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April 27, 2006

By E-Filing

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001

Re: Ex Parte No. 661 – Rail Fuel Surcharges – Comments

Dear Mr. Williams:

Enclosed for filing in the above proceeding are the comments of Robert M. Knight, Jr., Executive Vice President-Finance and Chief Financial Officer of Union Pacific Corporation and Union Pacific Railroad.

Please direct any questions about these comments or Union Pacific's participation in this proceeding to me at (402) 544-3897 or the e-mail address listed below.

Sincerely,

A handwritten signature in cursive script that reads "Lawrence E. Wzorek".
Lawrence E. Wzorek

Lawrence E. Wzorek
Assistant Vice President - Law

Contains Color Images

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**STB EX PARTE NO. 661
RAIL FUEL SURCHARGES**

**COMMENTS OF
UNION PACIFIC RAILROAD COMPANY**

PRESENTED BY

ROBERT M. KNIGHT, JR.

**EXECUTIVE VICE PRESIDENT-FINANCE
AND CHIEF FINANCIAL OFFICER**

**UNION PACIFIC CORPORATION
UNION PACIFIC RAILROAD COMPANY**

Date of Submission: April 27, 2006
Date of Public Hearing: May 11, 2006

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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INTRODUCTION

My name is Rob Knight. I am the Executive Vice President-Finance and Chief Financial Officer of Union Pacific Corporation and Union Pacific Railroad. I was named to this position in January 2004. I am responsible for all financial activities of both the Corporation and Union Pacific Railroad.

I began my career with Union Pacific Corporation in 1980 and have held a variety of positions in Audit, Accounting, Finance, Human Resources, Quality, and Marketing and Sales. In 1996, I was named vice president, Quality; in 1999, vice president and general manager, Energy in Union Pacific Railroad's Marketing & Sales Department. In 2000, I became vice president and general manager, Automotive, again in the Marketing & Sales Department. I returned to Finance in May 2002, when I became senior vice president, Finance of Union Pacific Corporation, the position I held before my election to my current position. I have a bachelor's degree in business administration from Kansas State University and a master's degree in business administration from Southern Illinois University.

My experience in both Marketing and Finance at Union Pacific has provided me with a unique perspective on Union Pacific's fuel surcharge program. I have spoken with customers, our investors, Wall Street analysts, and others about our need to recover our fuel costs. This issue is of critical importance to Union Pacific. As I will explain, we must recover our fuel costs in order not only to serve our customers, but also to protect our shareholders and employees, who depend on our economic viability.

SUMMARY OF UP'S POSITION

Let me summarize Union Pacific's position on our fuel surcharge program:

- UP has a comprehensive fuel surcharge program that began for carload traffic in 2002 to offset the high price of diesel fuel. This program has evolved in response to customer comments and input.
- UP does not have a fuel surcharge on 100% of its customers' shipments—although we would like to be able to recover from all shippers. This is a product of the history of the commercial relationships with our customers—large and small—that have developed over time.
 - UP's traffic mix includes regulated, exempt, and contract traffic.
 - Some older contracts do not have fuel surcharge provisions, and those customers have resisted UP's requests for fuel surcharges.
 - New price documents include fuel surcharge provisions.
- UP's fuel surcharge revenue does not fully cover our incremental fuel cost increase.
 - In 2004, UP recovered 52% of incremental fuel costs (i.e., cost above 75¢/gal.).
 - In 2005, UP recovered 74%. Even if all of UP's business in 2005 had been subject to the Highway Diesel Fuel surcharge, UP would have recovered just 99% of its incremental fuel cost.
 - In 2006, UP expects to recover about 90% of its incremental fuel-related cost.

- Due to increasing fuel prices, UP had more than \$800 million in unrecovered incremental diesel fuel costs from 2003 through 2005, not including nearly \$150 million for other fuel-related expenses.
 - This amounts to a subsidy of shippers at the expense of UP shareholders and employees.
- UP continues to make huge capital investments in its system, although UP does not yet earn its cost of capital.
- Unrecovered fuel costs impair UP's ability to invest in its railroad to meet the increased demand for rail transportation.
- UP must recover 100% of its fuel costs, but UP does not intend to recover through its fuel surcharge program more than 100% of its total fuel expense above 75 cents per gallon.
- UP has been receptive to customers' comments about our fuel surcharge program; and, in fact, our current program was modified from our original plan to be responsive to customer feedback.
- UP wants a fuel surcharge program that
 - enables UP to recover fully its cost of fuel;
 - is responsive to customers;
 - is fair/equitable; and
 - is easy to administer for both UP and its customers.

HISTORY OF UP'S FUEL COSTS

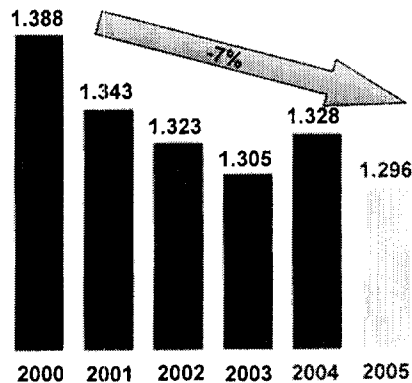
Union Pacific consumes a huge quantity of diesel fuel. So do other railroads. However, the geographic scope of Union Pacific's system, as well as our traffic mix and the terrain over which we operate, means that Union Pacific uses more diesel fuel than virtually any of the other railroads.

In 2005, UP consumed nearly 1.35 billion gallons of diesel fuel. We have worked diligently to control our consumption. We have invested in more fuel-efficient locomotives and implemented programs to conserve fuel. The following slide depicts the steps UP has taken to reduce fuel consumption.

[Slide #1]

Fuel Consumption Rate

Gallons per Thousand GTM



- Training
 - Train Handling
- New Locomotives
- Technology
 - Distributed Power
 - Auto Start / Stop
- Improved Operations

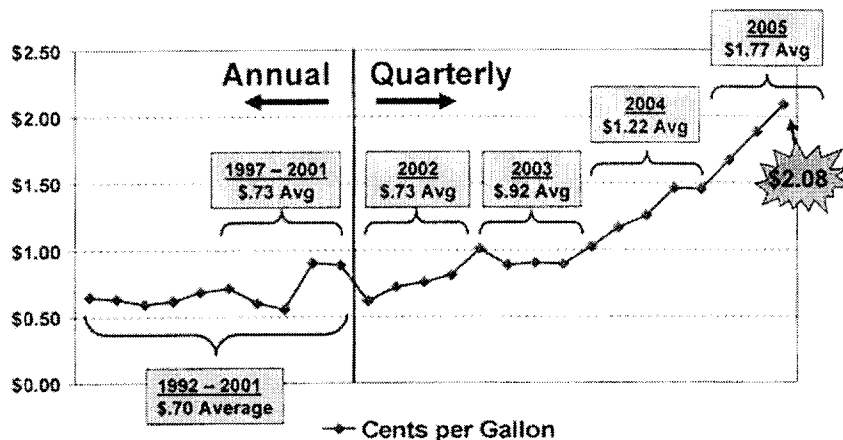
Nevertheless, fuel consumption has grown with the record demand for our rail service.

As the Board well knows, there have been substantial increases in the price of a barrel of oil over the last few years. That trend continues today. The increase in oil prices translates directly into the ever-increasing price we pay for diesel fuel.

The following chart shows the staggering increase in the cost of a gallon of diesel fuel in just the last few years.

[Slide #2]

UP Historic Fuel Cost Per Gallon



Our average price for the 1.35 billion gallons last year was \$1.77 per gallon, up 55 cents from \$1.22 per gallon in 2004. Our average price for a gallon of fuel during the fourth quarter of 2005 was \$2.08 per gallon. This resulted in UP spending a total of \$2.4 billion on locomotive fuel in 2005.

Fuel prices continue to rise. On April 20, 2006, UP announced its first quarter earnings. We stated that our fuel cost in the first quarter was \$1.87 per gallon, up from \$1.45 in the first quarter of 2005—but our cost of fuel as of the date of our earnings announcement had risen to \$2.10 per gallon.

In addition to diesel fuel, UP purchases electricity and other utilities, as well as gasoline, lubricants, and other fuels for our operations. In 2005 that added \$240 million to our costs, up nearly \$100 million from 2002 levels. In the first quarter of 2006, our combined fuel and utilities bills totaled \$692 million. That category alone represented

22% of our operating expenses. In the first quarter of 2002, fuel and utilities were only 10% of UP's total operating expenses in the quarter.

The chart referred to above [Slide #2] also demonstrates that UP's average fuel cost per gallon averaged 70 cents per gallon from 1992 through 2001, and then remained around 73 cents per gallon from 1997 through 2002. Consequently, when UP began to see the run up in fuel costs, expecting that they would return to lower levels in the foreseeable future, we designed our fuel surcharge program with 75 cents per gallon as the base cost, with a view to collecting the incremental cost above that amount through our fuel surcharge program.

UNION PACIFIC'S FUEL SURCHARGE PROGRAM

In its Notice of Hearing, the STB asked the railroads to explain the manner in which they calculate and charge their customers fuel surcharges. The Board also asked whether the fuel surcharges fairly reflect the increasing fuel cost of the movements to which they are applied.

Like most companies that have a fuel surcharge program, Union Pacific determines the fuel surcharge to be added to a customer's freight bill by referring to a publicly available index and periodic changes in that index. The fuel surcharge is calculated as a percentage that is applied to the customer's freight bill to determine the total amount of the transportation charge for a particular movement.

UP's fuel surcharge program began around September 2000, when we initiated a series of fuel surcharge provisions on intermodal traffic that was not under contracts. However, these early fuel surcharge provisions did not refer to any index.

On December 1, 2002, UP implemented its first standard fuel surcharge for carload business. The fuel surcharge was based on the price of West Texas Intermediate crude oil (WTI). A fuel surcharge was applied to the pertinent freight bills when the price of WTI oil, as published in *The Wall Street Journal*, exceeded \$28 per barrel for 30 consecutive days. The surcharge was applied in 2% increments for every \$5 per barrel the WTI exceeded \$28 per barrel.

In March 2003, customers informed UP that rapid swings in the WTI prices and the structure of UP's WTI fuel surcharge program impeded customers' ability to budget for fuel surcharge increases. This customer feedback caused UP to re-evaluate the formula of its "standard" fuel surcharge program. Consequently, in April 2003, after further discussions with customers, UP converted the WTI carload surcharge basis from the WTI price published for 30 consecutive days in *The Wall Street Journal* to a WTI monthly average price. We also modified the surcharge schedule to initiate the fuel surcharge and calculate it at 0.4% for each dollar tier above the monthly average of \$23 per barrel.

We continued to receive feedback from our customers on our fuel surcharge program. As a result of this customer input, UP linked its standard carload fuel surcharge in June 2003 to the Highway Diesel Fuel (HDF) Index published by the Department of Energy, because we concluded that the HDF is better aligned with the fluctuations in the diesel fuel price that UP pays. Additionally, the HDF is the fuel index used by the trucking industry as well as other carriers with whom we compete for business. It is easier to apply and more widely accepted by our customers as an index with which they are familiar. In moving from the WTI monthly average price calculation

that began at \$23.01 per barrel, UP implemented the HDF fuel surcharge at \$1.35 per gallon (approximately 80 cents per gallon for UP's fuel price), which was equivalent to approximately \$25.50 per barrel under WTI (an increase in the base price of oil from which the fuel surcharge applied).

Union Pacific administers the HDF fuel surcharge program in this manner:

- The fuel surcharge is adjusted on a monthly basis.
- The basis for the surcharge is determined by the HDF for a calendar month, as reported weekly on the DOE website.
- If the average monthly price of HDF equals or exceeds \$1.35 per gallon, a surcharge beginning at 1.5% applies. (The \$1.35 per gallon equates to a UP fuel price of approximately 80 cents per gallon, while our cost recovery calculation begins at 75 cents per gallon.)
- For every five-cent increase above \$1.35 per gallon, the surcharge increases by 0.5%.
- When the average DOE price drops below \$1.35 per gallon, no fuel surcharge will apply.
- The surcharge is billed to applicable shipments beginning the second month following the month on which the DOE average price calculation was based. (For example: the average reported DOE price for the month of May 2005 determined the fuel surcharge applied throughout the month of July 2005.) Although UP originally planned to have only a one-month lag, our customers convinced us to go to the second month.
- The HDF program is designed to recover 100% of the incremental fuel expense above 75 cents per gallon if all shipments were covered by this program.

Union Pacific's coal business has a separate fuel surcharge program.

Historically, most of our coal business moved under long-term contracts with a variety of escalation provisions. We attempted to simplify the administration of our coal business transportation rates and terms. Consequently, in November 2004, UP established a fuel surcharge for its coal business that is HDF-based. The surcharge begins at the

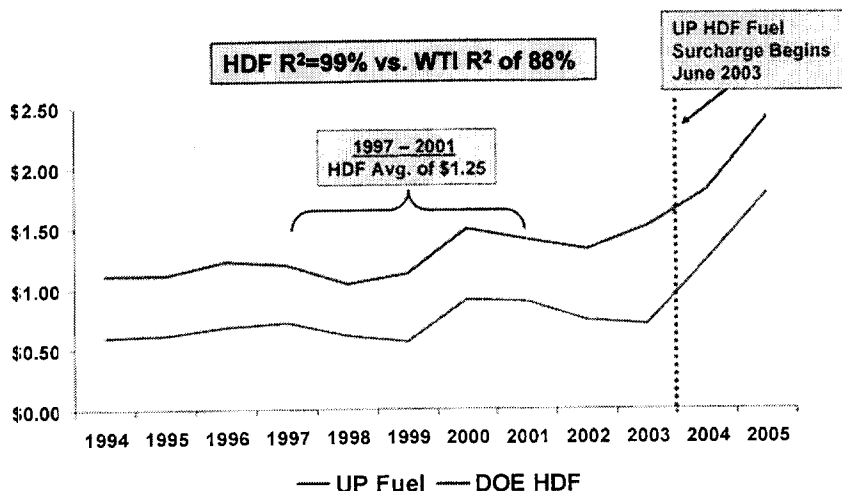
rate of 1.5% when the HDF index is at \$1.35 per gallon. The surcharge increases 0.5% for each additional increase of five cents per gallon up to \$1.60 per gallon. After \$1.60 per gallon, the surcharge increases 0.75% for each additional five cents per gallon. The variation from the standard HDF program is designed to cover the higher costs associated with the increased fuel consumption on unit coal trains which carry more tonnage than manifest trains.

Our Intermodal Group has determined that the fuel surcharge for intermodal traffic should be calculated based on the HDF, but slightly differently from our carload fuel surcharge because of the comparable nature of this business with motor carriers. As a result, the base for our Intermodal HDF index is \$1.25 per gallon (rather than the \$1.35 per gallon for carload business). It is calculated by determining the percentage change between the base index and the previous month change. It increases approximately 0.6% for each additional change of four cents per gallon in the index.

It has been UP's experience that the HDF-based fuel surcharge more accurately reflects the change in UP's diesel fuel costs. The attached chart shows the correlation between the HDF index and UP's fuel cost back to 1994.

[Slide #3]

HDF Surcharge - Customer Driven Highly Correlated to UP Fuel Costs



UP IS NOT FULLY RECOVERING ITS INCREASED FUEL COST

There has been much discussion about the amount of money railroads receive from their fuel surcharges. One thing is certain: Union Pacific is not recovering the full incremental increase in the cost of its fuel via our fuel surcharge program.

Where possible, Union Pacific applies a fuel surcharge in order to capture its incremental cost of fuel above 75 cents a gallon. However, UP does not recover a fuel surcharge on 100% of the shipments we handle. The fuel surcharge is linked to the price document the shipper uses.

Union Pacific handles traffic under published rates regulated by the STB, as well as other shipments that are exempt commodities moving under public circular prices

that are not regulated by the STB. Numerous shipments also move under rail transportation contracts.

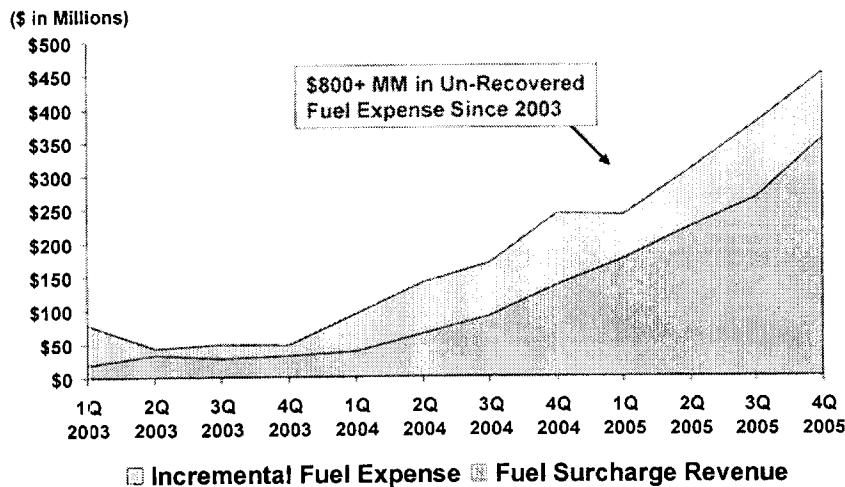
During 2005, approximately 80% of our rail transportation revenue was derived from transportation contracts or private rate documents pertinent to a particular shipper. Approximately 20% of our revenue came from traffic moving under published rates, some of which are regulated while others are in exempt public price circulars.

Commercial agreements from the past preclude Union Pacific from applying a fuel surcharge to all of its business. These limitations are being reduced over time. In 2004, our fuel surcharge program produced revenue that recovered 52% of the incremental cost of fuel above 75 cents per gallon. In 2005, when we paid approximately \$2.4 billion for locomotive fuel, our fuel surcharge revenue amounted to \$1.017 billion, as we reported in our Form 10K to the SEC. Seventy-eight percent of UP's revenue base in 2005 was subject to some form of fuel surcharge. UP recovered the equivalent of 74% of our incremental fuel cost. This demonstrates that UP is not over-collecting from our customer base in total.

There is a significant amount of incremental fuel expense that UP is not recovering via fuel surcharges. In fact, from 2003 through 2005, UP did not recover more than \$800 million in additional diesel fuel cost. That is depicted on the following chart. This does not include the nearly \$150 million in incremental fuel-related expenses (e.g., utilities, etc.).

[Slide #4]

UP Incremental Fuel Recovery



UP is still not recovering 100% of its incremental fuel expense in 2006. During the first quarter of 2006, we recovered around 90% of our incremental diesel fuel expense. This was a 26% improvement over our 73% recovery in the first quarter of 2005. In essence, Union Pacific and its shareholders have been subsidizing and continue to subsidize the higher cost of fuel for shippers on our railroad.

UP would prefer that every one of its customers pays to offset the higher price for diesel fuel—but they do not. This is a result of the marketplace dynamics. Our commercial relationships with many of our customers have developed over a long period of time. Some customers entered into long-term transportation agreements years ago, when the price of fuel was much lower and we had excess rail capacity to fill. Some of these contracts contain no fuel surcharge formula, while others have a price

adjustment provision based on a formula that gives inadequate weight to the cost of fuel.

Union Pacific is applying a fuel surcharge on every freight bill that it can. We are including a fuel surcharge mechanism in new transportation rate documents, whether that document is a tariff, an exempt circular, or a transportation contract. We will continue to pursue full recovery of our incremental fuel costs.

In the meantime, UP cannot undo or ignore the commercial arrangements it has with some of its customers—who, as a result of negotiations prior to 2003, secured a favorable arrangement before the run up in fuel prices. UP has approached some of these customers who enjoy rates without fuel surcharges (some of whom add fuel surcharges to bills they present to their customers) to determine whether they would agree to modifications that would allow UP to recover at least a part of the increased costs. While a small number of these customers were willing to help us offset our added fuel costs, the vast majority have rejected our request. UP is not able to simply walk away from that business or impose a fuel surcharge just yet.

UP RESPONSIVENESS TO CUSTOMERS

Union Pacific has not adopted a fuel surcharge program without listening to our customers. If we wanted to simplify our recovery process and minimize our exposure for unattained fuel costs, we would adopt one fuel surcharge factor. Instead we have four basic indices in place today. We have also accommodated quite a few variations to those indices as a result of past negotiations.

Some customers may pay more than the actual incremental cost of fuel we use to handle their particular shipments. Some pay less. While this may appear inequitable

to some, we believe standard surcharges are the most appropriate and reasonable way to manage a fair, equitable and easily administered fuel surcharge program.

Union Pacific adopted a fuel surcharge at a time when it appeared that the increase in fuel prices would be temporary or transitory. We did not anticipate that the rising cost of fuel would continue virtually unabated for as long as it has. Although this does not appear likely today, there is still a possibility that the price of oil and, consequently, the cost of diesel fuel will decline in the coming months and years. In fact, there have been periodic monthly declines in the surcharge during its use by UP. The use of our current fuel surcharge mechanism means that, as the price of fuel declines, so will the surcharge. In fact, fuel price declines have historically followed significant increases in oil prices that occurred, for example, during the mid-1970's, mid-1980's, and early 1990's.

The Board will hear from an array of participants in this proceeding. Some will tell you that the STB should mandate a fuel surcharge formula that guarantees that each shipper will pay no more than the cost of the fuel used for that particular customer's movements. While that may sound like a desirable goal, it is more difficult than simply calculating the mileage between the origin and destination. Other factors would have to be considered in a formula designed to link the charge to the fuel actually consumed. Those include the weight of the shipment, the terrain over which it travels (e.g., 100 miles over the Rockies is not the same as 100 miles across the plains of the Midwest), weather, train configuration, locomotive type, terminal switching, geographic fuel price differences, etc. Currently, the railroad industry does not have a single master rail mileage table that the freight billing railroad could use to calculate an interline

mileage surcharge. Additionally, customers would need a similar capability in order to maintain accounts payable records.

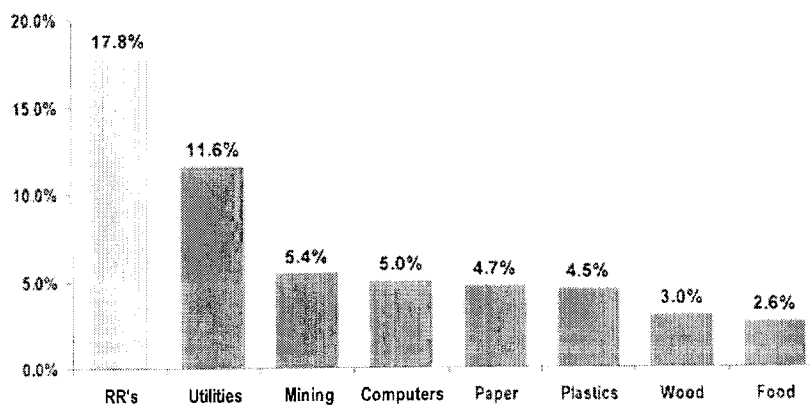
Shippers and railroads desire simplicity in the formula used. Otherwise, the administrative burden for the railroad of calculating the surcharge and for the customer of auditing or verifying the surcharge becomes insurmountable. It is simply not practical to have a unique fuel surcharge program for individual customers that takes into consideration all of the complex variables associated with their shipments.

CAPITAL INVESTMENT DEPENDS ON ADEQUATE RETURNS

As the STB is well aware, the rail industry is capital intensive. Railroads spend more of their revenue dollars on capital investments than any other industry. During the period of 1995 through 2004, railroads spent an average of nearly 18% of their revenue dollars on capital items.

[Slide #5]

Railroading Is Capital Intensive *Average Capital Spending as a Percent of Revenue*



1995 – 2004 Data: Selected Industry Data



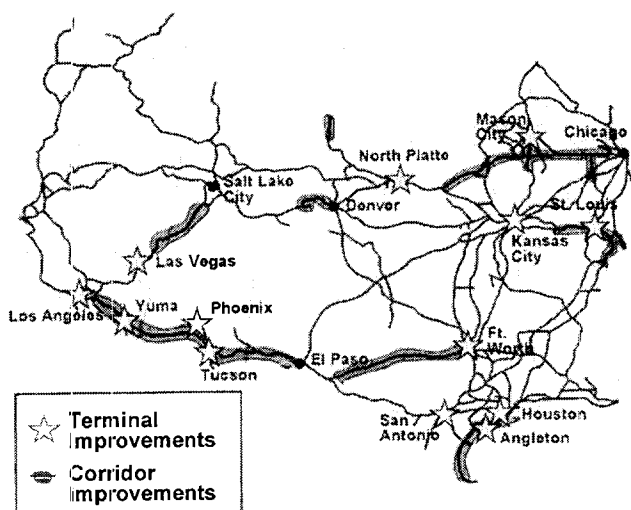
But Class I railroads have not achieved an adequate return on that investment.

The capital demands on railroads continue to be extensive—particularly now that there has been a dramatic increase in rail shipments, and that trend is expected to continue well into the future. Railroads are working to meet that demand by making capital expenditures at record levels. Union Pacific alone has spent approximately \$26 billion in capital investments over the past 11 years.

In 2005, we spent more than \$2.8 billion and plan to spend about the same amount in 2006. More than one-half of that amount is to maintain our track and physical plant, while another \$485 million is projected for growth capacity and commercial facilities. These are investments that take time to design, build and put into service so they necessarily require an authorization in anticipation of a recovery on the investments.

[Slide #6]

2006 Capital Spending Full Year Plan



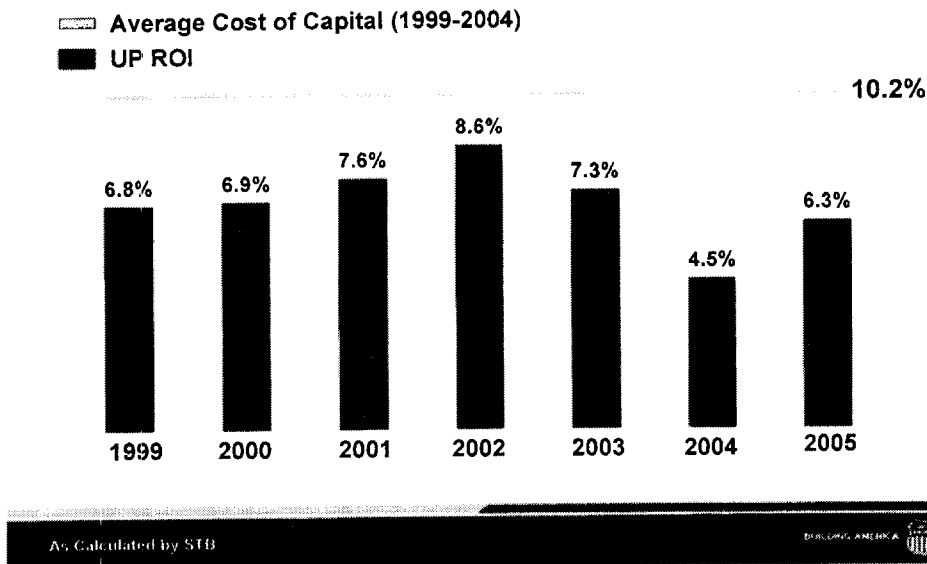
Highlights

- **\$1.5B Track Maintenance**
 - 4.2 million ties
 - 5.7 million tons ballast
 - 970 miles of rail
 - 9,250 miles resurfaced
- **\$305M Growth Capacity**
- **\$180M Commercial Facilities**
- **200 Road Locomotives**
- **2,700 Freight Cars**

Meanwhile, however, Union Pacific has not earned a return on its investment in capital expenditures that necessarily justifies investing as much as we have invested or as we plan to invest. The following chart depicts this point.

[Slide #7]

UP ROI Falls Short of Cost of Capital

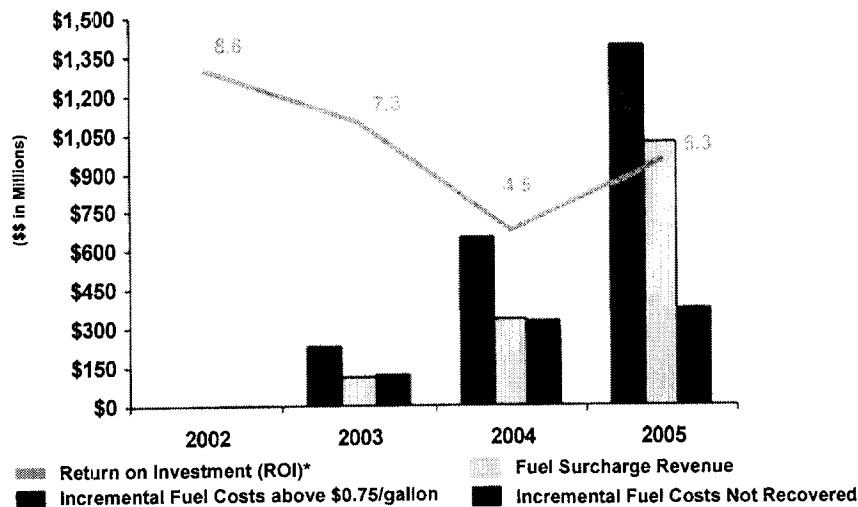


Nevertheless, Union Pacific has been willing—so far—to make these continued investments with a view that Union Pacific will eventually earn a return on all it has put into its transportation system for track, locomotives, freight cars, commercial facilities, and technology.

The fuel surcharge program is an integral part of Union Pacific's plan to attain reinvestability. As the attached graph indicates, fuel surcharge revenue has not covered the incremental fuel expense, much less the cost of capital.

[Slide #8]

UP Diesel Fuel Expense and ROI



That in turn has contributed to an inadequate return on UP's investment in its business.

It is crucial that railroads be permitted to recover fully their variable costs, like fuel. If Union Pacific cannot recover those costs, it certainly cannot afford to continue to make the annual multi-billion dollar investments needed to meet the demands on our rail network.

CONCLUSION

We do expect to eventually recover all our incremental fuel costs by means of our fuel surcharge program. But we are not there yet. No one involved with transportation likes high fuel prices. UP certainly does not. Nevertheless, our intent to recover our higher fuel costs has not dampened the demand for our services. But only by recovering our full costs and improving our returns will we be able to continue to

invest in our rail franchise to the benefit of our customers, our employees, and our investors. Changes that involve complex calculations and numerous resources to administer and audit are not practical.