WOLFE RESEARCH

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Thank you Chairwoman Brown, Chairman Oberstar and Ranking Member Mica, as well as your staffs for the invitation to present today on the state of the railroad industry.

My name is Ed Wolfe; I am the Managing Member of Wolfe Research, the leading boutique research firm on Wall Street focused on freight transportation and the macro economy. My team has been fortunate enough to be voted by investors as the top analysts on Wall Street for each of the past six years and eight of the past nine years.

I will make some comments for the record and submit the slides I hope to present to the subcommittee today.

In my thirteen years on Wall Street, as well as several years prior as an attorney, I have never before seen the U.S. or global financial markets and economy deteriorate in such a broad-based manner or at such a rapid pace. These truly are unprecedented times. The following slides show how quickly U.S. freight transportation demand has fallen off by mode and more specifically for the railroads by end user segment. I have also added some slides on rail and truck pricing, rail capital spending, returns and recent stock performance as well as our estimates for rail volumes, yields, revenue and EPS for the rails in 2009 relative to 2008.

Slide 1 lists several of the key reasons why rail infrastructure is critical and becoming more so for our nation's transportation needs. Railroads only comprise about 7% of total freight transportation spend in the U.S. but have become an increasingly critical line-haul component of moving bulk commodities and consumer goods to businesses and ultimately consumers throughout the U.S. and between Canada and Mexico. This has been accelerated over the past decade with the rise of global trade and offshore Asian imports into the U.S., which lend themselves to large, less expensive, non-time sensitive, long-haul moves on railroads rather than other modes of transportation. We estimate that rails are more than 3x more fuel efficient than trucks and with increasing highway congestion, the rails are one of the few alternatives for truck freight with meaningful potential capacity to help decongest highways and make America more productive, safe, and more environmentally responsible.

Slide 2 lists some of the major multi-year U.S. capacity expansion projects currently underway by each of the major railroads.

I will now turn to some thoughts on the freight macro economy generally and Chairwoman Brown's request for an update on how railroads are faring in the current economic crisis.

Our sense is that the recent further freight downturn since Thanksgiving reflects a material inventory drawdown and extended production shutdowns around, and since, the holidays, as freight has seemingly ground to a halt. Based on our channel checks, we expect these very weak freight trends to continue well into the first quarter of 2009, hence our expectation for -5% GDP during both fourth quarter 2008 and first quarter 2009.

Beyond extended shutdowns from the Big 3 automakers, we have seen announced production curtailments from a broad array of companies and industries including Peabody Energy, Toshiba, U.S. Steel, Caterpillar, Dow Chemical and Potash Corp among many others. We expect these shutdowns to further negatively impact already weakened freight volumes, as we have seen in December and January.

Slide 3 summarizes the 13 freight data series that we track each month, the rough date during the month the data series is released and the source of the data. As shown in the column on the right, only one of these 13 series improved sequentially in the most recent month of available data from November or December versus the prior month. The one positive trend of truck bankruptcies showing relative improvement likely reflects the recent plunge in oil prices keeping small truckers in the game a bit longer than normal given how weak demand is.

Slide 4 shows the Cass Freight Index, which has plummeted recently, including a 23% year-over-year drop in December, the sharpest decline in the 18-year history of the index, which is now at its lowest absolute level since January 2004. For the full year, the Shipment Index declined by an average of nearly 12%. The separate Cass Freight Shipper Spending Index is distorted, because it includes fuel surcharges. This index declined 16% year-over-year in December, its steepest decline since January 2002. Cass Information Systems is a financial company which processes over $14 billion in annual freight payables. Its freight index is a compilation of truck, rail and airfreight volumes and pricing.

Slide 5 shows monthly year-over-year changes in freight volumes for the past three years for Domestic Truck, Airfreight and Rail volumes as well as West Coast ocean import and export volumes. Each of these modes of transportation fell materially in November from recent trends, with reported truck tonnage holding up the best to date and down only 2%. Meanwhile, rail and combined import/export ocean volumes declined 9% and 15%, respectively in November. Rail volumes were down also 16% year-over-year in December and are down 18% thus far in January, 2009.

Rail and West Coast port volumes, the only modes that we have December data for, were materially worse in December compared to November, likely a bad sign for the other modes of freight when December volumes are reported. Export ocean volumes were up 20% on average for the first eight months of 2008 but were down almost 20% year-over-year in November and down over 27% during December.

Slide 6 breaks out the eight major rail product segments, showing annual year-over-year growth for the past six years on the left side of the slide, and data for the past eight quarters on the right side. Fourth quarter 2008 and full-year 2008 total rail volumes were down 9% and 4%, respectively. This marks the worst quarter since at least 1990 and the worst full year since 1985.

Note that in the fourth quarter, as was the case for full-year 2008, seven of eight segments were negative year over year, with only coal volumes positive. In the fourth quarter, automotive, metals and paper and lumber volumes were the worst performing volume segments for the rails, down 30%, 25% and 16%, respectively. While coal volumes, up 3%, remained the only positive segment during the fourth quarter, coal turned negative in December and remains weak thus far in January amidst the shutdown of several mines and weaker demand generally.

Slides 7 and 8 show the 62% correlation between U.S. GDP and rail carload volumes and then the even higher 68% historical correlation between Industrial Production and Rail volumes.

Slide 9 tracks Rail and Truck pricing over the past 32 years. Since Rail deregulation in 1980 the spread between Truck and Rail pricing has widened, in part driven by trucks being less fuel efficient and requiring higher fuel surcharges as oil prices have risen.

Slide 10 highlights Rail Capital Spending as a percentage of total rail revenue for each of the Class I railroads since 1995 compared to the average capital expenditures as a percentage of revenue for the Dow Jones 30 Industrials. On average, over the past five and ten years as reflected in the bottom table, Railroads have spent an average of 16.5% and 16.8% of their total revenue on capital spending. This is almost three times higher than the spend by the average of the DJ 30 during those periods. Also note that during 2009, the rails, on average, still expect to spend about 17% of their revenue on capex. Capital spending guidance thus far indicates that capex for the rails will be down about 10% overall and down about 5%-10% for the U.S. rails only. This compares to some industrials, such as Alcoa, which have recently announced 50% capex reductions.

Slide 11 looks at each Rail's Return on Capital relative to the rail industry's Cost of Capital as published each year by the STB. While the Rails' returns have, on average, improved from a low of about 6% in 2000 to 10.7% in 2007, they remained below the industry's cost of capital of 11.3% during 2007. Norfolk Southern was the only U.S. railroad to return its cost of capital in 2007. While rail returns were likely higher in 2008, they will be materially lower in 2009.

Slide 12 lists our current forecasted volume, yield, revenue and EPS declines for the Rails for 2009. Our numbers have been coming down quickly over the past six months, and while we think we are getting closer to a bottom at least for 2009, we are not yet confident that our estimates have bottomed. In our current assumptions, we are assuming about a 6% decline in volumes, on average, for the four major U.S. rails next year, despite easy comparisons of -4% and -3%, on average, in the previous two years. In the prior three years from 2004-06, the four U.S. rails averaged volume growth of nearly 4%. These significant volume declines, along with slower real pricing gains and materially lower fuel surcharge revenue, should translate to about a 14% revenue decline on average in 2009. This is down from 10% revenue growth, on average, in the previous five years through 2008. Combined with negative operating leverage for the high fixed cost rail networks, we anticipate about a 16% drop in rail earnings per share next year, down from 27% earnings growth, on average, over the previous five years.

Finally, Slide 13 reflects recent annual and quarterly stock performance of the Rails relative to Truck and Airfreight & Logistics stocks as well as the S&P 500. On average, the rail stocks returned 11.5% annually from 2000-2008, above the other freight sectors which returned about 7% and well above the S&P 500, which, because of poor returns in the early 2000's and 2008, produced an average 5.3% annual decline over that period. Note that while the Rails outperformed the other transports and the market over most of the past eight years and 2008, during the past fourth quarter and thus far in January, the rail stocks have underperformed as prospects have become less positive, reflected by our expectations on slide 12.

In conclusion, the rails are vital to the North American transportation network and will be increasingly important to infrastructure in order to alleviate highway congestion and promote a more efficient and environmentally conscious transport grid. While the group has seen strong earnings and stock performance in recent years, this is the most capital intensive industry of which we are aware. 2009 looks to be very challenging for volumes, yields and profitability, yet the group intends to minimally reduce their strong spending initiatives. Given low financial returns, if the downturn lasts beyond 2009, we would expect that shareholders would demand more substantial capital plan reductions.

I thank you for your time and welcome your questions. Also, for any interested congressional or administrative staff members who wish to receive our award winning daily transportation research, you can sign up free of charge on our website at www.WolfeResarch.com