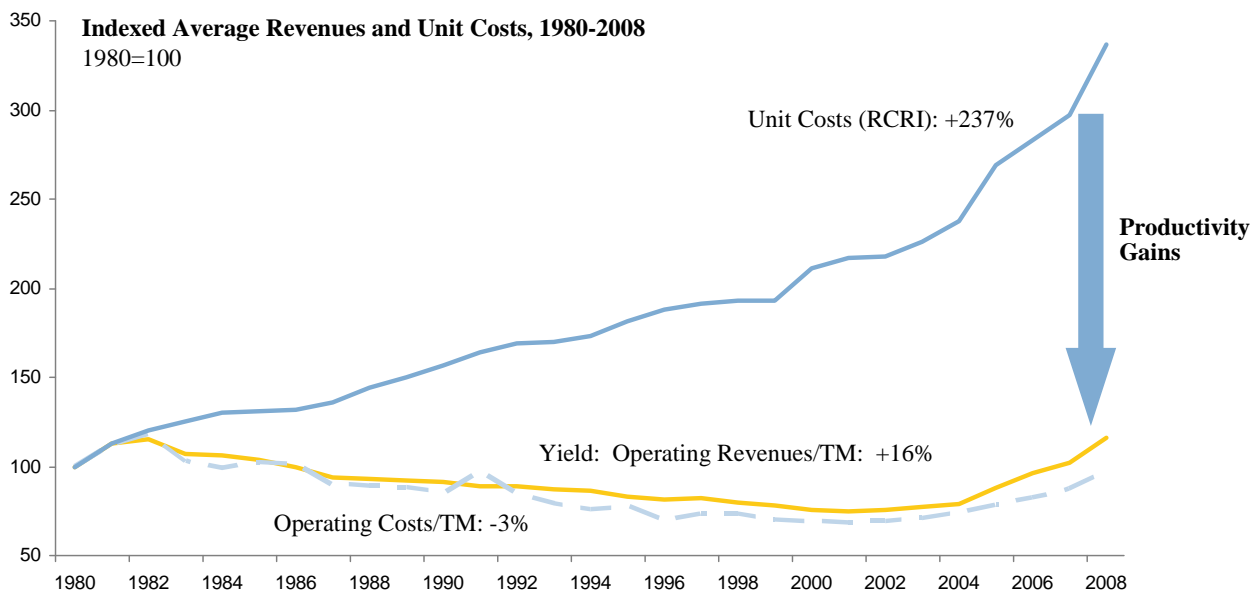


Source: AAR Analysis of Class I Railroads, R-1s, Oliver Wyman analysis.

One of the most telling bits of analysis that we update every quarter and have been watching for the last 25 years is what we show in **Exhibit 8**. This is really a phenomenal tribute to the industry, because since 1980 the unit costs - this is the inflation of anything that the railroads buy - increased 237%. That is not the cost per unit, but the inflation of the individual units that the railroads purchased. During this same period, the railroads were actually able to take operating costs down by 3%, and increase operating revenues by 16%. This chart and this relationship

Exhibit 8: Rail performance drivers

Management of variable costs and productivity have driven rail performance improvement for nearly three decades and helped to mitigate the impacts of the downturn.



Competition between carriers is real, as most productivity and cost benefits are passed to customers.

Source: AAR Analysis of Class I Railroads, Oliver Wyman analysis.

really capture the whole underpinning of why railroads' performance has been the way it has since the Staggers Act. The rails have made very, very substantial productivity changes. While the cost per unit, based on inflation, has gone up considerably, the number of units of input the rails required to produce the transportation services and products that they offer has fallen substantially. Whether it be labor or the amount of locomotives that the rails are using per ton mile, we have seen very strong and consistent performance over a longer period of time that has put the rails in a very strong position to further manage things tightly as we entered into this downturn.

Our experience with the railroads is that they don't necessarily measure variable cost, or have variable costs analytical projects going on. In the current economy, there is more of a focus on managerial costs. **Exhibit 9** is our attempts to show at least one good example of what an approach to variable costing looks like, in order to give some sense of the variability that might be in the cost. The Surface Transportation Board (STB) has a uniform costing system, called URCS - the uniform rail costing system, and out of that costing system they produce levels of variability over periods of time. It's not important as to which railroad this was, or exactly what year, but you can see what four years worth of variability looks like. For example, transportation fuel is considered to be 93% variable, car load expenses 90%, and down to the bottom with freight car repair overhead expenses at 30%. This picture is much more interesting if you consider that the variability is much higher today than it was if you went back some 10, 15, or 20 years. The railroads have been able to basically build a cost structure that can be flexed very quickly and very much in line with traffic flows.

Exhibit 9: Impact of cost variability

Converting the cost structure to a high percentage of variable costs is providing the railroads with a level of cost flexibility not available in past downturns.

Sample of URCS Data for an Eastern Class I Railroad
Variable cost percentage by category

Illustrative

Expense Category	1 Year	2 Year	3 Year	4 Year
Transportation Fuel Expense	93.1	93.3	93.3	93.2
Carload-Related Expenses	90.2	90.2	90.3	90.4
Switching Maintenance and Overhead	90.0	90.5	90.4	90.1
Switching Crew Wages	87.8	88.4	88.9	89.0
Yard Locomotive Repairs	82.2	83.1	83.7	83.9
Running Crew Wages	79.7	80.5	80.7	80.5
General & Administrative Expenses	78.3	78.6	78.8	78.7
Transportation Overhead Expense	76.6	77.5	77.7	77.4
Yard Operations	65.1	66.4	67.5	67.8
Running Track Maintenance	63.4	63.8	64.1	64.0
Road Locomotive, Service, Repairs & Overhead	62.1	63.0	63.0	62.6
Road Train Inspection	62.1	63.0	63.0	62.6
Wreck Clearing Expenses	53.7	54.9	55.2	54.9
Track Maintenance Overhead	48.5	49.0	49.3	49.2
Freight Car Repair Overhead Expenses	29.6	30.3	30.7	30.7

Source: Surface Transportation Board, Uniform Rail Costing System (URCS).

Note: Variable cost data developed on a bottom-up basis from the detailed analysis of railroad cost accounts and expense variability calculated through multi-period regressions.

through each of the nine cost control areas outlined in Exhibit 10. We will start with focused infrastructure spending, then we will look at operating plan redesign, and we will finish up with some of the more creative uses of public funding.

One of the very important practices of the railroads, which has pretty much changed in the last ten years, is their ability to spend more of their money and deploy their infrastructure funds in, what I would call, more organized, highly efficient programs. For example, on a railroad you can change a cross tie out in a production gang where you’re putting anywhere from 1,000 to 2,000 ties a day into a line with a mechanized operation, and your cost of tie insertion might be in the \$50 range. Most times railroads handle that kind of an event under road CAPEX. Alternately, one can change those cross ties out one or two at a time (when they fail) with a roving control gang, and it’s probably going to cost \$95 to \$125 to do so.

So, the growth of the orange colored bar (or road CAPEX) on Ex-

Again, this is probably not something you’d see pinned up on the walls of any railroad managers or individuals who work in the regulatory process and deal with regulatory costing, but it is something that gives a consistent year-to-year view of how variable costs are.

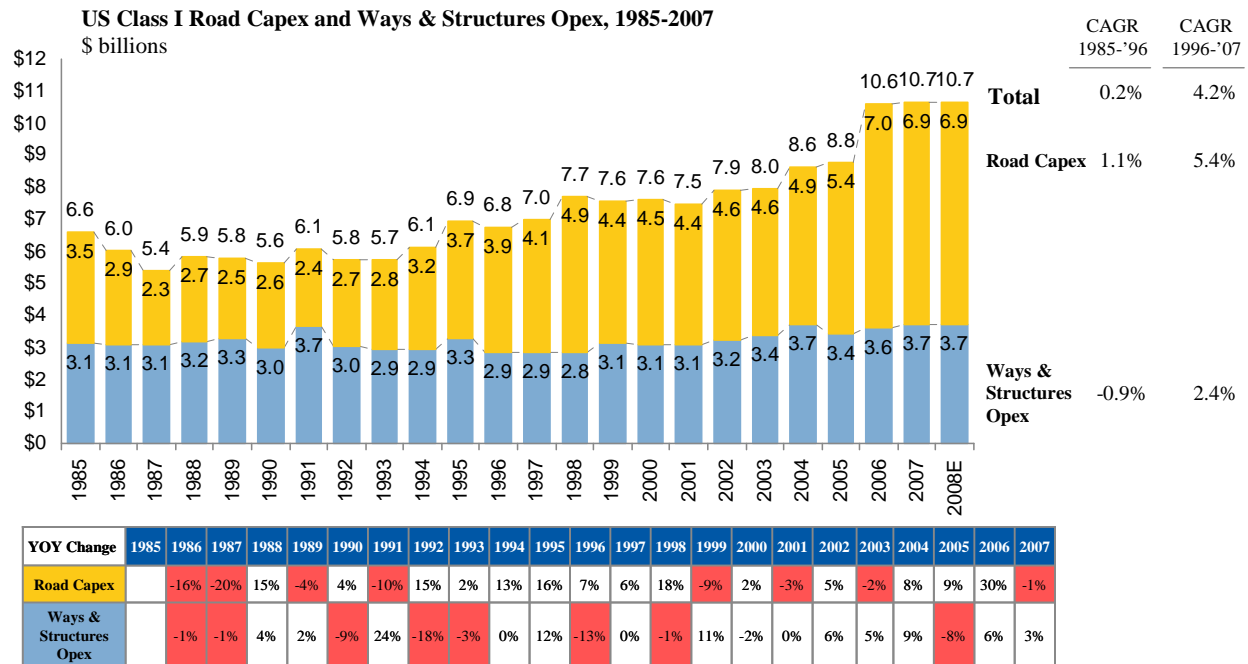
As I said earlier, there are many different reasons why railroad performance has improved. We have tried to pick some key areas that represent where the railroads have been able to lower costs. As you can see in Exhibit 10, there are areas that we consider to be larger and have more of an impact to costs, such as operating plans redesign, and there are areas that we consider to be slightly smaller, such as the outsourcing of weed and brush control, so this gives you a sense of the breadth of these cost cutting programs. We will now go

Exhibit 10: Railroads have been able to lower costs in many key areas:

- Focused infrastructure spending
- Lower unit costs
- Operating plan redesign
- Improved velocity & asset utilization
- Increased employee productivity
- Outsourcing
- Cost sharing
- Fuel cost management
- Use of public funding

Source: Oliver Wyman

Exhibit 11: Infrastructure spending: Class I's invested heavily in infrastructure during and after the boom years. These investments are providing a foundation for efficient operations during the downturn.



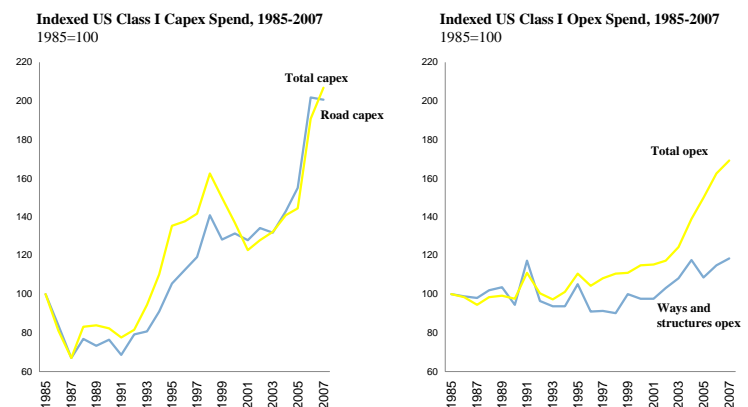
Source: R-1 Reports filed with the STB and Oliver Wyman analysis.

Note: Operating expenses exclude depreciation. A portion of fringe benefits are included in opex. US Class I dataset includes five US Class I railroads and US operations for two Canadian railroads.

Exhibit 11 is partly to do with expansion for capacity, but a good deal of it is related to, what I would call, more program structured, organized infrastructure spending. It's quite important to note that the percentage growth of road CAPEX during the illustrated period was a much higher percentage than the way and structure growth. If you look at Exhibit 12 you can also see some of the same effects. Road CAPEX, which is the spending on infrastructure, tracked very closely to total CAPEX. If you look over on the right hand side, however, way and structure operating expense has witnessed much slower growth trajectory than total operating expenses. This enables railroads to

drive down the day to day costs of operating and maintaining the infrastructure. So, when there is an economic downturn and traffic falls off, the rails can still keep up a lot of the very efficient program work and at the same time are able to shed costs, because they are more variable. These are more variable because way and structure operating expenses are related to the adjustments and realignments that rails have to do to their infrastructure, and they are often based on the wear

Exhibit 12: Infrastructure spending: Well placed road-related CapEx has supported carrier reductions in infrastructure OpEx



Source: R-1 Reports filed with the STB and Oliver Wyman analysis.

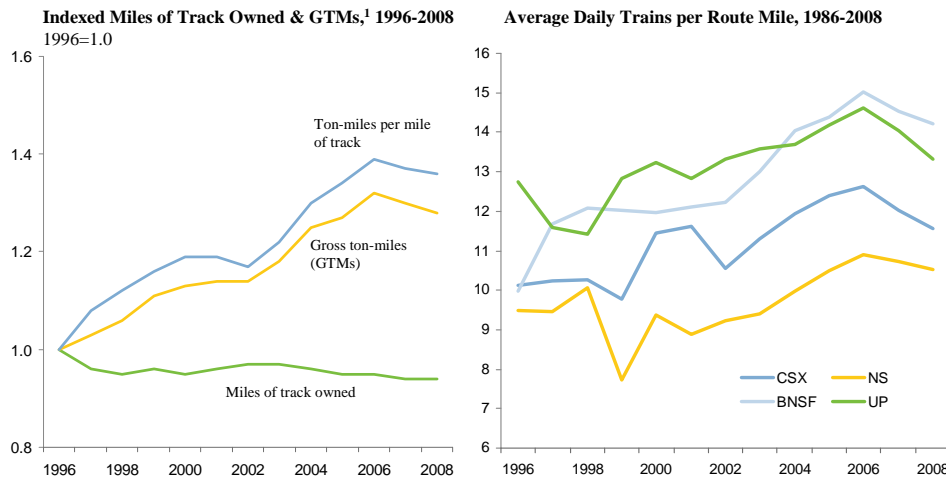
Note: US Class I dataset includes five US Class I railroads and US operations for two Canadian railroads.

and tear of the traffic base. This phenomenon is one that didn't even exist four or five

years ago, so it has given a great lever to the railroads to continue to build strong infrastructure, yet simultaneously flex the very inefficient routine maintenance and adjustments that they do on the day to day basis.

The other important point is that as traffic has picked up, and even though we’re currently seeing a very strong fall off in traffic, the volumes are still quite high compared to the mid-nineties. If you look on **Exhibit 13**, we show

Exhibit 13: Lower unit costs: Class I railroads have succeeded in improving asset utilization and driving greater traffic density. The business model drives more “water through the pipe” at lower costs per unit.



High line density gave the carriers experience with managing high traffic volumes. The downturn has decreased density only to 2004 levels.

Source: R-1 reports: Schedule 775 lines 1 and 104; AAR Analysis of Class I Railroads; Oliver Wyman analysis. 1. US Class I dataset includes five US Class I railroads and US operations for two Canadian railroads.

that ton miles per track mile, which really peaked out in 2006/2007, are 20% to 40% higher than they were in 1996. And if you also look at the green line (miles of track owned), you can see that track miles have showed relatively consistent decline since 1996. What this does is allow the rails to leverage the value of their infrastructure in a far more efficient way. Once you’ve

got the track on the ground the wear and tear component of costs are relatively small, so driving more trains per mile (or driving more “water through the pipe”) really helps the rails to drive down the average cost per ton mile of the traffic that is spent on the line. I think the railroads’ ability to keep volumes high on a network that has been well structured has been a very important factor in driving down costs.

Exhibit 14 highlights what we believe is one of the most important developments that has occurred over the last 15 or so years in the railroad industry. Each day there is probably somewhere between 100,000 to 150,000 rail cars loaded on the railroads and, prior to the mid-nineties, most of the management (or planning) of the path or trip direction that each car would take was a manual calculation. Exhibit 14 lists some of the projects that Oliver Wyman was involved in, and as you can see,

Exhibit 14: Operating plan redesign: Over the past decade, railroads have implemented operating plans that are highly productive and designed to reduce operating costs and decrease transit time.

Oliver Wyman Operating Plan Projects

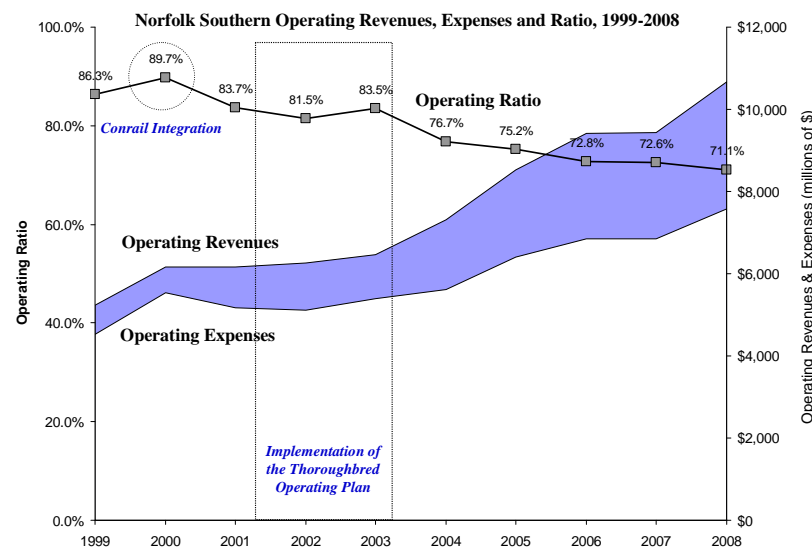
1995-96	UP/SP Operating Plan
1996-99	TFM Operating Plan
1996-99	Conrail Transaction
1998	CN/IC Operating Plan
1998	CN Operating Plan Redesign
1999	CP Genesis Operating Plan
2000	CN/BNSF Operating Plan
2001&05	BNSF Carload Operating Plan
2002-03	NS Thoroughbred Operating Plan
2004-05	CSX OnePlan
2005-06	UP Unified Plan
2006-07	SBB (Switzerland) Operating Plan
2007-08	Green Cargo (Sweden) Plan
2008-09	TFR (South Africa) Op. Plan
2009-10	KTZ (Kazakhstan) Operating Plan

The fundamental premise of the scheduled railroad is that by protecting the “plan” one can maximize asset utilization, network capacity, fluidity, and customer service – and ultimately reduce costs.

Source: Oliver Wyman

in the early nineties Union Pacific was trying to recover from service problems that it had as part of the SP integration, so the railroad began developing what I would consider to be state of the art technology, or computer based operating plans. This technology was then applied to TFM in 1996, the Con Rail in 1996, CN in 1998, and BNSF in the early 2000s. What this operating plan does is give the railroads a blueprint and a very structured and useful way of optimizing the traffic flows through the system every day. So, in a situation like the one we are faced with now, with the ebbs and flows of traffic, the railroads have an extremely important, highly powerful tool to make dynamic decisions surrounding operations (e.g. to re-route traffic to avoid accidents, congestion, etc.). I believe this has been greatly responsible for the performance improvements of the railroads.

Exhibit 15: Operating plan redesign example: Norfolk Southern
 NSC’s scheduled railroading philosophy enabled it to manage expenses while revenues were rising and even though the OR increased in 2Q, provided a solid set of practices to more effectively deal with the current severe traffic decline.







Source: United States Securities and Exchange Commission, Annual Report - Form 10-K, for the Norfolk Southern Corporation for 2002-2008.

If you look at **Exhibit 15**, which just looks at Norfolk Southern, there are many other reasons why the company’s operating ratio came down. Certainly, the railroad’s introduction of what they call the thoroughbred operating plan (their version of this operating plan) between mid-2001 and 2003 started a process of discipline and control of the traffic flows which not only affects transportation, but affects locomotive utilization, mechanical activities with rail cars, and even the infrastructure. It was really part of a core change in the railroad’s performance that led to an improved overall operating ratio over the years.

Some years ago Union Pacific did some work to determine what the value of the better performance that resulted from these operating plans was, and you can see their estimate on **Exhibit 16**. For every one mile per hour improvement in train speed, a railroad can reduce its locomotives by 250, its freight cars by 5,000, and its train and engine employees by 150. Every one hour improvement in car terminal dwell is worth 2,500 freight cars, every day you can take out of your car cycle is worth 25,000 freight cars, and every one hour improvement in locomotive terminal dwell is worth 125 locomotives. So, you can see that even though this was done some years ago, small improvements can go a long way for the railroads.

Exhibit 16: Improved utilization: Increases in network productivity and velocity, as well as reduced congestion, dramatically improve the utilization of carrier personnel and assets. For example, UP calculations suggest:

Reduction (Improvement) of:	Yields:	Illustrative
▪ 1 mph in train speed →	▪ 250 locomotives ▪ 5,000 freight cars ▪ 150 TEY employees	
▪ 1 hour car terminal dwell →	▪ 2,500 freight cars	
▪ 1 day of car cycle →	▪ 25,000 freight cars	
▪ 1 hour of locomotive dwell →	▪ 125 locomotives	

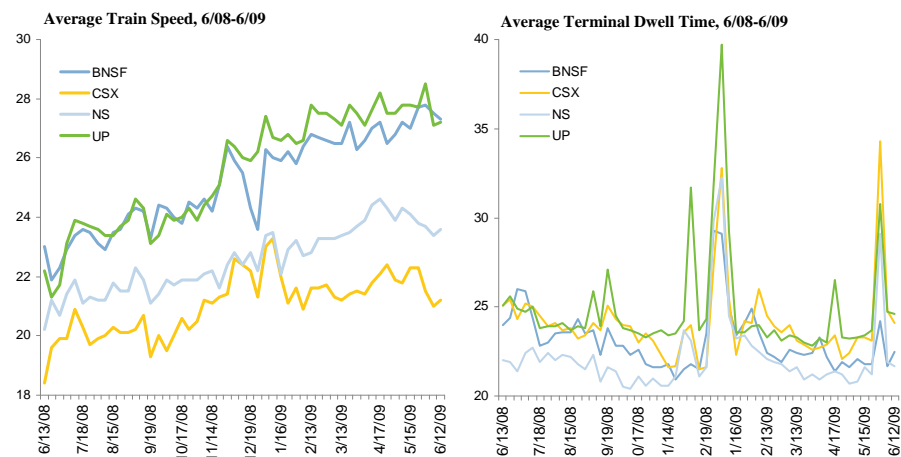
Source: Oliver Wyman, Union Pacific Corp.

Another phenomenon that I’ll comment on is the continuous improvement in velocity in the railroad system, seen in **Exhibit 17**. Since the railroad infrastructure was designed for rapidly growing capacity, when the traffic volumes fell off so rapidly in this recent downturn, the railroads decided to keep up spending to keep the network moving at a higher velocity rather than slowdown spending for infrastructure improvements. Operating at a higher velocity has many benefits. Looking back Exhibit 16, we

can see that higher velocity allows you to have fewer locomotives. Additionally, if you reduce the number of rail cars that are required then you take out the cost of those rail cars. So, for every 1% or 2% increase in overall average train speed you’re able to take thousands of rail cars out of the system and also reduce the various expenses that are associated with those

leases. If this were 15 to 20 years ago you could say, “well that’s a great thing but that means the railroads are going to be storing thousands and thousands of more cars.” However, one of the things the railroads have done is outsourced, or shed, a lot of the rail car ownerships, so when they run the system faster it’s the shippers and the leasing companies that wind up holding the bag on those cars.

Exhibit 17: Improved utilization: During the economic downturn, railroads increased velocity and reduced dwell time, allowing them to significantly reduce variable operating cost.



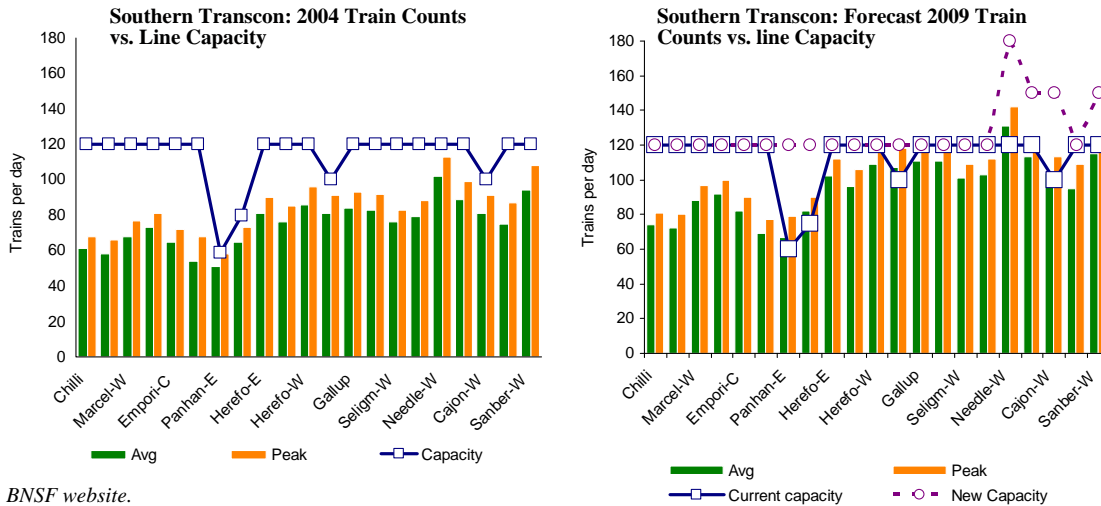
Reduced traffic and improved operating performance has allowed railroads to reduce assets and improve financial performance.

Source: AAR.

The one last area that I’ll comment on is network planning. **Exhibit 18** is public information that came out of a BNSF presentation relating to how they planned line capacity changes, and this happens to be their transcontinental line that runs from Los Angeles. The ability to manage the whole resource allocation and capital allocation process, along with operating plan sophistication, has really improved based on a whole series of engineering, op-

Exhibit 18: Improved utilization: Well tested resource planning tools carefully focus carrier infrastructure spending in ways that contribute to increased velocity and efficiency and reduce operating cost.

- Improved planning tools allow railroads to progressively add and remove assets, even during a downturn.
- “Rifle shot” capacity improvement projects are contributing to ongoing efficiency during the traffic downturn.



Source: BNSF website.

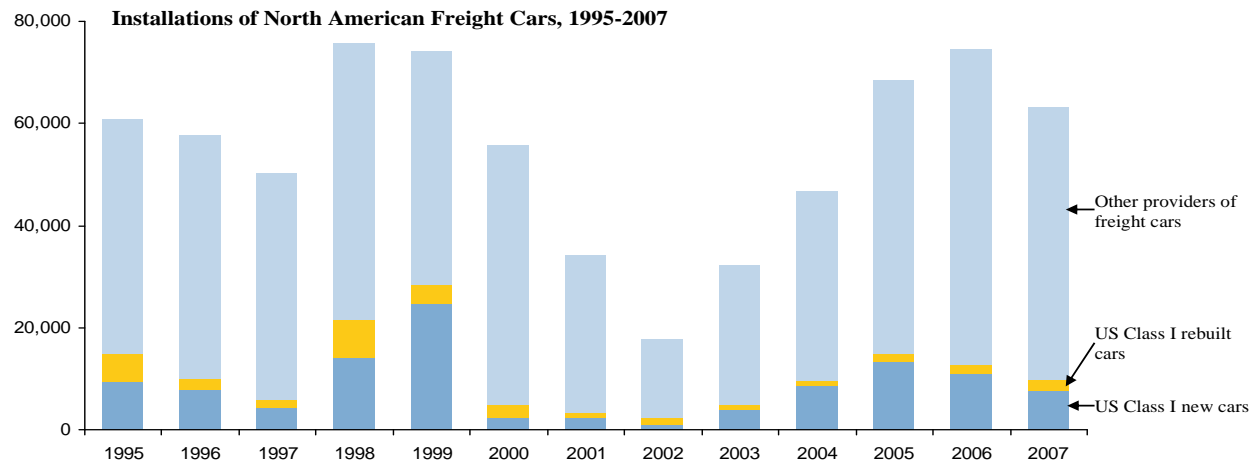
erational planning, technology, and software tools so that the railroads are able to very carefully craft, and incrementally improve, the infrastructure, section by section, as traffic picks up. So, going into this downturn there wasn't a lot of waste. All the railroads don't have exactly the same system as BNSF does, but one way or another they have ways of doing essentially the same thing. As you can see in the graph on the right, between 2004 and 2009 BNSF had ratcheted up their transcontinental group, by section, in a very careful and deliberate way. Keep in mind this is just a summary, the actual calculations are done in a much more granular way. This meant that BNSF didn't have a lot of wasted CAPEX sitting on the bench when we entered into the recession; rather CAPEX was much closer in line with where the traffic levels were.

Jeff Elliot

I will start with **Exhibit 19**. As Bill has said the railroads have had these decision tools to help them manage their operations and their capacity in order to get every benefit possible out of their capacity. They've also had other tools that they've used in order to rationally adjust their cost structure so that they're in a better position than they certainly were eight or ten years ago. One of the other strategies used is the increase in outsourcing various areas that, either from a strategic or from cost standpoint, don't make sense for them to do or areas that are not within their core competency.

As Bill previously mentioned, one of those areas is the ownership of the railcars. Ever since the railroad industry was deregulated almost 30 years ago they have been taking a very hard look at whether it makes sense to own certain railcars by looking at which ones have a strategic value to the rails and which ones are cars they would rather manage on their network but not own (because they don't have the desired strategic value).

Exhibit 19: Outsourcing: Carriers have been increasingly shifting parts of the value chain to shippers and lessors: companies other than Class I railroads now provide nearly 80 percent of new North American cars – a trend expected to continue to 2019 and beyond.



Leasing companies now supply virtually all of the new cars being added to the North American railcar fleet.

Source: AAR 2007 Railroad Equipment Report; Oliver Wyman analysis.

A good example of this is tank cars, where the tank car serves a dual purpose as rolling storage for the chemical companies and as a transportation vehicle. When you look at the turns of those cars they move very slowly, and the railroads changing the velocity of the network doesn't really change that due to storage being a major component of their use.

So as you look at **Exhibit 19**, what you see is that, over the last 15 years or so, the railroads have slowly but surely moved away from reinvesting in certain car types, resulting in the leaseholders or customers now being in the majority ownership position of the fleet. As Bill noted, while this is certainly good for the customers and the leaseholders when the market is robust, when the market is down (like it had been in this recession) it has meant that the railroads are in a better position to shed costs, as they don't own the equipment and therefore the responsibility for the equipment is someone else's.

Exhibit 20 raises the issue that the railroads are going to have to put somewhere between \$6 billion to \$8 billion into positive train control (PTC)

over the next few years. This is in addition to the railroads' normal CAPEX. And when one looks at where they put their money, in terms of capital investments, one walks away saying, "Maybe this is also going to be a lever that's going to push more rationalization of the fleet and more owner-

Exhibit 20: Outsourcing: Faced with \$6 billion-\$8 billion in unreimbursed capital expenditures for federally mandated positive train control (PTC), the railroad industry will be under continued pressure to outsource equipment supply.

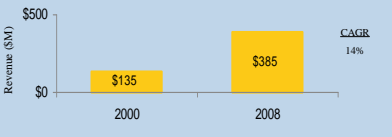
- Currently, railroads generally retain equipment when:
 - They need to be the primary supplier of the equipment
 - They need more control over velocity and trip times
 - The revenue model supports re-investment in equipment
 - There is a perceived strategic reason to own the equipment
- While there is a cost to storing their own equipment, the railroads generate a revenue stream when they store equipment owned by a third party.

Source: Oliver Wyman analysis.

ship by third parties rather than the railroads.”

Exhibit 21 illustrates another example of outsourcing. During the last four to five years, while rail traffic was robust, the individual railroads really didn’t have the resources to perform all the maintenance activities, especially expansion capital activities, on the railroads. As a result, what you had was a railroad, with some slow union assent, bringing in third parties to take over parts of the maintenance of the networks.

Exhibit 21: Outsourcing: MOW and other core functions are also being transferred to strong third-party providers.

Example Third-Party Provider: Herzog	Performance Considerations
<ul style="list-style-type: none"> ▪ Diversified MOW services company <ul style="list-style-type: none"> – Top industry player for past 40 years – Primary services include track construction and maintenance and equipment leasing and rental ▪ Solid customer base, although low penetration <ul style="list-style-type: none"> – Major Class I’s, many short lines and major transit companies – \$385M share out of \$11B+ annual MOW/capex spend 	<ul style="list-style-type: none"> ▪ Increasing outsourcing potential for key activities <ul style="list-style-type: none"> – \$150B capex to be spent over the next 20 years – Growing line density will increase maintenance spend – Continued interest in outsourcing construction and maintenance to non-union resources ▪ Several potential upside levers <ul style="list-style-type: none"> – Economies of scale – Further MOW services offering development (e.g., Progress Rail’s growth from parts supplier to AAR certified shop) – Global expansion: Currently US-centric market ▪ Supplier risks to be managed: <ul style="list-style-type: none"> – Reduced MOW spending growth due to recession – Customer concentration: Class I spend dominance – Labor backlash

Rail has and will continue to benefit from increasing capacity expansion and maintenance expenditures, along with greater outsourcing of these services.

Source: Herzog news releases, industry periodicals, AAR, Oliver Wyman analysis.

This is especially true for the shorelines, but some of the Class I’s also moved in this direction. One of the key questions in this downturn is, will the unions try to claw back some of that without a major return to former traffic levels?

Another example of outsourcing on the maintenance side is the vegetation maintenance shown in **Exhibit 22**. Vegetation maintenance is just another example of a non-core competency, something that the railroad doesn’t do

well or can’t do cost efficiently, that has been moved to a third party (of course, the rails had to work with the unions to agree on terms). It makes sense to do this if the rail can adjust these expenses based upon the economic environment they’re operating in.

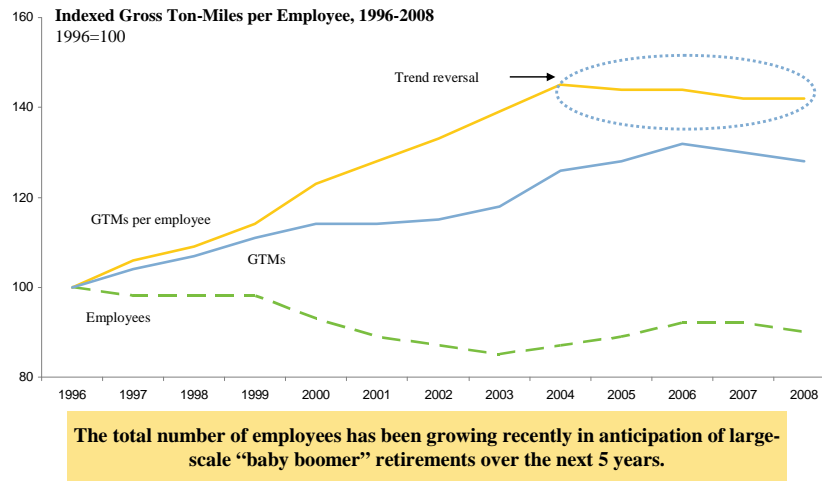
Exhibit 22: Outsourcing: While railroads typically perform much of their predictive maintenance in-house, some functions like vegetation control have been outsourced.

Example Third-Party Provider: Asplundh	Performance Considerations
<ul style="list-style-type: none"> ▪ Diversified services company across industries <ul style="list-style-type: none"> – (Primary) transmission line clearance and construction – Vegetation control for rail and pipelines – Right of way clearance and maintenance – Meter reading, advertising maintenance, emergency storm service, many others ▪ Large family owned company with 28,000 employees across US, Canada, Australia and New Zealand ▪ Revenues of ~ \$2.4B in 2007 	<ul style="list-style-type: none"> ▪ Tree-trimming is one of the largest operating expenses for utilities and is estimated to be a \$7B-\$10B market in the US. Rail also spends heavily on vegetation control ▪ Several potential upside levers <ul style="list-style-type: none"> – Economies of scale and consolidation opportunities in the US rail network – Expansion into similar labor intensive functions ▪ Supplier risks to be managed <ul style="list-style-type: none"> – Customer concentration among major utilities and Class I railroads – Family ownership structure – Monitor safety record and workers compensation liability

Sources: Asplundh web site, Forbes 2008 list of largest private companies; “Blackout Solutions,” Special Task Force on the Condition and Future of the Illinois Energy Infrastructure, 2004.

Exhibit 23 leads one to believe that the rails haven’t made drastic changes to employee numbers. Certainly, as Bill mentioned earlier, employee productivity has been one of the key productivity factors that the railroads have relied on over many years to improve their cost base. While that curve has abated somewhat over the past 4 or 5 years, if you looked at it on sort of a same store basis, there are still productivity gains but certainly not as the rates they’ve had historically. One of the key issues over the last three to four years has been that the railroads are faced with a

Exhibit 23: Employee productivity: Employee productivity has peaked: while substantial gains were made during the merger-intensive years of the 1990’s, productivity has slightly declined over the past three years.



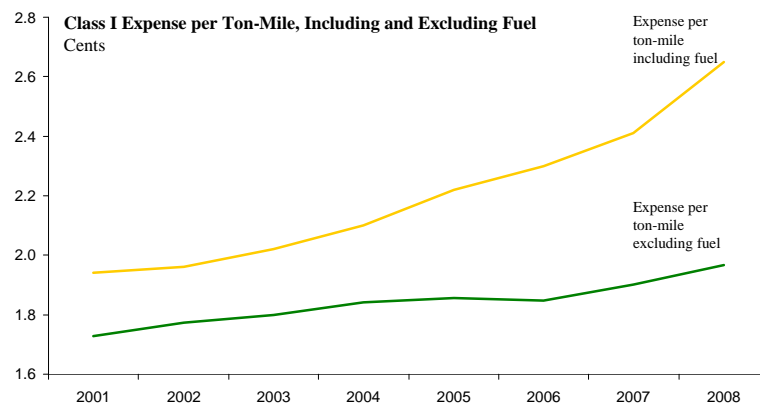
Source: AAR Analysis of Class I Railroads, Oliver Wyman analysis.

major transition of the labor force. They have a bimodal distribution in the age of their labor force, with a lot of young guys or newly created labor force and a lot of people who are in their fifties and are looking at retirement within the next four to five years. This has also impacted some of the numbers that we’ve seen over the last couple of quarters from the railroads and, specifically, from Norfolk Southern. Norfolk Southern said that they were reluctant to cut their labor force in the

first quarter due to the downturn because of their concern over the cost and difficulty of bringing these people back. This goes directly to the issue of how you manage a labor force in this downturn given the fact that the long term picture for railroads is growth. The railroads are looking at a dislocation in the market and also looking at a major transition that they have to manage in their labor force.

Exhibit 24 addresses the fuel issue. Fuel is one of the main reasons why we saw all negative numbers on Exhibit 6, yet an outcome that showed OR improvement. One of the reasons for this is that fuel is a major cost component for railroads. As everybody on this call recognizes, over the last three to four years fuel prices have been increasing and the rails have become increasingly uncertain as to what the price for fuel is going to be. The railroads and other transportation providers have been

Exhibit 24: Fuel cost: Beginning in 2004, changes in fuel prices became a major component in the cost of transportation. Prices began to rise, reflecting the reality of supply versus demand.



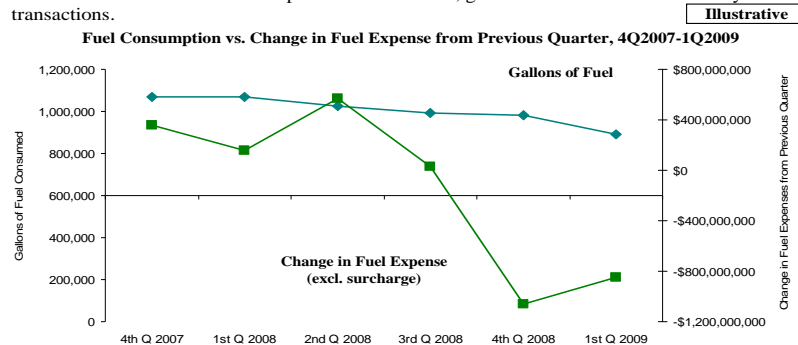
Source: AAR Analysis of Class I Railroads, Oliver Wyman analysis.

installing in more fuel surcharges to their customers. To the railroads this has been an effective hedge against the volatility of fuel price. More importantly, it’s enabled them to match a dollar increase in the fuel cost with something close to \$1, not quite there but close, in terms of their revenue.

Exhibit 25 illustrates a few points relating to fuel. The first point (Exhibit 25.1) is that the net effect of fuel cost fluctuation for the railroads is their fuel surcharge revenue ends up fluctuating based upon the cost of that compo-

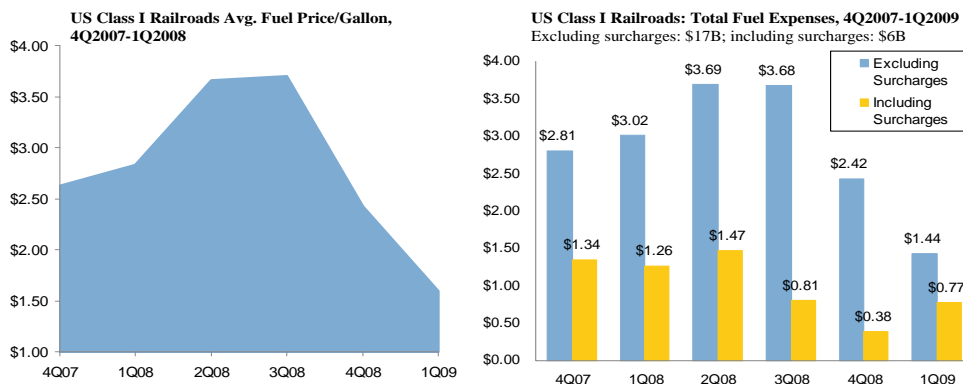
Exhibit 25.1: Fuel cost: Fuel usage has declined during the recession, but price volatility has been exacerbated by uncertainty around supply/demand fundamentals and traders anticipating the shifts.

- Railroads, like other transportation modes, have implemented fuel surcharges to hedge both the price and volatility of their fuel expense.
- This mechanism has had to be implemented over time, given the contract nature of many rail transactions.



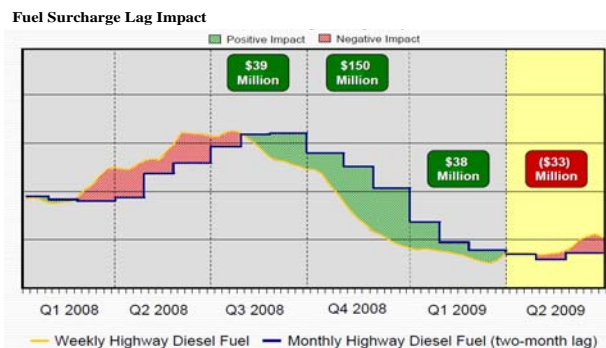
Source: Surface Transportation Board, Fuel Cost, Consumption, and Surcharge Revenue Reports for 4th Quarter 2007 through 1st Quarter 2009. Includes BNSF, CSX, Grand Trunk, KCS, NS, Soo Line, and UP. For the 4th quarter of 2007, CSX and Soo Line data for change in fuel cost from previous quarter were not available.

Exhibit 25.2: Fuel cost: As a pass through, surcharges substantially hedged fuel expense increases in 2008, lowering railroad exposure to changes in fuel prices



Source: Surface Transportation Board, Fuel Cost, Consumption, and Surcharge Revenue Reports for 4th Quarter 2007 through 1st Quarter 2009. Morgan Stanley research, NS Corp., July 28, 2009. Calculations: Average fuel cost was calculated as the total fuel cost divided by the total gallons of fuel consumed for each quarter. Average fuel cost with surcharge was calculated as the total fuel cost minus total revenue from fuel surcharges divided by the total gallons of fuel consumed for each quarter. Figures for seven Class I railroads (US operations).

Exhibit 25.3: Fuel cost: As surcharges lag fuel price changes by two months, however, they distort the timing of results for railroads – improving results in 4Q 2008/early 2009 due to declining fuel prices in late 2008, but creating prospective shortfalls as prices rise – as they have in the past few months.



Despite the ability to recover fuel cost increases through surcharges, there is still an incentive for the railroads to keep fuel costs low, since surcharges can drive traffic from rail to truck.

Source: CSX, Second Quarter 2009 Conference Call, Financial Review, Oscar Munoz, Executive VP & CFO.

ment and their customers are paying for the risk. The second point (shown in Exhibit 25.2) illustrates how fuel surcharge programs have helped to hedge fuel costs drastically since 4Q07. The final point (shown in Exhibit 25.3) relates to how fuel surcharge programs have been a headwind and tailwind at different points in time. You can see the picture, taken out of the CSX second quarter 2009 results presentation, to show the lag in the effects of the fuel surcharge programs. So, while fuel price is increasing the railroads end up not capturing enough fuel surcharge revenue to cover their fuel expense. On the other hand, while fuel price goes down the rails see a benefit from higher fuel surcharge revenue than fuel expense. Certainly, over the 4Q08-1Q09 period the rails benefited from the fact that their fuel surcharge calculation has a lag in it. However, you can also see that, beginning with the second quarter of 2009, the rails are back into the negative territory in terms of the fuel surcharge. So, it's a hedge. It distorts the results a little bit but it does help the rails manage a very important cost component quite well.

Exhibit 26: Sharing capacity and investments: Sharing capacity and joint investments is also helping railroads to reduce costs.

As we look to **Exhibit 26**, one of the other things that the railroads have done effectively is the sharing of capacity between railroads in order to reduce the total investment costs and improve the utilization of the various parts of the systems, whether it's the infrastructure or equipment between the carriers. The good example of this is the agreement between Kansas City Southern and Norfolk Southern to manage a piece of Kansas City Southern's railroad, called the Meridian Speedway. Other examples could be places where there's coop-

- For example, KCS and NS announced a joint venture to increase capacity and improve service on KCS' Meridian Speedway between Meridian, MS. and Shreveport, LA in December 2005.
 - This rail line connects rail shipments between the southeastern and the southwestern United States, reducing mileage and bypassing congestion at the New Orleans gateway.
 - KCS contributed 320 miles of line between Meridian and Shreveport to the joint venture company.
 - NS invested \$300 million in cash for capital improvements to increase capacity.



Source: Norfolk Southern press release, April 10, 2006, retrieved from: www.nscorp.com/nscportal/nscorp/Media/News%20Releases/2006/ns_kcs.html.

Map: http://content.edgar-online.com/edgar_conv_img/2007/06/12/0000702165-07-000154_MRMIMG018.JPG.

eration between the railroads through different corridors, a good example being New Orleans to Houston between the Norfolk Southern and Union Pacific. There's also cooperation going on with respect to things like maintenance equipment, where the rails allow maintenance inspection and capital equipment to move across two rail networks so they get better utilization out of the equipment. This enables them to do more inspections on their individual networks and keep the equipment utilized and reduce their overall equipment expense.

Exhibit 27 highlights a relatively new phenomenon in the industry, which is that railroads have become more sensitive to the fact that there are certain initiatives that they would like to do that have public benefits. Where there are significant public benefits to the rails investing activities, it makes sense for them to engage the State and Federal governments in sharing some of the costs. Essentially this means that the States are paying for the public

Exhibit 27: Use of public funding to variabilize railroad costs: Public funds have been used for capital improvements (which are then repaid by the railroads through tolls), thereby shifting most of the risk to the public sector.

- These projects need to demonstrate job creation or retention, reductions in highway congestion, improvements in environmental quality, or other public benefits before government agencies will assume the risk.

Example Project: Shellpot Bridge, Delaware	Example Project: Alameda Corridor, California
<ul style="list-style-type: none">▪ Swing-style railroad bridge providing an improved connection between the Port of Wilmington (DE) and Amtrak’s Northeast Corridor rail line, which is used by Norfolk Southern▪ The State of Delaware, acting through the Delaware Department of Transportation (DOT), provided \$13.5 million for restoring the bridge, with \$5 million from grant appropriations and the remainder from state tax-exempt bonds▪ Norfolk Southern compensates the state over a 20-year period through a per railcar fee	<ul style="list-style-type: none">▪ 20-mile freight expressway between ports of Los Angeles & Long Beach and the BNSF & UP transcontinental rail yards near downtown Los Angeles▪ The \$2.4 billion in funding was provided through the Alameda Corridor Transportation Authority (ACTA)<ul style="list-style-type: none">– \$1.16 billion in bonds sold by ACTA– \$400 million in loans from the US DOT– \$394 million from the Port of Los Angeles and the Port of Long Beach– \$347 million in grants administered by the Los Angeles County Metropolitan Transportation Authority– \$130 million in other state and federal sources and interest income▪ Debts are retired through tolls paid by the railroads

Source: “Return on Investment on Freight Rail Capacity Improvement,” National Cooperative Highway Research Program, Project 08-36, Task 43, Transportation Research Board, April 2005.

benefits of the capital project and the railroads are paying for the private benefits. As shown in Exhibit 27, one great example of the use of public funding is the Alameda Corridor in California. Certainly, you can also point to some of the recent corridor improvements that Norfolk Southern and CSX have been working on with the local agencies over the last couple of years in the Northeast and Southeast United States.

As Bill stated before, the railroads have been tending to their knitting for a long time. They have quietly but efficiently taking a long hard look at the services they provide, the cost to provide those services, and trying to push the costs and risks around so that the person who is responsible, or has core competency, is paying for it. More importantly, the railroads have a rational cost structure that reflects the true costs of offering their transportation businesses. It’s not been a short-term process; it’s been a long-term process. These cost reductions have been systemic and the recent downturn shows all the work that they’ve done and how effective they have been in rationalizing their cost structure so that they’re able to manage it most effectively as traffic goes up and down.

The key issue for the railroads still remains, what’s going to change in the regulatory environment and will some of the rules that result from regulation be detrimental to the long, hard work the railroads have been doing over the last several years?

So, with that we’re going to talk a little bit about the regulatory changes and the regulatory environment since the last time we held a Stifel Conference call about five months ago. I’m going to quickly turn through this but we have three issues that are on the top of the list. The first is the recent Union Pacific standalone cost (SAC) case. The second are the negotiations underway about potential deregulation and antitrust immunity and the STB authority. And finally, the recent changes to the hours of service rules.

Exhibit 28: Recent rate cases: On July 24, 2009, the Surface Transportation Board ruled against the Union Pacific Railroad on a rate case.

- In Oklahoma Gas & Electric Co. (OG&E) v. Union Pacific Railroad (UP), STB Docket No. 42111, the STB granted an estimated \$100 million in reparations and rate reductions over the next decade from UP to OG&E.
- OG&E serves more than 750,000 customers in Oklahoma and western Arkansas.
- UP has hauled roughly 6 million tons of coal per year from Wyoming's southern Powder River Basin to OG&E's Muskogee Station power plant in Fort Gibson, OK under contracts between the parties.
- The latest contract expired on Dec. 31, 2008:
 - UP and OG&E could not agree on a new contractual rate.
 - OG&E asked UP for common carrier rates, which the utility began paying in January 2009.
 - OG&E then challenged the new rates in a complaint to the Surface Transportation Board (STB).
- Both OG&E and UP agreed that the Muskogee Station is captive to UP. Both parties also agreed that the January 2009 common carrier rates should not exceed 180 percent of the variable costs of providing that transportation. **The central question put to the STB in this case centered on how to calculate the 180 percent revenue-to-variable cost ratio.**
- The STB found that the amount of relief owed to OG&E for the first two quarters of 2009 ranged from \$1.66 to \$1.91 per ton in shipper-supplied rail cars, depending on the mine origin. The decision ordered UP to set common carrier rates for the next 10 years at the 180 percent of variable cost level.
 - Assuming historical volumes of 6 million tons a year, the relief to OG&E will likely exceed \$10 million a year for the next 10 years.

Source: “The Surface Transportation Board Orders \$100 Million in Rate Relief and Damages for a Captive Utility Plant,” 07/24/2009 press release. Retrieved from http://www.stb.dot.gov/_85256593004F576F.nsf/0/2EF7868E6E7D29AB852575FD0063E8CA?OpenDocument.

I don't want to spend too much time on this but, as many of you know, last week the STB ruled in the customers' favor against Union Pacific on an SAC case (shown in **Exhibit 28**). This one is very similar to the BNSF Western Fuels Association case earlier in the year; in that one of the key issues in the decision was how does one calculate 180% of revenue over variable cost? The methodology for calculating it ended up costing the railroad money as the STB took its most recent calculations and found that the railroad had in fact charged rates above that regulatory threshold. When one looks at this case one continues to ask, do three SAC cases (because this is the third) settled against the railroads out West make a precedent? Or does it mean there is a change in the way that the STB is going to look at these cases over long term?

Exhibit 29 highlights the recent discussions of re-regulation. Obviously a bill has been introduced in the House called the Railroad Antitrust Enforcement Act of 2009, which they're hoping to have a vote on in September. There's also a Senate bill, the Railroad Antitrust Enforcement Act of 2009, which was introduced by Jay Rockefeller and Senator Cole. Both of these would, as we discussed on the last

Exhibit 29: Update on Antitrust, Re-Regulation, and the Surface Transportation Board

Antitrust & Reregulation	Surface Transportation Board
<ul style="list-style-type: none">▪ Railroad Antitrust Enforcement Act of 2009 (H.R. 233)<ul style="list-style-type: none">– Introduced by Rep. Baldwin (D. WI) to eliminate exemptions from antitrust law for commercial railroad companies– Approved by the House Judiciary subcommittee– Could face a hearing and full committee vote in September▪ Railroad Antitrust Enforcement Act of 2009 (S. 146)<ul style="list-style-type: none">– Introduced by Sen. Rockefeller (D. WV) and Sen. Kohl (D. WI)– Contains a repeal of the antitrust exemptions for railroads and an overhaul of the STB▪ Taking Responsible Action for Community Safety (TRACS) Act (H.R. 3410)<ul style="list-style-type: none">– Reintroduced by Rep. Melissa Bean (D. IL) last week. Original bill by Bean and Rep. Oberstar (D. MN) last year– Requires STB to consider community impacts on any transaction involving a Class I railroad– Originally aimed at the CN purchase of the EJ&E, TRACS would make approval of rail mergers and other transactions more difficult	<ul style="list-style-type: none">▪ Daniel R. Elliott III nominated to become STB chair<ul style="list-style-type: none">– Former associate general counsel for the United Transportation Union (the largest rail union)– In Senate hearing, stated that he shares Sen. Rockefeller's belief that “the STB should always be impartial, balanced and open-minded in carrying out the law”– In response to questioning by Sen. Rockefeller, Mr. Elliott suggested that the 1980 Staggers Act, which deregulated the rail industry, was outdated▪ STB reviewing the Uniform Rail Costing System<ul style="list-style-type: none">– URCS is used by the STB to determine a railroad's variable costs in a variety of regulatory proceedings– Adopted by the ICC as a general purpose costing system in 1989, with minor updates in 1997– Public hearing held on April 30, 2009– Changes could include updating historical tables, changing costing of unit train and intermodal traffic, updating statistical relationships, etc.– Changes could significantly impact rate cases

Sources: “Nominee Calls for Scrutiny of Rail Freight Pricing,” Josh Mitchell of Dow Jones, July 31, 2009, retrieved from <http://online.wsj.com/article/SB124900542847195859.html#articleTabs%3Darticle>. Statement of Daniel R. Elliott, III Nominee to Serve as Member of the Surface Transportation Board Before the U.S. Senate Committee on Commerce, Science and Transportation July 29, 2009. STB Notice (Ex Parte No. 431, Sub-No. 3) Review of the Surface Transportation Board's General Costing System. Progressive Railroading Daily News, August 3, 2009 and August 4, 2009.

Stifel Conference call we held, repeal the antitrust immunity, but also have a few additional items that hopefully will be discussed and deliberated on, which may give the railroads some heartburn. The next thing is the TRACS bill. This is a bill which was introduced last year in response to the Canadian National/EJ&E purchase and has been reintroduced this year to add to the issues (specifically environmental and community concerns) that the STB has to concern itself with, with respect to any kind of merger or acquisition of rail lines. I think the other real issue on Exhibit 29 is that you’ve got a new STB chair, Daniel Elliott, who appeared to say in his testimony, when questioned by Senator Rockefeller, that maybe the Staggers Act need some looking at. We’ll see whether that actually plays out in his tenure on the board, however.

Finally, I want to talk about the hours of service rule shown in **Exhibit 30**. I think the major issue on the hours of service rule is that these rules have been constructed in a very similar way to the changes in the hours of service rules for the trucking industry. They allow for more structured rest time for the railroad employees. The concerns in the industry are around managing the workforce. Many people in the industry believe there will be some loss of productivity as a result of this new rule. There’s also some concern from some workers, especially guys who like the extra hours and pay, because they are going to be forced to take more time off.

Exhibit 30: New hours of service rules: Signed into law on October 2008 as part of the Rail Safety Improvement Act, the new hours of service rules became effective on July 16, 2009.

Overview of Legislation
<ul style="list-style-type: none">▪ Revises the Hours of Service (HOS) requirements for rail and signal employees:<ul style="list-style-type: none">– Limits total on-duty and limbo time¹ for rail and signal employees to 276 hours per month– Limits total allowable shift time for employees to 12 consecutive hours– Increases uninterrupted off-duty hours from 8 to 10 hours in a 24-hour period– Requires two consecutive days off after six consecutive days worked and three consecutive days off after seven consecutive days worked– Reduces allowable “limbo” time to 40 hours per month, then 30 hours per month after one year

Implications
<ul style="list-style-type: none">▪ For the railroads and the unions, this means:<ul style="list-style-type: none">– Reduced labor productivity– Increased labor costs– Reduced wages for some railroad employees

Bottom Line
<ul style="list-style-type: none">▪ May promote increased innovation in labor agreements to allow railroads to more effectively use the labor force

Union Pacific has about 4,400 train and engine employees on furlough, down from a peak of 5,300. CEO James Young said some of the reduction in furloughs is the result of employee retirements, summer vacations and a new federal safety requirement restricting consecutive work hours. But he said the company's view of volume trends also has played a role.

Source: *cnnmoney.com* July 23, 2009.

1. Time spent by a crew traveling to an assignment is considered on-duty time. Time spent by a crew awaiting transportation and then traveling from an assignment to their final release point is considered "limbo time;" it is neither on-duty nor off-duty.

Questions:

John Larkin: Jeff you hinted that perhaps, over the last say six to eight weeks, the level of railroad management heartburn has increased slightly, as this legislative process has worked its way through the House, but more particularly the Senate. Any preliminary thoughts on what might be contained in the legislation that could create the heartburn on the part of the railroads?

Jeff Elliott: I think that the concern in the industry, at least from the discussions I've had over the last several weeks, has been more around the fact that the discussions are not making the progress that they had hoped they would make up until now. Congress only has so many more weeks when they're going to be in session and the rails are concerned that, in a rush to get a bill out, the key concerns and issues they think need to be addressed may be glossed over. They want to make sure that the bill that comes out is one that truly represents both the railroads' position and some of the concerns that rail customers and the legislators have.

Bill Rennie: I think that was more of a broad based concern, but I think concern grew as the nature of the legislative process began to give the railroads some concern that it would be more compressed, or possibly a last minute kind of compromise, where all the issues couldn't be fully vetted. I don't think there are any new provisions brought in, the legislators are still talking about essentially the same things. However, the mechanism on which those provisions would be considered is slightly different as time becomes a concern. We have all heard about what happens sometimes when these issues get crammed into a bill, so that possibility is giving the rails concern.

Listener #1: What do you see out there in the intermodal business and how is this potential regulation going to affect the intermodal business?

Bill Rennie: I think, even during the downturn (and it's hard to exactly get the numbers out of it), domestic intermodal appears to be much stronger than people had considered and certain lanes have actually even started growing. It's my feeling, from our discussions with truckers and with intermodal folks, that one issue to be aware of with domestic intermodal is, and I know John has had a couple of experts speak on this topic, when we come out of this recession and volume starts picking up, the ability of the trucking industry to handle domestic freight is really going to be questioned. We saw another bankruptcy announced today with Evergreen, which was a large truckload carrier in Alabama. We've had other bankruptcies out there, but more importantly the ability for the carrier, or the owner/operators that serve the carrier, to get credit is going to be a problem. As we have heard from our work with financial institutions that are involved with the motor carrier industry, there are a lot of distressed properties right now. They're not all in the same position that Evergreen is in, but there is some distress there. In fact, you can even track some of the growth in intermodal, as shippers are beginning to hedge their bets and saying, "you know, if we want to get comfortable with intermodal, we want to have a relationship with an intermodal agent, or an intermodal marketing company, or the railroads themselves so that when things pick up we will be in

the right position." So, I have a sense that domestic intermodal will grow quite strongly as part of the downturn. The international flows I think will recover more slowly.

As far as regulation of intermodal goes, because of the direct truck competition, I wouldn't say it's totally without regulation but it's very much deregulated and it's the closest thing in the railroad service portfolio to deregulated truckload. So, I don't think that too many of the regulatory issues will effect intermodal, as long as they're well below any of the revenue variable cost thresholds that are being talked about. The only thing that does affect them, for example, is hours of service.

Listener #1: Are there any, or close to any, special carrier relationships on the East Coast like the J.B. Hunt/BNSF relationship in the West?

Bill Rennie: No, I think from time to time the motor carriers and the intermodal marketing companies do line up and do shift their business back and forth between providers. Also, just because of the way the networks work, the motor carriers themselves will often play the traffic with an intermodal marketing company and a railroad because they're working in different points. I think there isn't that one strong long haul relationship like you have with J.B. Hunt and BNSF; it's almost unique in the business for a trucking company.

Listener #2: You spoke about how rail traffic declines are outpacing the economic deterioration much more so than historical correlations would suggest. I think you mentioned that there were several reasons for that, could you cover that again?

Bill Rennie: Remember the GDP is the overall general GDP of the economy and it has a number of industries in it that really don't use rail. But if you go back and look at Exhibit 5, which covers what commodities fell off (metallic ore, metals, motor vehicles, lumber, and wood), you can see the industries that have really been hurt in this downturn. The automotive industry has really been hurt. Steel, primarily because of automotive and the drop in building, has also been hurt. So the ores that go into steel and the coiled steel and finished steel has been hurt. If you look at the upper right hand corner of Exhibit 5, you can see the railroads have had a much heavier concentration in these three sectors that themselves fell faster than GDP and industrial production. And layer on top of that the fall off in exports with the containers down by 626,000 from where they were a year ago.

John Larkin: Jeff - first of all, is it your opinion that the railroads roughly breakeven over the long term on their fuel surcharge with respect to the volatility of fuel prices? Secondly, why haven't the rails shortened up lag time in calculating fuel surcharges? I believe that the average railroad fuel surcharge is about a 45 day lag, which creates a lot of mismatches in periods of rising or declining fuel prices. I believe the trucking industry is set up more along the lines of a one week delay. What couldn't the railroads do that?

Jeff Elliott: I think that the yield from the fuel surcharge for the railroads at this point is probably in the 80% to 85% range. I think that the issue here is that, because the industry deals in a lot more long term contracts, there still are contracts out there with customers that for one reason or another don't include the fuel surcharge in them. So until you've transformed all of these contracts, you're really not going to get closer to the breakeven.

With respect to the lag, I've asked a couple of people why they tolerate the lag and really the only answer that I've gotten from them is that they're buying fuel in such large quantities, so the way they buy the fuel makes the lag work better for them. Whether 45 days is the right number or 60 days is the right number, I don't think anybody's really sort of gone down and assessed that. But in their mind there is a reason for the lag, in terms of the way they go and purchase the fuel.

Bill Rennie: The other thing that I think is very different about the railroads, and even the trucking industry, and why some of the lag exists is that for the most part the railroads are handling products that are in an intermediate stage in the supply chain. Let's say they're at the wholesale level or they're raw materials. Because the rail rate itself becomes part of the price of the goods, they would be creating very substantial fluctuations in commodity end markets that basically are stable month to month or else it's hard to find out what steel prices are. So, I think that part of that comes from the terms of trade for the customer often is such that it would create chaos if you were changing the fuel prices every few days and fuel surcharge every few days. Because, that fuel surcharge ultimately has to get passed on to the ultimate consumer.

Jeff Elliott: That, in conjunction with the fact that it takes them, both in terms of the way they're purchasing it and the way they distribute the fuel, many days to get the fuel that they bought actually in the power. There's some convenience in having a lag.

John Larkin: When fuel took its first big run up a couple of years ago just about all the railroads were busily implementing their fuel surcharges, but they also had hedges in place which generated pretty significant cost benefits. Since that time I think only one railroad has laid out a sizable hedge and that one hasn't really generated anything but some losses. What's your view on the railroads' use of hedges going forward? Do you think just leave that alone as the fuel surcharge coverage percentage reaches closer to 100%?

Jeff Elliott: Actually I think there are some dialogues going on with the railroads about whether there is a more effective way to hedge some of their fuel expenses. I think that right now the fuel hedging program that they had before was a static hedge and yes it did produce some gains but it also produced some losses. And the fuel surcharge is a very effective hedge, at least at this point. But I don't think that the railroads are standing still and saying, "We're never going to hedge again." I think they're looking at other financial instruments which would improve their hedging capabilities and they may change their mechanism at some point in the future.

Bill Rennie: I think clearly the old pre-fuel run-up hedges that were available are just not there. I mean I think the risk of people writing some of those kinds of hedge instruments is just very high and there is some work being done to look at more creative, more comprehensive, and different structures.

John Larkin: I want to thank both of you, Jeff and Bill, for doing a terrific job of walking us through what a great job the railroads have done here over the last ten years in variabilizing their cost structure. I think there was a misconception out there on Wall Street that perhaps all of that variabilizing came into being here over the last six months, but clearly that's not true. Also, your thoughts on what's happening in Washington were greatly appreciated by all the listeners. Thank you very much for the great, insightful work.

END

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