STATUS OF RAILROAD ECONOMIC REGULATION

(108–59)

HEARING

BEFORE THE

SUBCOMMITTEE ON

RAILROADS

OF THE

COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE

HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

MARCH 31, 2004

Printed for the use of the
Committee on Transportation and Infrastructure

U.S. GOVERNMENT PRINTING OFFICE

95–124 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
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Wednesday, March 31, 2004

HOUSE OF REPRESENTATIVES, COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE, SUBCOMMITTEE ON RAILROADS, WASHINGTON, D.C.

The subcommittee met, pursuant to call, at 10:08 a.m. in room 2167, Rayburn House Office Building, Hon. Jack Quinn [chairman of the subcommittee] presiding.

Mr. QUINN. Good morning, everybody. Thank you for your attention, and I thank Mr. Boswell for joining me this morning to begin the hearing in a timely way. Ms. Brown is on her way here, she'll be here any moment. I appreciate Mr. Boswell sitting in.

This morning's hearing is part of the Subcommittee's ongoing oversight responsibilities, as most everybody in this room probably knows, regarding the Surface Transportation Board. Last year we examined the resources and requirements for the agency, and today we're going to explore the STB's authority over the remaining Federal regulations of freight railroad rates, practices, probably talk a little bit about mergers, various other transactions. As has been the case since the original creation of the Interstate Commerce Commission in 1887, there always are, it seems, disagreements over the scope and standards of economic regulations for railroads.

The broad deregulation of railroad rates in the 1980 Staggers Act is generally credited with saving railroads from bankruptcy. However, there are still some serious differences of opinion about the effectiveness of Staggers and the ICC Termination Act in 1995. Our goal this morning at this hearing is to gather testimony and information from all the affected parties on the status of economic regulation of the railroad industry in general. To do that, we've assembled a cross-section of conflicting views. That's not uncommon when we schedule a hearing.

We're going to hear first from the STB Chairman, the Honorable Roger Nober. Our second panel is comprised of Mr. Ed Hamberger and Mr. Rich Timmons, representing the interests of the Class One and short line railroads, both gentlemen hardly strangers to this Subcommittee and the hearing room. We're glad to have both of them with us. And our final panel includes rail shippers from the chemical, industrial and agricultural sectors, also outside experts who have followed and analyzed economic trends within the railroad industry.

I think we've put together a fair and balanced hearing to hear all those views this morning and all of us look forward to exchanging those views. I don't believe we'll be interrupted with any votes, at least for the early part of the morning, and may be able to get through the hearing, so we're hopefully going to have the House Floor cooperate with us.

Mr. Mulvey, I want to mention, I know Ms. Brown will, depending on action on the other side of the Capitol, this may or may not be your final meeting with us here. You'll be joining Mr. Nober over at the STB, and Frank, I think it goes without saying, I don't want to steal Corrine's thunder, but from my point of view on my side of the aisle, all of us, the staff work that you've done for us on the Subcommittee and the full Committee has been invaluable.

We'll count you as a friend when you're over at STB but we know there's a line we have to draw somewhere there. But congratulations, and we hope it moves as quickly as possible. Thank you for your help also out in Las Vegas at our recent field hearing.

I want to recognize Mr. Boswell for some brief opening remarks before Ms. Brown gets here. Mr. Boswell.

Mr. BOSWELL. Thank you, Mr. Chairman. Thank you for deferring to Ms. Brown, when she shows up, and counsel, I'm glad I heard that statement, because I did just want to add one comment. The Surface Transportation Board has a big role to play in a lot of our States, as you well know, and again, thank you for doing this hearing. I think in terms of my rural area, I've got industrial areas, Des Moines, Cedar Rapids and so on, but I've got a lot of rural areas, and we really survive on what it costs to move, for example, coal to the power plants and the RACs.

So I'm glad we're going to have a friend over there. So this is something that's weighing on our minds as we think about the economy and so on and the stresses that are going on across America. I think in my State, we really rely on the rail and there's limited competition. So it's a concern. That's just sort of my opening ramble on that piece.

Mr. QUINN. Thank you, Mr. Boswell. Thank you very much.

Let's move to our first panel, the Honorable Roger Nober, the Chairman of the Surface Transportation Board. I think we all know that we'd like to ask you, Roger, if you could, to keep your remarks to about five or ten minutes or so. We've received your testimony, thank you very much, as always, well prepared and it becomes part of the record. We'll hear from you and then move to questions.

TESTIMONY OF HON. ROGER NOBER, CHAIRMAN, SURFACE TRANSPORTATION BOARD

Mr. NOBER. Good morning, Chairman Quinn and Mr. Boswell and other members of the Subcommittee. My name is Roger Nober and I'm Chairman of the Surface Transportation Board.

I certainly appreciate the opportunity to appear before this Committee on the important issue of railroad economic regulation. I'm particularly pleased to be here on the day that the Committee is considering and will take to the Floor its reauthorization of TEA-21. I have to say that if six years ago you told me that when the Committee was taking that bill to the Floor, I'd be here testifying on rail issues, I wouldn't have necessarily thought that would be the case.

This is another appearance of mine as the sole board member, and hopefully my last. I am looking forward to Mr. Mulvey and the other nominee, Mr. Buttrey, who is also in the audience, hopefully joining us soon and the other body acting quickly and putting my 11 months as a single board member to a rapid close. That's my hope. I'm crossing my fingers like everybody else. We have a lot of work to do down at the agency, so when these folks get there, they're going to get to roll up their sleeves and get to work quickly on a lot of the issues that we're going to discuss today.

Now, in my oral statement I will first review the general rate and service issues faced by shippers, particularly captive shippers. Next I will discuss the need for railroads to earn adequate revenues, and finally, I'd like to address some potential remedies for these concerns, including legislation introduced by some members of this Committee.

Under the Interstate Commerce Act, the Surface Transportation Board has exclusive jurisdiction to determine whether a rate paid by a shipper is unreasonable. In rate matters, as in all matters, the Board must balance what are often conflicting objectives. On the one hand, it must help railroads earn adequate revenues and on the other hand, the rate paid by individual shippers must be reasonable and fair.

That balance, as we all know, is not an easy one. Rates that are too high can harm rail dependent businesses, while rates that are too low will not allow railroads to pay for new capital. The Board must do its best to carry out the law in a way that is fair to all.

The Act limits the Board's rate jurisdiction to those instances when railroads have market dominance. In other words, when the railroad is charging a rate above a threshold level and the shipper is captive, meaning it has no effective transportation alternative. The statute directed that there be different procedures for handling large and small rate cases. Let me first start with large cases.

The Board uses the well settled standalone cost method for large rate cases. These are expensive and complicated. They can cost $3 million or more to prosecute, $5 million or more to defend and generate more than 700,000 pages of material. They are time consuming. While the Board has nine months to decide a case after all the evidence is filed, preparing and filing the evidence could take more than twice that long.

Recently there has been a significant increase in the number of these large rate cases. Where in past years we may have had two or three, today the Board has ten, and I understand several more will be filed in the next coming year.

Thus, I made streamlining the Board's large rate case a high priority and did so by instituting a number of reforms. I'm pleased to say that we have already employed all of these many times, and they are making the SAC process better, faster and cheaper, and I think producing clearer and more predictable results.

Now, with respect to small rate cases, the Board has not had a single one since it first adopted its guidelines in 1996. My top priority is to provide shippers who have smaller rate disputes a regulatory forum for resolving them. The issue is difficult and the Board must keep in mind the delicate balance between the concerns of shippers and carriers that I spoke of earlier.

I spent much of the past 16 months learning why no shippers have brought any small rate cases. Let me summarize for you what I've learned. First, it's ambiguous who would qualify for the rules. Second, there are no limits to the discovery process. Third, the current small rate standard is unclear, ambiguous and under legal challenge.

I believe we can address many of these concerns. Some certainty can be brought to who would qualify, so that if a shipper met the test, he would automatically be eligible. And the discovery and resolution phases can be streamlined by creating a process that mirrors the speed of arbitration while still meeting under the Interstate Commerce Act.

However, identifying an appropriate rate standard is the greatest challenge. Last year at our hearing, there was universal condemnation of our current standard. But when I asked all the parties to provide suggestions on ways to revise it, none did so.

I'm pursuing every effort to make progress. A Board team met with other regulatory agencies, such as FERC, the FCC and the Postal Rate Commission, to learn how they handle smaller disputes. I'm also exploring whether the Board can enhance and expand its existing and formal dispute resolution function, so we can be more responsive to shipper concerns.

In sum, despite the importance of the issue, the Board has not moved forward in this initiative. I've decided that a new process for resolving small rate cases is significant enough that I should not take action as a single Board member, even though I have the power to act alone. When the new members here today are confirmed and sworn in, we will swiftly restart the process.

Now, another way captive shippers can improve their situation is to gain service by building a new line to a second competing railroad. I would like to highlight two such projects. First, the DM&E Railroad seeks to build into the Powder River Basin in Wyoming which will provide another rail option for coal shippers in the Midwest. Second, the BNSF Railroad, in partnership with the consortium of singly served chemical shippers, one of whom is testifying here today, seeks to build into the Bayport industrial area near Houston, Texas.

While build-ins can provide many benefits, they are not perfect solutions. Projects can be expensive. Construction projects can be controversial. Indeed, both the projects I have mentioned have generated extensive local opposition and spawned court challenges. Despite some recent setbacks in court, I believe construction projects are an important option and will be an important remedy for competitive issues.

Now, as the Board considers the concerns of captive shippers, it must also keep in mind the concerns of freight railroads, particularly the need for capital investment. Capital investment is a key part of the conundrum that has faced the rail industry for several generations, which is how to provide a level of service that will allow them to grow their business while remaining viable private entities.

Now, under the statute, railroads may price their services so they earn a reasonable return on the facilities needed to serve captive traffic. That is a fundamental principle of railroad economics.

But some of the legislative proposals to address shipper concerns would alter that principle. I'd like to turn to those now.

Taken as a whole, this type of legislation would fundamentally change the economic model of the railroad industry and I think it is unwise. Not a single one of our major railroads is revenue adequate, and if enacted, these bills would call into question the continued viability of our freight rail system. While some shippers might realize short term gains from lower rates, in the long run statutory changes of this type could significantly degrade the freight rail network to the detriment of all its users.

The supporters of these bills would not be calling for this legislation if the Board had interpreted certain provisions differently. I understand that. But to me, the individual provisions are less significant than the concerns that give rise to this legislation in the first place. And I have worked to understand them.

First, many shippers neither have confidence in the Board as a regulatory body nor feel it is practical to bring a case before it. Recognizing this, I have worked to address these concerns in a number of ways. I have taken several concrete steps to change the perception of the Board, including restoring regular voting conferences, holding hearings on significant cases and matters, and oral arguments on large cases.

I have helped railroads and their customers informally resolve their disputes. In fact, I have had the opportunity to work with several of the witnesses here today in those efforts, including Mr. Platz and Mr. Strege. In one situation, I hosted meetings with the Governor and shippers from North Dakota and the senior management of the railroad to address the delays in moving grain. As a result, the parties agreed to a number of measures to address the problem and work off the backlog.

I believe we can do more in this regard and consider this behind the scenes approach a model for resolving problems. However, the Board must still be an effective regulatory forum for adjudicating rate and service issues when informal means won't work. Because of the problems with our current small rate case guidelines, arbitration is often suggested as an alternative because of its speed and simplicity. I oppose arbitration, because those proceedings are outside of the strictures of the Interstate Commerce Act and would likely produce inconsistent results.

In all of our national network transportation industries, whether trucking or aviation, we have national rules and arbitration would alter that. But I think the Board must develop a small rate case process to address these shippers' concerns, and as I indicated earlier, I believe we can do so.

But in doing so, we must recognize that the economic relationship between shippers and carriers is complex. Shippers may have facilities which are both captive and competitively served and ship to numerous destinations on several railroads. While the legislative proposals seek to simplify the shipper-carrier relationship, in reality they are enormously complicated and not easily understood. Many shippers do have economic leverage with railroads when the totality of their business dealings is considered, and the legislation takes no account of this reality.

Second, many issues between shippers and railroads arise because of the way shippers are treated by their railroads. They assume railroads act this way because they are monopolies, and that by introducing competition, railroads will be forced to be more responsive to them. I continually impress upon railroads the importance of operating in a more customer responsive fashion. While their senior leadership understands this, that attitude does not always translate through their entire organizations.

The good news is that the rail networks do work with their customers to improve efficiency and take costs out of the supply chain. But this is not common enough, and must become the norm and not the exception.

Finally, the economies in certain areas of the country, in particular the upper midwest, are disproportionately depending on a single rail carrier for economic health. The Board must pay close attention to unique sets of concerns in that part of the country. But the issues faced there are longstanding, complex and not easily resolved. However, attention and not legislation is the best way to make progress and while attention may not solve every problem, significant progress is possible if there is communication and focus as I talked about earlier.

In conclusion, I believe that the Board can and will do a better job to address the concerns raised by captive shippers. The reforms outlined today and not substantive changes to the law are the best way to address the concerns raised by captive shippers while maintaining a healthy, private freight rail network. It is a difficult balance but one that can be achieved.

I appreciate the opportunity to be here today and discuss these important issues, and I look forward to any questions that any of you might have. Thank you very much.

Mr. QUINN. Thank you, Mr. Nober. Thank you very much.

I'd like to get a couple of just housekeeping affairs taken care of. I'd like to ask unanimous consent to allow 30 days for members to revise and extend their remarks and to permit the submission of additional statements and materials by witnesses. Without objection, so ordered.

I'd also like to ask now, even before he arrives, for unanimous consent to allow Mr. Baker to participate in the hearing this morning. Without objection, so ordered. Thank you very much.

Welcome, Ms. Brown. I'm glad you could be back with us this morning.

Mr. Nober, thanks for your testimony. This whole idea of captive shippers is one, of course, that interested me a couple of years ago, even brought me to the point of introducing legislation. And then with the help of a lot of people, many of them in this room, we arrived, on the full Committee and the Subcommittee, at some solution, so I'm intrigued by your interest and your action with these informal discussions that you talk about, the behind the scenes discussions, if you will, that solve some problems, and as you point out, of some of the people in this very room this morning.

How far can you, well, let me back up a little bit. I think that's the best way sometimes to solve these concerns, but I'm always a little bit concerned about what's public and what's private and if someone wants to know the discussions, the contents of what was discussed, or one of the parties decides it's not a good solution and they object, and so on and so forth. I don't want to tie your hands or the agency's hands to not do that kind of thing.

But how much of it is public, how much behind the scenes can you do without getting into the area where you're not open enough, open meetings laws, all those sorts of things? Can you comment on what you're doing in that area? Because I think it could be very successful. I'm not trying to stop it, but I want to make sure maybe we do more of it and it gets a little bit more formal.

Mr. NOBER. Certainly, Congressman, and that's a very good question. I think the answer is, it really depends upon the circumstance and the particulars of the case. If it's an instance like we had with North Dakota where we're meeting with public officials, and I'm a public official, as is the Governor, those are to a certain extent public. The Governor's schedule is public, mine is public. So you can't hide the fact that we are meeting.

On the other hand, we are allowed, as you are, we are allowed to have meetings where the discussions are confidential among the parties. What we did in that situation was the parties discussed what was going to be said and who was going to say it. The one ground rule I normally have is that I don't want to be talking about things. I don't feel that if we do them, my putting out a press release trumpeting what we did is the best way to make progress. The parties in that circumstance went to North Dakota, they held a press conference, they talked about the outcome of the case and I was very pleased about that.

In another circumstance involving some other folks, it was completely private. I called the two CEOs and urged them to speak and they did and I think were able to address some issues that some of their staffs weren't able to. And that was very positive.

I get calls on a daily basis from people asking me to help in these kinds of things, as you all do. It's one that, you have to look at it situation by situation.

On the other hand, sometimes people don't want to be helped. I was recently dealing with a group of shippers and one of them raised what I thought was a very legitimate problem. I asked if they had called the railroad and they said no, and I offered to do it on their behalf and they said they didn't want it. I don't know what to do in that circumstance--where if you don't call the railroad and you don't want us to intervene on your behalf. Sometimes you can't always help people help themselves.

Mr. QUINN. Right.

Mr. NOBER. Not everyone wants to come to the Board, and I understand that. But much of it is personal. When I give a personal commitment to help, I mean it and I think have done so in every case.

Mr. QUINN. Here again, I don't want to discourage this. In fact, I'm more on the side of trying to encourage it. That's what you're there for, in bigger, larger rate cases where it's very public and we need to take minutes and produce a document of records and all the rest. That's perfectly fine and that's the way it should be. And you're right, public officials like Governors and yourself and myself and others, once you're in a public domain, that is public and it must be.

But I would, maybe this is a discussion for a later time with the Subcommittee, for example, we've discussed the whole issue of security more than once with the Subcommittee. We've discussed it openly here, and we've also discussed it where it's not been in open forum, if you will, only because it's talking about security and a lot of those things shouldn't be discussed there.

So it's a fine line, and I don't want you to think by this line of questioning I'm discouraging it, in fact, I'm encouraging more to happen because what you've done or what you're doing is solving those little problems before they become bigger problems.

Mr. NOBER. Another example, Mr. Chairman, is, I was recently in Houston and meeting with some officials there about concerns they have about the Bayport project that I talked about earlier. While I was down there, it turned out that one of the big problems Houston is having is with the operation of trains in the city, blocking crossings, idling near schools.

Again, I offered to help facilitate some discussions. I spoke to senior officials of the two railroads down there and just to set up a process where the city officials and the railroads can begin to identify, these are the places where the problems are and what are the causes of it. There are a lot of causes for it.

But that's again, not a public function, but just to try to help facilitate those kinds of discussions which really ultimately, we're not going to be a part of them. I mean, we'll be a part of them, but it'll be between the railroads and the city to try to address these. I think that some progress can be made. We'll see how much.

Mr. QUINN. From my perspective, I think it's right on, and I think as an objective third party, many of these situations, that's all they really need, is that objective third party. And you have done it alone, and when you get a couple other board members over there, who knows, maybe you can solve all our problems out there with these behind the scenes discussions.

Mr. NOBER. As you see, a lot of times it does just need a little bit of a push to get a dialogue going.

Mr. QUINN. Exactly right. Well, thank you for doing that. Maybe after today's hearing as your full board comes together we can talk some more about that. I think it's an important one, and I also think it's appropriate, it's exactly why you're there, among a whole host of other reasons. But in my mind, that's one of the reasons you're over there. So thanks very much.

I yield to Ms. Brown now for either opening statements, comments or questions.

Ms. BROWN. Thank you.

First of all, thank you, Mr. Nober. You're over there by yourself and hopefully we can soon send you some assistance.

Mr. NOBER. That's the hope, I hope very quickly.

Ms. BROWN. I want to also thank you for agreeing to convene with me a town hall meeting in Jacksonville. I think we're still working on the date, but I think now more than ever, we need to have that meeting. Because I'm very concerned about overall security as far as the railroads are concerned, both threats from foreign sources and also from the results of downsizing the industry, and whether or not we're cutting back to the point that we're jeopardizing safety. So I'm looking forward to that town hall meeting.

Mr. NOBER. I am, too, ma'am.

Ms. BROWN. I have a question. In your testimony, you noted that the stand alone cost method of analyzing railroad rates is both complex and expensive. Could you explain how this method works and if there is an easier or less complicated approach?

Mr. NOBER. Sure. Probably any method, I can answer the second one first, any method would be less complicated.

[Laughter.]

Mr. NOBER. But essentially, a standalone, it's very, very complex in its application. But the principle is very simple. When you're a captive shipper, what we look at is, the measure is, is the rate being charged to captive shipper reasonable. And railroads are allowed to charge them more than they would charge other customers, so how do we measure that.

What the stand alone cost test does, it says, can that shipper basically construct and operate its own railroad, serving it and other related traffic, cheaper than the railroad is providing it. So if you can build and operate your own railroad for less than the existing railroad is charging you, the rate gets lowered down to that level. And then there's a floor which you can't go below.

Now, there's a number of, any number of complexities, almost an infinite number as to how you build and operate the railroad, because running a railroad is a complicated matter. But the fundamental principle is fairly simple. The problem is that the standalone cost, it addresses certain kinds of concerns. If you have a lot of volume, like any transportation asset, the more you use it, the less the cost per use is, because you've got to put all this cost into it.

So for smaller shipments or for shipments that are going a lot of places, where you don't have a lot of traffic on a set route, standalone cost isn't really a good measure, and secondly, it's very, very expensive to put one of these together. There are armies of lawyers and consultants that have to work on these cases. As I said, I think the $3 million and $5 million estimates of these cases are probably under. I think they're probably more than that. I often think I'm probably on the wrong side of the dais when we hear these cases, if that's what they cost.

But it's very, very expensive. If you're not looking at relief that's going to be imposed for 20 years, like a coal shipper would be, and it's only for a year or two, it's just not practical to spend $3 million or more to put on one of these. You'll hear some shippers today talk about, some of the later panelists will talk about what it means to put a case on. They'll tell you, it's a very unsatisfying process.

Now, there are some different ways of looking at it. One is to look at different measures, a different rate standard. Right now we have one that looks at several measures. It's very unclear as to how it would be applied, because the standalone cost method is what the courts like. That's what the D.C. Circuit has approved, and that's what they think is our preferred method, because it allows for differential pricing and not for averaging.

What the courts say we can't do is come up with something that looks at the average rate and pushes everybody to it. That doesn't take account of the railroads need for differential price, so we can't do that.

A lot of folks would like to see us do that. The legislative proposals essentially do that. They say, we look at what the average for competitive rates is and that's what you get. And if the Congress does that, it certainly would be legal, but we can't impose anything like that.

So we are looking at different ways of either clarifying the different measures and standards to take care of this averaging problem, or looking at simplifying the stand alone cost procedure. We have internal measures in place that create averages, that look at the average railroad cost for any number of things, more measures than anyone can think of. What happens is in the stand alone cases, everybody likes to adjust those. There's an enormous amount of complexity and the cost of it is taking the average measure for the average railroad and saying, well, what I'm doing is not the average, it's cheaper than the average, so I want to get an adjustment for that.

If you just went to the average and looked at simplifying this act, that's another option. So I think there are a couple of different ways of looking at it, but you've asked a very fundamental and difficult question, Congresswoman, and I think if there was an easy answer, 20 years later somebody would have figured out a way to do it.

But I do think there are different things that can be looked at. I'm looking to the guidance of the two new members to help solve this. This is what they're going to put a lot of energy into. But I do think there are ways of simplifying it. You can't completely simplify it, because we are limited by what the courts say. I'm sorry for the long answer.

Ms. BROWN. Thank you.

Mr. QUINN. I want to welcome the other members of the Subcommittee who have joined us here this morning. Mr. Moran, do you have questions for the witness?

Mr. MORAN. Mr. Chairman, thank you very much. Mr. Nober, thank you for joining us.

What percentage of shipping actually involves captive shippers?

Mr. NOBER. About 80 percent, I'm going to guess now, about 80 percent of all plants are singly served. But a very small majority of those are market dominant, they don't have options with trucking or—but I think about 15 or 20 percent of all movements are subject to our jurisdiction, meaning they are captive shippers and there's market dominance. So even though most are singly served, truck is a viable option.

Mr. MORAN. Are there characteristics of those circumstances that exist as a geographic, either located in rural areas, is there a way to pinpoint where the captive shipper problem exists?

Mr. NOBER. I think there are a few general categories of captive shippers. The first are power plants, coal-fired power plants, which use enormous amounts of coal. They'll have, I was visiting a plant in Texas that got three 110-car trains, which are a mile and a half long, every two days. So it's usually, they're one category of captive shipper, and I think you have a witness from a power plant today.

The second are large industrial plants, chemical companies, cement plants, things like that that ship a lot of bulk shipments long distances. That's another characteristic of rail movement. Plastics plants, for example, moving plastic pellets, I visited two last week. Or some types of liquid chemicals. So that category, industrial plants very often are captive as well.

Then the third category would be agricultural movements. In certain parts of the country, large grain elevators and milling operations, where they're not near rivers and trucking is really not an option to move it long distances, to port, for example, where you're moving big, big volumes of heavy, relatively low value per pound, but just large volume is another sort of category.

So I think those are the three basic groups of captive shippers. Then there are lots of others, you have the occasional auto plant, and there will be individual types, ports, other types of facilities. But they're more on an ad hoc basis.

Mr. MORAN. How serious of a problem is generation of capital for the rail industry?

Mr. NOBER. I think it's a very serious problem. The railroads, on the one hand have too much infrastructure, they are abandoning lines, and on the other hand have too little. That's because their networks were laid out 100 years ago during the Victorian era. The freight flows in the 21st century don't necessarily match the freight flows in the 1890s or the 1880s. In one case I was looking at a line that was pre-Civil War. And adjusting the modern economy and modern demands in the rail system to its antiquated, to the networks that were laid out 100 or 150 years ago, that's the part of it that's expensive.

For example, one eastern railroad has quadruple tracks between the coal fields in Appalachia and the port in Norfolk to move export coal. The problem is, there's one-tenth the amount of export coal that was moving when they built the railroad.

On the other hand, the main intermodal shipments coming from the Port of Los Angeles on the west coast to the northeast go up the Shenandoah Valley line, which was built before the Civil War, that winds through and was never meant to carry heavy volumes. But that's the most efficient route to carry intermodal traffic. Today that railroad would like to have them flipped, they could use a single track going to the dock and they would like the quadruple track carrying intermodal traffic. But a railroad costs $2 million or $3 million a mile to build, and double tracking it is expensive.

Mr. MORAN. Has the passage of the Staggers Act resulted in reduced freight rates?

Mr. NOBER. Oh, it certainly has. Freight rates have come down in real terms for the past 20 years. In fact, one of the concerns railroad has, one of the problems railroad has is trying to have price increases match their increase in costs. Freight railroads have gotten very efficient, they've passed on their cost increases and almost all of these, as with many transportation companies, trucking as well, have been passed directly to their consumers.

Mr. MORAN. And finally, it seems to me your testimony, your conclusion as I read it and heard it, but just listening to your testimony as well is that you need to change the way you do business and the way you hear cases and the complexity and the difficulty in bringing the case. But at this point, have no request of any legislative changes from Congress to address this issue or your ability to do that. Is that accurate?

Mr. NOBER. I don't think substantive legislative change is the issue. There are a couple little legislative matters that would help, but really it's a matter of our agency working out its process in a way that passes judicial muster and makes it practical for the parties to bring cases.

Mr. MORAN. And your testimony is that if you had a practical, if there was a practical way of bringing cases before you that you could address and resolve to some satisfaction the issue of captive shipping?

Mr. NOBER. What we could be is a forum of last resort. I wouldn't want, every time there was a dispute between two businesses that they would run to our agency on the one hand. But on the other hand, if things break down to the point where they cannot be fixed and it has to be resolved by somebody else, there ought to be a forum for those to be heard. And right now, you can't go to court under the law, you have to come to our agency and we have to provide a forum where that can be. I think large rate cases, while, as I said to Congresswoman Brown, are very unsatisfactory, they are a model in that sense, in that when things get so bad, you do have a place to go. We've had about 15 of those cases over the years. The shippers have won 10, the carriers have probably won 5. So it's a crap shoot what happens when you come to us, but there is a place of last resort, and there isn't right now for small cases. I think we need to fix that.

Mr. MORAN. Thank you, Mr. Chairman. Thank you, Mr. Nober.

Mr. QUINN. Thank you very much.

Mr. Simmons, questions for the witness?

Mr. SIMMONS. Yes, Mr. Chairman, thank you and thank you for your testimony. I apologize for being late, but I think I've ready most of what you had to say about H.R. 2924, which is the Baker Bill introduced last year, designed to address the issue of bottlenecks and of some rail shipment customers who feel they've been isolated and subject to unreasonable rail rates for a variety of reasons.

As I understand your testimony, you feel this legislation is unwise, I think, to use your word. And obviously speaking for myself, I have no interest in doing anything to degrade the overall health of our freight rail system, because I think it's usually important. By the same token, representing a New England constituency where there is not a lot of competition in freight rail, and where those costs place some of our larger customers at risk of simply shutting down their operations, because the alternative to rail is costly and inadequate, I guess I feel I'm caught between a rock and a hard place.

As I understand your testimony on page 19, you have attempted to increase the transparency of your operations and to serve as an "informal facilitator" when shippers and carriers have difficulties. Is that something you've done more than just in the Dakotas? Have you responded to requests from New England folks when they need a little bit of informal facilitation?

Mr. NOBER. When they've made them, we have. We recently had a matter, last fall in New Hampshire, where a short line and the sort of large regional railroad in the region were having a dispute about serving some plants on the short line's route. I dispatched one of my staff, who's here today, up to be a mediator in that case. We thought we had made a lot of progress and had resolved it, but it turned out in the end that one of the parties didn't want to settle it and they brought a proceeding before us.

I don't think any of the shippers in New England have come to me, I'm not aware of any with any particular issues, we've had a number of issues in New England looking at trans-load facilities and they've been controversial, particularly in Massachusetts. But if anyone from New England did come, we certainly would go to address it. I'm from New England myself, so it's always good to have to go there.

Mr. SIMMONS. And would your informal facilitation extend to disputes between freight rail and Amtrak or the use of Amtrak lines by freight rail, again a problem in New England?

Mr. NOBER. It has. We had an issue that did not become a formal one between VRE and Amtrak. We have had an issue in between Boston and Portland involving Amtrak on freight rail. And we had both a formal and informal proceeding. We were taken to court on that one. So sometimes informal issues go all the way up to the D.C. Circuit.

But where it's appropriate, we can do that and we will do that.

Mr. SIMMONS. Are you aware or have you been approached by Providence and Worcester for their problems with Amtrak rates?

Mr. NOBER. I don't think that I have. I'll ask staff if it has gotten to the board yet. No, it has not.

Mr. SIMMONS. That being the case, let me just say that from what I'm hearing, the informal facilitation is very useful.

Mr. NOBER. It can be.

Mr. SIMMONS. I appreciate that, and you may be hearing from my office shortly.

Mr. NOBER. I'd be happy to help.

Mr. QUINN. Tank you, Mr. Simmons.

Ms. Carson, questions?

Ms. CARSON. Thank you very much, Mr. Chairman.

I have to beg naivete here, I'm new to the Committee. I always use that, even after 40 years. I'm new to the Committee. Maybe if I hold this up, you can understand what I'm talking about in terms of the routes and the rates and stuff like that. I get information that—could you briefly summarize why the small rate cases have been brought before your board? And why there is a restriction on competition in terms of a consumer getting a competitive price in terms of movement—do you know what I'm talking about?

Mr. NOBER. Sure, yes, ma'am. Let me start with the small rate cases. What I've found is there are three reasons why people haven't brought small rate cases. The first is that they're afraid that the railroads would spend a lot of money and time arguing over who even gets, whether it's a small rate case at all. So while you get to bring a faster, cheaper process, if you're a small case, you have to spend a lot of money and time debating whether you really are a small case or not. And the shippers don't want to do that.

Secondly, even if they were a small case, how we would judge it is unclear, because the standards we have are very fuzzy. So nobody knows how much preparation you'd have to do, and how much information you'd have to get from the other side and how much analysis, and that that could wind up snowballing into becoming large and expensive because of the uncertainty of it. Without having a whole lot of cases to look at for guidance, it was a great deal of uncertainty. That's another fair point.

The third one is that we have a standard that has three different measures to it, and we don't say and have never said what weight we would give to each and how we would use that. And that's kind of a role of the dice. Now, I've had other representatives of shippers sit there and say, well, the reason we've never brought a case is we're not certain that we would win. And I've said, well, you're never going to be certain that you would win, so if that's what you're waiting for, you're going to be here for a while.

What we should have is a fair process, one that gives a reasonable chance of winning, but by no means guarantees anyone is going to win, and that's just not what—if you have a good case, you'll win, and if you don't have a good case, you won't. So that's why I think no parties have brought small cases. But you'll have several of the parties who contemplated them and didn't bring them testifying later. They can rebut what I've had to say. But I've spent time with all of them.

Secondly, I think what you are saying is that if a carrier is singly served and a shipper is singly served and there are two railroads nearby, how come we don't let the other railroad on the first tracks and serve them. Is that the question?

Ms. CARSON. Or at least allow some understanding about price.

Mr. NOBER. I think the reason for that is, these are private networks. What some shippers are after is kind of the best of both worlds. What they want is from, where two railroads meet and there's competition, they want the benefit of that competition. So the two railroads will compete for the business and come up with the best price. Then on the remaining portion that only one railroad serves, they say, well, we don't want the market to set that rate, we want there to be strict rate regulation and a limit on how much they can charge on the end piece.

So they want regulation on the part, on one part, and then they want competition on the other part. Either you have regulation the whole way or you have market based the whole way. And if you have market based the whole way, they may not like what they get charged for the last few miles. I think that's just a fundamental principle of how the railroads work.

We don't prevent any shipper from getting a quote on that part. What they have to do is show that another railroad is willing to provide the service and willing to give it to them, and if they have a contract, fine. And then we'll require the other railroad to just quote them a rate on the little part.

But we normally don't tell—we let the market set these relationships. The one railroad that owns the last few miles doesn't want to just carry it the last few miles, because it's expensive and they lose money on that. They want to carry it the whole way and that's how they want to price it. Our doctrines have let them do that, unless they could show another railroad would carry it.

That's not a satisfactory answer to a lot of people, and I understand that. But that's why we do it.

Ms. CARSON. Okay, I want to understand, now. You do not permit a potential carrier from finding out how much it would cost on their track to deliver something to a certain point, unless they already have a contract signed with the other rail?

Mr. NOBER. Correct, ma'am.

Ms. CARSON. Well, why is that? If you are going to go out and buy a car—and I know that railroads and cars are different—but if you are going to go out and buy a car, can't you sort of shop the market to get some price before you sign a contract to see what is best for you and your purposes? Isn't that the marketplace rule of operation?

Mr. NOBER. Again, I think that the shippers that want to see that, they don't want the market to just work, because they want the market to work from the point where two railroads start—you know, the two railroads come together—and go forward, and then they want us, our Board, to strictly regulate the remaining part. So they don't want the market to set the remaining part of the rate. They want that section to be—that small section to be governed by strict price regulation, so that you can't overcharge, in their view, overcharge. If shippers just wanted the market to set the rate, then you get a market rate from the junction point on and you get a market rate on the small segment, as when you want to buy something that's popular and there's a small supply, you've got to pay more for that. I remember going to buy a car that they said, adjusted market value, and I said, what the heck is that? They said, that's when they charge you more than the sticker price because a lot of people want it.

Ms. CARSON. Do you have the flexibility of not setting the rate per se and just allowing the consumers to get the best price?

Mr. NOBER. They could, but—

Ms. CARSON. Without you injecting price controls or costs or any of that?

Mr. NOBER. We do have price controls—

Ms. CARSON. Just allow the consumer to find the best product for the best price without you saying, if I want to buy a Chrysler product here and there, well, you can't charge any more for this car than you can charge for that? That market works for itself. And it's perpetuated by consumer demand. And you get what you get, what you bargain for, right?

I don't want to belabor the point, but—

Mr. NOBER. It's a fair question, and deserves a fair answer. If I haven't clarified it for you, I should. Under the law, there is rate regulation on the small piece of it. So even if we said, okay, you've got to get a rate on just the small piece of it, that's not a market rate. That's a rate subject to caps under the law. So the shippers who are after this are saying, what we want is a market rate from the point where two railroads come together and there are two railroads serving it. But we want a capped, regulated rate on the small piece of it.

So if the whole thing is going to be at market, I don't know how we would do that, but that would be a different situation than the current one, which is, if we did what the shippers are asking for, if our decisions changed it, then they'd be getting a rate subject to a rate cap on one piece of it and then a market competitive rate on the other. That's, I think, having it both ways.

Mr. QUINN. Thank you.

Thank you, Ms. Carson.

It's likely that some of your informal discussions and behind the scenes discussions might be helpful for Ms. Carson.

Mr. NOBER. We'd be happy to explore it further.

Mr. QUINN. Me too. Good question.

Mr. Nober, I have one more question, at least from my perspective, and it deals with the court case involving the STB licensing of the new construction lines of the DM&E Railroad. Evidently the STB was ordered to further analyze the environmental impacts of the commodity that's going to be transported. Instead of just studying the environmental impacts of the project itself, you've got to project the amount of coal that's likely to be transported, and then whether or not that coal might pollute the air when it gets to its destination, if I understand it correctly.

So that seems to me almost like trying to predict how many potentially polluting products a truck might haul on a road that hasn't been built yet. And I may have missed the point. So I guess I would ask you, is that—do you think you'll be able to do that, number one, and number two, are you able this morning to let us know if you're going to appeal the Eighth Circuit ruling?

Mr. NOBER. First of all, Mr. Chairman, you have not misunderstood it. It's a very disturbing development. If there is any one thing that I believe in, it's not letting overly expansive environmental review be the stop of transportation projects. And in this one, we did a 2,000 page, three-year study of the environmental effects of this rail line. And there was—down the line, it was being built from near Rapid City, near Mount Rushmore, into northeastern Wyoming. The folks who were very upset about it were 500 miles away, down the line in Rochester, Minnesota, at the Mayo Clinic, where they were concerned that if this were built and coal was going to be carried, these trains were going near the Mayo Clinic, a legitimate concern.

These groups from that part of the country appealed, and essentially raised 50 or 60 different grounds. The court, I think, was very praising of our environmental review, but sent it back to us on three issues. The first two were typical for transportation projects, it was, we didn't look at train noise and vibration from going by, and that's fair and we didn't look at the effects of blowing train whistles in Rochester, that's fair too, and we'll look at both of those and we'll do a better job on those.

But the third issue that you raise essentially goes like this. The court said, the new rail line will increase the supply of coal coming out of the Powder River Basin. And if you increase the supply, it will reduce the price. If you reduce the price, you will increase the demand, and if you increase the demand, you will increase the amount burned. If you burn more coal, it will pollute more, and you go figure out how much that is and model that.

Now, I think we had talked extensively to the Department of Justice and DOT, and that is the first time any agency has ever been asked to look at what is the effect of the commodity being carried, as you indicated, as opposed to just the road or the airport or the rail line. We did appeal to the Eighth Circuit already and we went for reconsideration.

I'm pleased that very many in the industry joined in on that, and in fact, the Edison Electric Institute and the American Association of Railroads joined together on a brief, which I don't think they agree on anything. But they were able to file on that, which speaks to the gravity of the situation. Two of the competing railroads that serve the Powder River Basin now have joined on a brief, even though this project would compete with that, because the principle is so important.

We will look at the court's decision, which I think leaves a little bit of ambiguity as to exactly how much of this review needs to happen. It's ongoing, we've been meeting with the Department of Energy and the Energy Information Agency and EPA to try to get some folks who are more experienced with air quality modeling than us to help. It's one that will be a big drain on our resources, unfortunately. I think it's the wrong approach, but I'm sworn to uphold the Constitution, and we'll do what the court asks us to do. But it's not a step forward for transportation.

Mr. QUINN. That's that way I look at it myself.

How about timing for this now, if you're in the process of preparing more information? Has the court given you a time line to follow?

Mr. NOBER. They have not. I think that much of the timing is dependent upon the project proponents, the DM&E has to hire a consultant and get going. There have been six months and they're slow about it. So we want to urge them to get moving, and I've called them in, because it's an important principle.

Mr. QUINN. Sure.

Further questions for Mr. Nober? Mr. Simmons?

Mr. SIMMONS. One further question. I understand that you regulate the process of giving up certain rail lines that the freight rail carriers no longer wish to operate, and that in many cases these move into a rails to trails type of situation. What happens to a land owner who may own property on both sides of the right of way who, for perhaps many years has encountered a situating where there's been little to no rail traffic, but now is confronted with a situation where there may be substantial public use of these lines that encroach on private property, private dwellings? Does that landowner have some appeal rights under your board to appear and to testify and request being made whole? That's question one.

And question two is, in the average of cases that you deal with, are those rail lines rights of ways or is the land under the rail condemned and purchased by the rail operator, the freight rail operator?

Mr. NOBER. Let me start with the first question, Congressman. Our role, converting rails to trails is governed by the Rails to Trails Act, which is, I'm not sure it's even in this Committee's jurisdiction. I think it was the Resources Committee. Our role in that is a ministerial one. When a party wishes to convert, when somebody wishes to see an abandoned railroad, or a railroad in the process of being abandoned converted to a trail, they petition to us for a condition of trail use. And we really don't have a lot of discretion in the matter. If they ask us to set that condition, we do.

What that gives them, the people who want to make it a trail, is the right to negotiate with the railroad for a trail use agreement. And if they are able to reach it, what that does is that rail banks the line as being held for transportation purposes. And we have had circumstances where railroads that have been converted to trails have been reactivated as rail lines. A lot of times people who use the trail are very unhappy about that, but it's happened three or four times, that traffic in a new plant has gone in and they've said, we've got this corridor and we're going to put a rail line back.

So I think the legal status of it is that it is rail banked. Now, there have been court cases in the court of claims that have said that once these are turned into a trail, the property owners who may have owned the land and the railroad had an easement, that those are still valid and these are no longer rail lines, it's not being used for rail purposes and therefore it's taken, and they can go and appeal for compensation. That is a somewhat controversial aspect of it.

Our agency is not the one that would determine whether or not they are due compensation or not. Under the law all we can do is say, if somebody wants it to be a trail, we'll grant the trail use condition, and we do probably on two thirds of the abandonments we get, we see that. So that's typically how the trail use works.

Mr. SIMMONS. And typically, do you encounter that those rail lines are rights of way over private property or are they at some previous date, is the land on which they operate condemned and purchased by the rail operator?

Mr. NOBER. Sometimes they are easements. Sometimes the railroad owns it. Sometimes it can be parcel-by-parcel; some of them they were able to buy, some of them they purchased easements on, and I think there is no real set pattern to that. It is kind of a mishmash. As I said earlier, these were laid out oftentimes 100 or 150 years ago.

I will say that I think there are very few landowners today who were alive when the easement was granted, but if there are any, they should stand up.

Mr. SIMMONS. As you know, I am from New England, where the rails have been around for a long time. In fact, the first interstate railroad in America came to my home town in Stonington from Providence, Rhode Island. But those differences involving the ownership or the terms of the right of way, do those have any impact on your decision? Or are you saying that those factual details apply more to the decision of the Rails and Trails Act.

Mr. NOBER. The latter. It wouldn't make a difference to us in granting a trail condition whether or not it was an easement or the property was owned. We are not given that discretion.

Mr. SIMMONS. Thank you.

Thank you, Mr. Chairman.

Mr. QUINN. Thank you.

Ms. Brown?

Ms. BROWN. Thank you. Short line railroads are potential competition for Class I's, but many are constrained by agreements that they signed with the large railroads when they were first created. Aren't these agreements contrary to the public interest? Don't you agree that phasing out these paper barriers, as provided for in H.R.

2924, would promote competition and solve many of the problems that shippers face today?

Mr. NOBER. Congresswoman, I know there are a lot of short lines and folks who are located on the short lines who would like to see any restrictions that were placed, when those rail lines were originally sold and purchased by the short lines, very often they contained restrictions saying that you can only give your traffic to the Class One that it connects to. And many shippers feel that, even though those short lines may cross another line, that that barrier prevents them from getting competition. And that's a legitimate concern.

However, what you see is that when these short lines were first sold, they essentially were sold for a much cheaper price, because those barriers were in place. And very often, what happens is the short lines are given two options. They can pay more for one without the barrier or less for one with the barrier. And a lot of times, the short lines say, well, what the heck, we'll just take the lower initial cost to get the rail line up and running.

And what you see is sometimes many years later they've been very good businesses and done a very good job and say, well, even though we paid less for it in the beginning, we'd like to undo that.

So I think that requests to look at transactions that occurred in the past and undo these barriers would be very, very difficult and one I would have a great deal of difficulty doing. Now, going forward, you say—I'm sorry.

Ms. BROWN. Just one point. Doesn't that go to the question that in many areas there is no competition?

Mr. NOBER. It can. There can be in that circumstance, or usually the folks who are complaining are just circumstances that Ms. Carson identified, which is, there's a shipper on the line who's served by only that short line, and they want to have the ability to go from the short line to any of either of the two big Class Ones in the region. But again, the whole reason that line may be in place and may be operating is because that short line bought it at a cheaper price in the beginning.

That's a market transaction, where the carrier—that's not the case in all short lines and all paper barriers. And I confess that there are the occasional paper barriers that come to me that are very frustrating. But it's very hard to go back to contracts and transactions that are 10 or 15 or 20 years old and change the terms of them.

Ms. BROWN. Let me ask the question, so it's open ended, there's no ending to it?

Mr. NOBER. Sometimes.

Ms. BROWN. Could that not be a problem?

Mr. NOBER. It depends.

Ms. BROWN. How do you renegotiate? What kind of relief? That's part of the problem.

Mr. NOBER. The short line could buy its way out of the paper barrier. They could pay more for the right to move the other traffic. It was a free market decision. What happened is many times the short lines were in such bad shape and the carriers didn't have a lot of capital that they were offered a bargain basement price on the line, if not given away, in exchange for their right to have it.

I think Class Ones have many times used short line spinoffs as a way of creating a feeder network and the short lines get the line for free.

So in retrospect, looking back, if they did a good job and promoted the business, you say, well, that was wrong. But they might never have gotten the business off the ground if they had to pay a higher price in the first place.

Ms. BROWN. The last question in that area is the short lines are in need of additional funds to help upgrade their tracks, because the trains are getting heavier. Where are we as far as getting resources to assist those short lines?

Mr. NOBER. I worried about that for a long time. I know there are legislative proposals to do that. And I know you all are evaluating those and have a bill on the Floor that spends an awful lot of money on capital and you all are making a judgment as to whether to include it there or in another forum.

Mr. QUINN. Thank you, Mr. Nober. Thank you, Ms. Brown.

Ms. Carson, do you have a final question? No questions. Mr. Nober, let me thank you on behalf of the Subcommittee for your testimony today and for your answers to questions as well.

I also want to take just a quick moment to welcome some students from the Close Up Foundation who are here with us watching today's proceedings while they're on the Hill for about a week. We're happy to have them stop in to join us and talk about railroads a little bit—although you're not allowed to talk.

[Laughter.]

Mr. QUINN. You're allowed to be here, and we're glad you're with us.

Mr. Nober, thank you for being with us, and we'll go to our second panel.

The second panel that we'll move to consists of Mr. Ed Hamberger, the President of the Association of American Railroads and Mr. Richard Timmons, President of the American Short Line and Regional Railroad Association. Welcome to you both, thanks for being with us again this morning, gentlemen. We have received your written testimony, as always well prepared. We remind everybody that we're going to ask you to keep your oral presentation this morning to about five minutes each. And after we've heard from both of you, we'll entertain questions from the Subcommittee.

Mr. Hamberger, you're on our list first. Would you like to begin, sir?

TESTIMONY OF ED HAMBERGER, PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS; AND RICHARD TIMMONS, PRESIDENT, AMERICAN SHORT LINE AND REGIONAL RAILROAD ASSOCIATION

Mr. HAMBERGER. Thank you very much, Mr. Chairman. Mr. Chairman, Congresswoman Brown, members of the Subcommittee, thank you on behalf of the Association of American Railroads for the opportunity to appear here today to discuss issues related to freight rail regulation.

Before I begin my prepared remarks, I would like to join you, Mr. Chairman and everyone else, in offering my congratulations to Frank Mulvey for his nomination and hopefully his soon to be confirmation. We have enjoyed working with him here on the Subcommittee, and look forward to continuing that working relationship at the STB.

The current system of economic regulation put in place by the Staggers Rail Act of 1980 relies on competition and market forces to determine rail rates and service standards in most cases. Rate and other protections are provided for those few rail shippers who truly need them at the STB. Staggers replaced a failed system of almost total regulation that had lasted more than 80 years, leaving in its wake bankrupt railroads throughout the northeast and midwest, declining market share, billions of dollars of deferred maintenance, soaring accident rates and scant improvement in productivity.

Since 1980 and Staggers, market share has increased after decades of decline. More than $320 billion in private capital has been invested to maintain and improve infrastructure and equipment. Productivity has increased 183 percent and that productivity has been passed along to our customers since average rail rates have dropped by 60 percent on an inflation adjusted basis and, as important as any statistic, train accident rates have fallen 68 percent.

H.R. 2924 and its companion bill in the Senate would reinject Government control over wide areas of freight operations with what we believe would be disastrous results. Railroads oppose this legislation and so does rail labor. Five railway labor presidents, representing over 80 percent of the work force, wrote to the Senate when the Senate was considering this legislation, saying any further shifting of the regulatory balance toward shippers would result in greater job losses and wage and benefit suppression.

Now, in a way this opposition was to be expected, I suppose. But what was unexpected was the overwhelming outpouring of opposition to these bills from railroad customers. Almost 400 railroad customers wrote to the Senate since last fall to oppose re-regulation. I submit to you that this is not a fight between railroads and their customers, but rather, a fundamental difference between some customers who cling to the belief that Government should dictate the marketplace and the rest of America's shippers, who understand and recognize how deregulation has improved service and lowered their rates.

On the one hand, there are those customers who believe the heavy hand of Government regulation should intrude by placing a cap on prices, imposing uniform pricing by severely restricting use of differential pricing, take away from the railroads the operational efficiencies of routing prerogatives, policies all designed to drive rates down and to make it impossible for railroads to ever earn their cost of capital.

On the other hand are those customers who oppose re-regulation because they recognize the strides made by the industry since 1980. They recognize that the level of supply and demand means there will be differences in pricing and that re-regulating railroads would rob them, the customers, of their opportunity to continue to compete in world markets by relying on the best freight rail system in the world.

Here is what some of our customers have written. The Alliance for Auto Manufacturers said re-regulation would "undo the progress made since the Staggers Act deregulated the railroads in 1980." The Port of Los Angeles noted that increased efficiencies and improved services have enabled the rail industry to divert significant amounts of business from highway to the intermodal option. But to maintain that momentum, the Port warned, railroads must continue to invest heavily, and re-regulation could make that impossible. We cannot run the risk of that happening, they said.

The CEO of Kokomo Grain wrote that deregulation has been a positive experience and that, "I do not want to see those gains and benefit thrown aside with a move toward re-regulation." Dyno Noboy Chemical Company called re-regulation "remarkably shortsighted," and said that in the long run, all rail users will be losers, because the inevitable result will be to devastate the ability of the railroads to continue providing their present levels of service, much less make vitally needed investments for the future.

Finally, the financial community on whom railroads depend for capital has consistently stated that re-regulation will lead to capital starvation and disinvestment. Just two months ago, John Barnes of Deutsche Bank warned, "In the beginning, there would be short term benefit for captive shippers through lower rates; however, instant gratification usually comes with a headache the next morning, and there would be no Advil strong enough for the long term damage associated with railroad re-regulation. Over the long term, everyone would share in the hangover—shareholders, customers, railroads, the entire transportation system, the U.S. and global economies. In the worst case scenario, a repeat downward spiral similar to the 1970s could occur with multiple bankruptcies that could cripple the transportation system."

In closing, let me refer you to testimony before the Senate Appropriations Committee on September 12th, 2000, from Eric Asmunstad, then President for the North Dakota Farm Bureau, who posted the rhetorical question of whether railroads should even be allowed to operate as for-profit entities. I commended him then and I commend him today for so succinctly posing the policy question before Congress. The policy question is, where does the money come from to meet this industry's huge capital investment requirements. There are only two sources, the taxpayer or the private sector.

So I would urge you today, and I'm joining with rail labor, with the Short Line Association and a large array of freight rail customers to urge you to keep the opportunity and the responsibility for earning investment capital where it belongs, in the private sector and with the railroads. Thank you.

Mr. QUINN. Mr. Hamberger, thank you very much, and we now call upon Mr. Timmons.

Mr. TIMMONS. Thank you, Mr. Chairman and members of the Committee. Let me also echo to Frank Mulvey previous congratulations and wish him a speedy confirmation in the weeks ahead. We look forward to working with Frank.

My name is Rich Timmons and I'm President of the American Short Line and Regional Railroad Association, and I surely appreciate the opportunity to be here today and for your interest in the small railroad industry which you have exhibited so forcefully in the past. Mr. Hamberger has spoken of the many successes of railroad deregulation under the Staggers Act. This Act helped spur the creation of the modern short line railroad industry. In fact, 81 percent of the total short line mileage is operated by railroads that were established after 1980 when Staggers went into effect.

These railroads have survived and prospered because of the provisions of the Staggers Act and the entrepreneurs who own and operate them. While it has been forgotten in the mists of time, creating a short line railroad industry was not the driving consideration behind this policy choice. Twenty-four years ago, almost no one envisioned the rapid growth of short lines and the economic benefits they would deliver to customers and the freight system. The real driver at the time was the preservation of rail service for thousands of rural customers that would otherwise lose their connection to the national railroad network. Rail customers were the ultimate beneficiary of our creation then and our customers today will be the beneficiary of our success in the 21st century.

Short line railroads serve over 11,500 customers. These customers employ over 1 million workers. For the majority of those customers, the short line rate is far more economical than the truck rate they would have to pay if the short line was not there. Existing truck rates are also depressed for many other customers because of the threat of a short line competitor. Short lines also benefit the larger rail network since the Class Ones harvest between 18 to 24 percent of their bottom line revenue from short line railroad business. This is a testament to the wisdom and the practical consequences of the Staggers Act.

There is no denying the existence of some disagreements between short line railroads and their large counterparts. Likewise, there are outstanding issues between some railroads and customers. Many of those issues do not have simple solutions. These may be tough issues, but they need not be incendiary issues to the degree that they impede business growth. Our industries must continue to work together, because railroads and rail customers have an equal interest in building the most efficient and safe transportation system possible. Our economy depends on it, and I do strongly believe that we are all engaged.

Although it is important to focus on areas that need further attention, and we all are, we should not overlook those things that are going well. Differences and disagreements occur in every industry. What is different in our industry is that short lines and Class Ones have spent more time than ever improving communications and relationships between the railroads in ways that result in more meaningful discussions and positive decision making on rail issues to the benefit of our customers.

Let me take a moment to briefly summarize the forums for discussion and problem resolution that are in place today which are addressed in more detail in my written remarks. At the industry level, the North American Rail Alliance and the Rail Industry Working Group provide valuable forums for the Short Line Association and the AAR to address major issues between our railroads. Each quarter, the Safety Operations and Management Committee and the Network Efficiency Management Committee work through operational, marketing and equipment questions that impact all classes of railroads. The short lines are deeply enmeshed in these committees and the process.

Each Class One railroad hosts annual and quarterly meetings with their short line interchange partners, and the short lines complement this with their own annual and regional meetings. As a new and evolving initiative, the Association conducts a confidential survey each year for each Class One railroad related to their operational and marketing performance with the short lines over the preceding year. This survey then becomes the foundation for high value problem resolution between the large and small railroad partners.

The point of all this is to highlight the extensive and continuous exchange of information between the Class Two, Three and Class One communities as they strive to develop seamless, reliable and consistent service for our customers. The American Short Line and Regional Railroad Association has also engaged groups that represent our customers, such as the National Industrial Transportation League. Indeed, one short line railroad now sits on the NITL board, and a number of short lines have recently joined that organization. By bringing customers and railroads closer, we hope to enhance communications to resolve differences and benefit our customers.

One sterling example of this cooperation is support for H.R. 876, introduced by Representative Moran and co-sponsored by every Subcommittee member in this organization that we're testifying before today. This legislation would help short lines overcome the tremendous investment shortfalls that threaten service to our customers and will make possible infrastructure upgrades for future demands. Only 18 other pieces of legislation in this Congress have amassed more supporters than the 264 Congressmen co-sponsoring H.R. 876. This bill has been successful because of the active support of short lines, Class Ones, rail customers, unions and not lastly, this Committee.

H.R. 876 represents the end of a policy journey begun in 1980 with the passage of the Staggers Act. Congress determined that rural freight service must be preserved, and short lines were the agents for that preservation. Congress should now take the final step and ensure the continued survival of these lines, not just for the benefit of railroads, but for the benefit of our 11,500 customers and our national economy.

Before I conclude, I ask permission for two articles highlighting recent improvements in short line, Class One and customer relationships be included in the record of these proceedings. Mr. Chairman, thank you very much for your time and your support. I will be happy to answer any questions you may have at the appropriate time, and again, thank you very much.

Mr. QUINN. Without objection, those articles will be included in the record.

Mr. MORAN. Mr. Timmons, I thank you very much, particularly for your comments about House Bill 876. I commend my colleagues on this Committee and throughout Congress for their support and recognition of the significant issues that the short line rail industry faces. I also appreciate, Mr. Hamberger, the support for that legislation by Class One carriers, the whole railroad industry.

Again, I hope that as we begin debate today on a transportation bill in the Ways and Means Committee and the House considers the combination of that transportation bill and the Ways and Means component that we can be successful, as interested members of Congress in this topic and seeing something is finally done with regard to preserving and enhancing the short line industry. So thank you for both of your associations' support on something that I think is awfully important not only to Kansans at home, but to Americans and the rail industry, particularly customers. Thank you.

Mr. QUINN. Thank you for your leadership. Ms. Brown?

Ms. BROWN. Thank you.

Mr. Timmons, you mentioned your support for H.R. 876, which we all support. But you failed to mention the short line railroad assistance provision in TEA-LU, which is on the Floor now and we're going to vote on it tomorrow. Do you not support those provisions in Title IX of TEA-LU, which would provide twice as much assistance to your industry as does H.R. 876?

Mr. TIMMONS. Yes, ma'am. As you know, our strategy has been to go forward with both pieces of legislation, one which is in the grant process, which is what you're referring to this morning, and the other is a tax credit. As many in this Committee will recall, we ran into obstacles based on Davis-Bacon last year. We decided to use another approach, while keeping the grant approach—which was then H.R. 1020—alive. So we do fully support both of those initiatives.

In this constrained budget year, we're very concerned that even if we do get the grant approach through that we may not get an appropriation to support it, whereas the tax credit initiative does away with an appropriation element.

Ms. BROWN. Don't you think that's pretty ludicrous about not supporting the Davis-Bacon since railroads already adhere to prevailing wages? It sounds like a moot point to me.

Mr. TIMMONS. It's a very, very difficult thing for the short line community to understand. The prevailing wage that the railroads pay is well in excess of a minimum wage, and so it's an issue that, while it is a political issue from a practical standpoint, we just have a very difficult time dealing with it. We were very disappointed last year that we could not get that through, and I know that you tried very, very tirelessly to make that happen, and we thank you for that. There may be still some hope for it, but at this point, we're probably going to have more success in the tax credit direction.

Ms. BROWN. Thank you. Did you want to respond to that, Mr. Hamberger?

Mr. HAMBERGER. All I would add is that we support that provision as well. We supported H.R. 1020 when it was introduced in the last Congress and we're anxious to work with, under the leadership of General Timmons and this Committee, to accomplish one of those two goals.

Ms. BROWN. Mr. Lipinski had a question for me to ask you. Wouldn't a railroad trust fund, as proposed by himself, help close the gap between what railroads earn and what is needed to invest in the railroad infrastructure, so that the railroads can meet the projected increase in demand over the next 20 years?

Mr. HAMBERGER. I appreciate the opportunity to answer that question on the record. The short answer is no. Mr. Lipinski's idea would be to take the 4.3 cent deficit reduction fuel tax that the railroads currently pay into the general treasury and put that into a trust fund. It does not add any money to the railroads. What we would prefer is to get that money back. It's our money. We believe we know where to invest best to serve our customers. We know where to double track, as Chairman Nober was talking about. And we would prefer to have that money back so that we can address the needs of our customers directly, rather than running it through a trust fund and a Government agency here in Washington.

Ms. BROWN. You know, I don't disagree with you, but presently, we're collecting that money. Trust funds work with aviation, they work in many other areas. Wouldn't it not be wise if we could follow some of the guidance of Mr. Lipinski?

Mr. HAMBERGER. I am always anxious to work with Mr. Lipinski and of course, with you, Congresswoman Brown. But in this particular instance, we must disagree. The difference of course between the aviation and highway trust funds is that we are a privately owned network. So we have to raise the capital, we have to invest it, and we even have the privilege of paying taxes on that right of way that we operate. And so the difference, I think, is that we should repeal that 4.3 cents and repeal for that, by the way, is in the finance title of the TEA-LU bill that passed the Senate. So we're hoping that the House will go along with that and that it will be repealed effective January 1st.

Ms. BROWN. Rest assured I'll do all I can to support you.

Mr. HAMBERGER. Thank you.

Ms. BROWN. Thank you.

Mr. QUINN. Thank you, Ms. Brown. Ms. Carson, questions for the witnesses?

Ms. CARSON. I'm almost afraid to ask them a question, they look so mean this morning. I'm new to the Committee, so I get to be naive today.

I don't understand the operation of the railroad in terms of how you fix it, and that is to say, when you have tracks that are in disrepair, what do you do about fixing them? I have this view that in order to get America moving forward, one of the ways to do it is getting people to rebuild the railroads.

Mr. HAMBERGER. Yes, ma'am.

Ms. CARSON. That's just my little private interest in that regard. And so if you don't want to be mean to me about it, could you explain to me whether or not you would sort of consider that as a possibility of impacting the spiraling unemployment in terms of getting people to work in this country? Off record, off course, I know, but I'd like to know the answer.

Mr. HAMBERGER. I apologize if the General looks mean this morning.

[Laughter.]

Mr. HAMBERGER. The answer to your question, Congresswoman Carson, is yes, we believe as you do that one of the answers to America's ability to compete in world markets, one of the answers to solving America's congestion problems in our urban areas, one of the answers to solving clean air, energy demand, is for greater use of freight railroads.

And we invest, therefore, over the last five years, we have invested 19 percent of our revenues back into the infrastructure. Nineteen percent is six times more than any other industry or the average manufacturing industries in this country. They're around 3 and a half, 4 percent. So we are putting our money where our beliefs are. We are in fact investing billions and billions of dollars, $320 billion in the last 24 years.

I was pleased that the American Association of State Highway and Transportation Officials, last year issued a report called the Freight Rail Bottom Line Report, which itself called for more investment in freight rail capacity. It made a very important point, and a point I hope this Subcommittee will focus on. It called for public-private partnerships where the public sector recognizes that there are indeed these public benefits, public benefits of cleaner air, better fuel use, congestion mitigation, getting trucks off the road. Trucks are our best customers, so I'm not attacking trucks. But getting those trucks off the road and onto intermodal freight trains.

And if the public wants to achieve some of those public benefits working with the freight railroads who should pay for the private benefits, we're not looking for a handout, we're not here for a subsidy, but as in Chicago, a project that Mr. Lipinski is championing, where we are working with the State of Illinois, we are working with the city of Chicago and we're working with Metro and Amtrak, because there are passenger impacts as well, since they operate over our freight rail rights of way. We have put together a public-private partnership in the area of $1.5 billion to try to improve the fluidity of both passenger and freight to the most critical rail terminal in the country, Chicago.

Mr. QUINN. Mr. Timmons, response?

Mr. TIMMONS. Ma'am, your question gets at the absolute core of the short line and regional railroad industry challenge for today. As many in this room know, when those railroads, as a result of the Staggers Act, were passed from the Class One railroads to the small railroads, they inherited systems that had been long neglected, simply, they could not economically support them and they got rid of them.

Those little railroads did the best they could and have upgraded and improved those rail networks very, very sufficiently. However, they've done it at their own expense. With the advent of economic forces driving the 286,000 pound axle weight car, which is now beyond the industry standard and has been currently in production almost exclusively for the last 10 years, that car is now excessive in terms of weight for the small railroad system.

So the 50,000 mile Class Two and Class Three railroad system needs upgrades. The track weight itself needs to be upgraded, some ballast, and ballast needs to be replaced, ties need to be replaced. And very old bridges that were certainly suitable for the 263 and smaller cars are no longer suitable for the 286,000 pound car. What that really means is that the Class One railroads are short-filling their large capacity cars, which obviously they don't want to do, nor do their customers.

So what will happen ultimately in the future if we don't address this problem is that incrementally, there's no point on the calendar that I can select, but incrementally, small communities, small shippers and small railroads will start to melt away because they just won't be able to handle this larger car. Legislation under H.R. 876, which everyone on this Subcommittee has endorsed, 264 representatives in this Chamber have supported that legislation, tries to address that problem through a tax credit. And we're very hopeful that we can bring that forth, and we thank all the members here and others for the hard work to try to make that come to life.

But we have probably $7 billion worth of upgrades in that system. We just completed a very large data study that suggests of the 50,000 miles, we're probably somewhere around 20,000 to 25,000 miles that demand upgrades. The short lines will pay the majority of that when all is said and done, but we need that initial shot to jump start the system. And we believe that about a billion dollars is what we're going to try to get over the next five years. That would be our goal.

So it's an extremely important initiative. It will preserve the short line competitive posture against trucks in rural communities, and it will permit communities and industries to remain connected in a Class One railroad network.

As a parallel initiative, and we're optimistic about this, it's been in effect for about five or six years, but the RIFF program, overseen by the Federal Railway Administration, has recently undergone a very extensive renovation and review by Mr. Rutter, the FRA administrator. We've signed a memorandum of agreement. The American Short Line and Regional Railroad Association, along with the Federal Railroad Administration, signed an agreement that accelerates and moves forward in a much quicker fashion the approval of loans through that system. And I'm glad to say that we put that into effect in December and we've already seen some of the results within the last 60 days. Two fairly sizeable loans went through and we expect to accelerate that over the coming months.

So there's a parallel track here, one, there is the RIFF loan upgrade, we think that's moving forward, and then there is this legislation H.R. 876 which we're very hopeful for this spring.

Mr. QUINN. Thank you. Any further questions, I don't think, for this panel. Mr. Moran? Oh, I'm sorry. Good morning, Mr. Oberstar. How are you? Good to see you. Questions for this panel?

Mr. OBERSTAR. Mr. Chairman, thank you very much for calling this hearing. It's refreshing to work on something other than the 18 wheelers and the 4 wheelers and to turn our attention to trucks, which in the rail industry have a different meaning, as they are the support for rail cars. I regret that I was so preoccupied with bringing our transportation bill to the Floor that I was not able to get here at the outset of the hearing, which I requested to be held and which I think is very, very important.

Let me ask the distinguished President of the Association of American Railroads, a graduate of this Committee staff, and one who is therefore dangerous because he knows how things work, a question I would have asked another graduate of this Committee staff, Mr. Nober. The stand alone cost method of analysis is complex and expensive. So in your words, how does that work? How does the stand alone cost analysis work? How do you come to judgments based on that method for understanding how we can compare costs among different railroads?

Mr. HAMBERGER. I will try to answer that, and actually the esteemed Chairman of the STB did address a similar question. I think he put it quite well, it is a very simple concept but it is one that is very complex in application. The simplified concept is that the rate paid by the customer should not exceed what an efficiently run railroad would cost to build and maintain. And the difficulty comes because in fact, freight railroads are a very complex operation, so how do you allocate costs and how do you allocate revenues for traffic that might be operating over that railroad. There are a lot of permutations on that which requires economic analysis and legal analysis, as the Chairman pointed out, running into the thousands of pages for those cases.

It is therefore a very complex yet I think economically sound approach that is relevant and appropriate for large rate cases. The issue that Chairman Nober and hopefully soon your counsel will be wrestling with is, how does one apply the principles of Ramsey pricing, the principles of the constrained market price ideas that are embellished and embodied in the stand alone costs to smaller rate cases, to smaller shipments. That is something that we are wrestling with and hopefully in the months ahead the Board will come up with some approach.

Mr. OBERSTAR. Mr. Hamberger, we don't really have enough time to explore in greater depth the full answer to that question. But your description is right on with my concern and that is, thousands of pages, complex analysis, often years of waiting for a decision, challenge in rate cases then takes similar thousands of pages by those who file an appeal and years more to resolve. In your view, is there a less surreal way of addressing this matter, something less complicated to address this admittedly complex subject?

Mr. HAMBERGER. Well, I think Chairman Nober has implemented certain procedural improvements and has inserted the Board staff in a much more robust fashion in trying to address many of the discovery issues, for example, up front and trying to resolve some of the factual issues that would have been bandied back and forth between both sides. So I think he and of course under the leadership of the former Chair, who implemented a proceeding for mediation, has made mediation a formal part of the process. It doesn't always work, but can move the ball forward.

So I think there are some procedural steps that the Board has taken to try to lessen the complexity. The short answer to your question is no, I think it is important that the stand alone costs, the constrained market pricing approach be maintained for these large rate cases.

Mr. OBERSTAR. The STB, that's a matter we'll have to pursue in the future, but the STB is required to determine revenue adequacy for railroads. In my review of cases over the last decade that our committee has had jurisdiction over this subject matter, the STB has never found or almost never found railroads to be revenue adequate, making enough money. Yet railroads pay dividends to their shareholders.

How can you have revenue inadequacy and still be making payments to shareholders?

Mr. HAMBERGER. The private sector companies, if they're going to raise money which they need, and I would suggest to you the fact that we have not been found revenue adequate is not a reflection of the Board and the Board proceedings, but rather a reflection of the incredible amounts of capital that this industry requires. We have reinvested almost 20 percent, 19 percent to be precise, over the past 5 years of all revenues and capital expenditures, and that was matched by about another 20 percent—

Mr. OBERSTAR. Oh, no question at all—

Mr. HAMBERGER. So we need to—

Mr. OBERSTAR. I'm a firm advocate for the railroads as investors of great amounts of capital for the rolling stock, for improvement of the track bed.

Mr. HAMBERGER. But that money cannot be raised, we cannot raise that money from cash flow of the revenues we receive from our customers, because as you know, we have reduced rates by 60 percent over the past 20 years. And therefore, we need to go into the debt and equity markets to raise capital to reinvest. If you're going to raise capital in the equity markets, people are not going to invest unless there is at least some return on that investment for them, hence the need to pay dividends.

Mr. OBERSTAR. You know, the steel industry made that same argument in the 1970s. They were losing scads of money. And at the very same time they were losing money, they were paying dividends to shareholders and asking workers in the steel industry to take pay cuts and job cuts. I'm mystified by your discussion.

Mr. HAMBERGER. Then I apologize, let me try to clarify. About two-thirds of the money—

Mr. OBERSTAR. If you're not revenue adequate, don't the shareholders have to share in that inadequacy?

Mr. HAMBERGER. It is a balancing act between whether or not we can raise the money we need to invest to provide the service we need to provide to our customers. We cannot get that through the revenues we charge the customers, therefore, we need to go into the debt and equity markets to raise that money. One of the requirements of raising money in the equity market is to give those people who invest some sort of a return.

Mr. OBERSTAR. It may be an accounting matter, maybe there's a point in your statement which you take the shareholder dividends out before other factors are—

Mr. HAMBERGER. I don't have a precise answer for you to that, but I could respond on the record.

Mr. OBERSTAR. It would be an interesting exercise to have for the record.

One final question, Mr. Chairman. What prompts these hearings and the legislation that I've introduced over several Congresses is complaints from small shippers. They've lost LCL shipments, going back even further in time they lost the U.S. Mail service, you know my story very well. And the small grain elevators in the upper midwest, particularly in my district and that of my neighboring member of Congress, Mr. Peterson, have found their minimum requirement of hopper rail cars, grain cars, has been increased to the point where if a small elevator can't fill 5, 10 or 1,5 ton hopper cars the railroad won't serve it.

What happens it that grain then has to be shipped by truck, Mr. Chairman. That truck shipment is very costly. I stood at Peterson's Mill in North Branch, Minnesota, just two years ago, when a trucker handed to the farmer a check for 86 cents. That was all he returned on a truckload shipment of grain that had to go a couple hundred miles. If it had gone by rail car, he might have made some money on that. Which is a great tribute to the railroads.

But the other side of that coin is that the railroads seem to have lost the sense of public service to small communities and small grain farmers. They don't play the same today that they've played in the shaping and making of the nation. That's what I hear. This is a story I'm fabricating. It's what I hear from 200, 300 grain farmers that I meet with and that my colleagues meet with.

So what has happened to competition? Why isn't service being provided to small towns?

Mr. HAMBERGER. Let me answer that in two ways, if I might. Number one, and I think that General Timmons and his members, and the reason that they need and merit and deserve the support that this Committee has given them addresses part of your concern. The other part is the need to have American farmers be able to compete in the world markets. Those world market prices are set way beyond the railroad level of participation in the logistics chain.

One of the ways we're able to help our farmers participate in global markets is by using shuttle trains and improving the efficiency of getting as much grain as quickly as possible to the Pacific Northwest, down to the Gulf ports, as efficiently and as cheaply as we can. That requires, unfortunately, shuttle train elevators that can load in 15, 18 hours a 110 car train and that has 3, 4 turns a month, rather than 1 to 1.2.

Mr. OBERSTAR. And the small grain elevator just doesn't factor into that economic model.

Mr. HAMBERGER. Well, unfortunately it is the economic model imposed by the world markets. It is not being imposed by the railroads. And we are trying to work with our customers to enable them to compete in those world markets, not imposing on them our desire, but working with them to allow them to compete.

Mr. OBERSTAR. And in that economic model, the only real competition then in the central States of the U.S. is the barge industry. But from central Minnesota to a barge operator in say, the Twin Cities, is a truck haul. It used to be by rail. Not to a barge, but all the way to the Gulf. But the railroad doesn't call at the Harris Elevator and the North Branch Elevator. Then the only option is truck, and truck is too expensive, and the farmer loses money. And you're losing opportunities.

Now, if we take your economic model just a step further, if I may another moment, Mr. Chairman, to develop a short line rail haul that would be more economical, then we can restore the economic health of small communities and small grain farmers in the principle of the small family farm. But the Association of American Railroads doesn't seem to be coming forward with such proposals.

You just suggested something in your comment about aggregating sort of a hub and spoke system of rail shipments that may lead us in that direction. Mr. Timmons, would you have a comment about that?

Mr. TIMMONS. Yes, sir. Let me make two observations on that. One, first off, let me assure you that the small railroad industry is absolutely dedicated and committed and strives to serve rural communities. That's its bread and butter. So it works hard at trying to do that. I would also suggest that this business of grain shipments and the success of grain shipments using small railroads in rural communities is regionally tied. We have a number of small railroads that are doing extremely well in interchange with Class One railroads serving independent elevators throughout certain regions.

In your area, there are some challenges up there. I hear from my members that they are working hard to try to make this more effective, more efficient. And there are some challenges to work through. But there are other areas where there is hardly any work at all, but almost by gravity they're doing extremely well this year, even with this bumper crop.

Mr. OBERSTAR. Well, in the model that I just suggested, the short line could serve these two and other elevators. It doesn't need to go into all of them. They would have to roll over main line track and the cost of doing that is way too expensive. So I'm looking for some cooperation from the main line railroads with the short lines to enhance main line business using short lines as part of a hub and spoke operation.

Mr. TIMMONS. Part of that, as I think you know, is related to this larger car that we spoke of a little earlier.

Mr. OBERSTAR. Yes, I'm aware of it.

Mr. TIMMONS. And that is part of the issue. I don't think it's reasonable to expect a Class One railroad to short fill those cars. They purchase those cars, there are economic drivers that cause them to fill them up. And if they cannot run them on the track that is appropriate for the weight of those cars, it's both a safety issue and an economic issue, and they shouldn't do it.

As you well know, we've come forward with this legislation, H.R. 876, to try to provide some relief in that regard. As I spoke earlier, I think we're on the right track. Whether it comes to pass, I don't know. But all those in this Subcommittee had supported it, and we thank you for that.

Mr. OBERSTAR. Thank you, Mr. Chairman. I think we're explored the subject matter, it's useful to have this opportunity.

Mr. QUINN. Thank you so much. I'm going to yield to Mr. Baker, if I may, who has been very, very patient. Earlier in the beginning of the Subcommittee hearing, sir, we by unanimous consent welcomed you to participate. I know you're between your own hearings. So let me yield my time to you and take your own time now with the witnesses.

Mr. BAKER. Thank you very much, Mr. Chairman, for your graciousness. Someone may wish to reconsider that unanimous consent request in a few minutes.

I would have been here on time, and make apologies to the witnesses and those here earlier. I had my own subcommittee hearing, which I have had to leave to come over. To that end, I just wanted to respond to Chairman Nober's earlier comment. I'm sorry I was not here to express this to him directly. The question was basically asked, what's wrong with the current system and our STB processes that would result in having someone introduce a bill such as the one I've introduced.

Let me give you one small example, Mr. Hamberger, on the record. I have a chemical company that operates nationally. And in one particular facility, found that the cost for rail transport exceeded by several orders of magnitude the same movement of the same product for the same distance in other markets where there was rail competition. In fact, the costs at this one location for rail transport were exceeding the fixed costs of producing the product. Now, that becomes rather significant. Naturally they sought some remedy.

Their counsel advised them if they were to pursue a rate approval change at the STB no chemical company has ever won a rate case at the STB. That kind of makes you think about the process of maybe being successful.

Secondly, you have to file with a $62,000 check. It will take a minimum of two years and legal team estimated costs to basically litigate through the process to be upward of $3 million. That didn't seem to be a viable alternative.

So the STB recommended process, rather than challenging the competitive rate model, is for the industry to build their own railroad access, which they have started. The STB approved that rather quickly, at an estimated cost of $80 million to have a duplicitous rail constructed for the transport of commodities of one industrial facility.

Now, because it is building a new rail corridor, amazingly enough public fury has developed by some strange process, I can't imagine who would imagine to a second rail line being built where someone has a monopoly, I have to think about it maybe for a while, but public furor has gone to decibel levels. They have now been mired in an appellate court in Texas still having neither rate relief nor the ability to build out an $80 million project to get their product to market.

Now, the question was asked, do we have a problem? Maybe not everybody, but I can cite chapter and verse now for some time, years, where I have met with rail officials, made innumerable request for rate adjustments, we have great meetings, we all feel good when we leave, but nothing ever changes. And there is no relief afforded in the current regulatory structure.

As Mr. Hamberger, I read with great interest your comment about 2924, and it brought to mind a shipping commercial that's on television now, some package company, and there are two guys standing there, and one says, "Doomed." I don't know if you know the commercial, it's really great, in thinking of your testimony, because you say on page 8 of 26, would be doomed, taxpayers would step in with a bailout. You know how to get my attention. Freight service would disappear, highways would be overcrowded, environmental degradation would rise, safety would deteriorate. Sounds like Fannie Mae wrote this stuff.

[Laughter.]

Mr. BAKER. I don't know where you're coming to that conclusion to reach those kinds of statements. Let me get to my particular question for you that's the most troublesome. You attacked the bottleneck provisions that you say are steeped in laws of the 1920s. I understand that the bottleneck policy was first articulated in 1996, and contract rates were in fact prohibited until the enactment of the Staggers Act in 1980.

How can you allege that the bottleneck provisions that we now suffer under are rooted in acts of the 1920s?

Mr. HAMBERGER. It goes back to ICC decisions in that era, where the ICC ruled that a railroad does not have to shorthaul itself. Under a bottleneck approach, that would most likely be the result. That's the reference.

Mr. BAKER. Well, I appreciate your explanation. It does seem a little bit murky from my perspective, that the bottleneck policy is really a little over a decade, not a century old. And return to the subject Mr. Oberstar raised with you earlier, in which you responded relative to capital inadequacy and dividends to shareholders, that you were precluded from using the revenue stream from your shipping customers to make capital investment.

Mr. HAMBERGER. No, sir. Not precluded. To clarify, the amount of money that we have to invest is so great that there is not an adequate revenue stream from the revenues we receive. We confront about two-thirds from the revenue stream we receive and then have to go into the debt and equity markets for the additional third of capital investment that is required.

Mr. BAKER. Well, I just want to address that subject with you a little further, being on Financial Services, a little familiarity with debt and equity markets. If the TBA can raise money, the rails can raise money. My point was, it appeared to be represented that your revenue stream from fees generated from your customers could not be utilized to solve your capital inadequacy problems, and on the record, they can, it's just that you don't make enough money, in your judgment, to meet all the near term identified capital inadequacies, is that correct?

Mr. HAMBERGER. I guess the way I would phrase it is that the capital demands necessary cannot be met from the revenues generated.

Mr. BAKER. I understand. And those capital adequacy demands is a number arrived at by your own internal calculations as to what's necessary for the long term survivability of your particular rail line.

Mr. HAMBERGER. Well, I don't want to confuse capital adequacy and revenue adequacy. We're talking about the need to invest.

Mr. BAKER. I got it.

Mr. HAMBERGER. The short answer to your question is yes, and that is driven by the demands of our customers and the capacity that they need and the employee base that we need, the locomotives.

Mr. BAKER. So in this current interest rate environment we're in, record low rates with a AA rated rail going into the debt and equity market, you're telling me you couldn't find enough long term capital with your current revenue stream to adequately address your short term construction needs.

Mr. HAMBERGER. We are finding that revenue. The question was whether or not we're paying dividends at the same time.

Mr. BAKER. Just want to get a handle on it.

Now, as to the bottleneck problem, as I understand it today, if you're subject to such a problem, and I come to rail company A and ask for a rate, there is no requirement for that rail provider to give me a rate. They can just refuse not to give me one, is that correct?

Mr. HAMBERGER. If we're talking about an A, B, C traditional bottleneck case. If the railroad who operates over the bottleneck also operates to the terminus or the origin point, that is correct. And the issue is, is the rate from A through B to C reasonable or not. And that is what the STB then takes a look at to see whether or not that is a reasonable rate.

Mr. BAKER. So if I'm sitting at a chemical plant below Baton Rouge and I want to ship a product and I'm subject to the conditions you just recited and ask for a rate, I'm not obligated, they are not obligated to tell me what it would cost me to use that rail service. What would be wrong with requiring someone just to give me a rate? I'm not telling you what the rate is, I'm not trying to regulate, I'm just trying to get an answer. Tell me what it would cost if I used your facility, since it's the only one around I can use, what would be wrong in your free enterprise defense of requiring someone to provide me with an honest rate?

Mr. HAMBERGER. Well, of course that rate would be taken to the Board and challenged. And it is a segment of the entire shipment. And what is relevant is, what is a reasonable rate from A through B to C.

Mr. BAKER. So because someone might allege your rate setting was unreasonable and it might be—

Mr. HAMBERGER. Just on that one segment, not on the entire segment.

Mr. BAKER.—and be taken to the STB, you're concerned that you're going to lose one with the chemical industry?

Mr. HAMBERGER. The issue is, what is the revenue that we need and what is the rate, is it a reasonable rate from A through B to C.

Mr. BAKER. But why can't you tell the customer if it's a dollar, $10, whatever per ton mile assessment you want to levy, what is wrong, I'll give you the reverse. This is my concern. If I'm in the chemical business and the neighbor down the street is in the chemical business and we're both selling the same product and we go to the diner down the street and have coffee and decided we're going to raise our prices in the same amount to the same level, that's called price fixing. That's an anti-trust violation of significance.

Mr. HAMBERGER. Yes, sir.

Mr. BAKER. On the other hand, if two rail companies get together, we're neither going to quote a rate, that's fine, because you're not doing any rate fixing, you're just agreeing not to cite a rate at all. Now, I find that very problematic, because what's happening is, when you don't get the rate quote, you then force people to go to buildouts, which are extremely expensive, or the person has to ship by truck. And it's happening in market after market.

I haven't heard clarified a justifiable reason, other than you don't want to have to go to court and defend your judgment, as to why you shouldn't be required to quote a rate. Just give the man a price.

Mr. HAMBERGER. I think that the Chairman of the STB actually said it well, and that is that we are either operating in a market environment or in a regulatory environment. We are in a regulatory environment. And the issue for protection of the customers and the shippers is whether the rate from A to B to C is reasonable.

Now, in that environment, we have to be able to earn our cost of capital, which we are trying to do. And I would like to read into the record if I might, Mr. Chairman, a letter from David Sopel, who is chairman and chief executive officer of MidAmerica Fuels. In the mid-1990s, it was MidAmerica who brought the bottleneck case against Union Pacific. And he said as part of that, "We asked the ICC, now the STB, to change one of its earlier decisions, known as the Bottleneck Decision. We were unsuccessful."

"We currently enjoy an excellent relationship with Union Pacific Railroad, and we've come to understand the terrible ramifications overturning the Bottleneck Decision would have on the freight rail industry. We depend on a vibrant and healthy rail industry to make us competitive. Changing the railroad's economic regulatory structure to artificially create competition where the marketplace would not support it would deprive the rail industry of the revenue it needs to sustain itself which will ultimately hurt companies like ours that depend on quality rail service."

Mr. QUINN. We've got a vote pending, and I'm afraid the Chairman, who is liberal as he's been, is going to blow the whistle on me. I know you'll be disappointed. But when the position is, you've got one way out of town, I call up, I can't get a rate quote, would the rail industry oppose having the rails be required to give a customer a rate or is your position the best interest of the consumer is served by not giving him a rate at all?

Mr. HAMBERGER. He does get a rate. He gets a rate from A through B to C. But he doesn't get a rate from A to B, that's correct.

Mr. BAKER. Well, if I can't go from A to B, going from B to C isn't going to help me much. I'm going to have to use Mr. Oberstar's trucks or fly it in by cargo plane. That's not and economic remedy. Do you or do you not oppose having a rate required to be disclosed to the customer, regardless of it's A to B, B to C, Y to X?

Mr. HAMBERGER. The answer is, we do not believe that overturning the Bottleneck Decision is appropriate public policy.

Mr. BAKER. And there we are. Mr. Chairman, I rest my case. We have come to the end of the track and at the end of the day, a customer who wants to ship is not given a rate. The industry would oppose requiring the customer to get a rate when the customer has no options. I'm not for regulating. I think we ought to stay as far away from board rooms in corporate America as possible. But when you have a single provider of a service in a market and all you're asking is to tell me what it will cost me to use your services as a regulated public utility, that's a problem when you won't respond.

I thank the Chairman for his generous time.

Mr. QUINN. Thank you, Mr. Baker. What I'd like to suggest before we recess for a few minutes, we've got nine and a half minutes to get to this vote, are there any questions you'd like to submit for the record for the third panel?

Mr. BAKER. You're very gracious to ask. Just a comment, and to put into the record the comments of the Lafayette Utility System representative, Mr. Terry Huval, who will later talk about the transportation costs associated with the local utility service in southwest Louisiana, a very small community, it is like many other rural communities having its economic difficulty.

Mr. QUINN. Without objection, so ordered.

Mr. BAKER. And the annual cost passed on by this captured environment in Lafayette is $6 million a year to the end users of utility systems in Lafayette, Louisiana.

Mr. QUINN. Without objection, so ordered.

We're going to recess and be right back.

[Recess.]

Mr. QUINN. Good afternoon, and thank you for your patience. We're going to begin as we wait for one of our colleagues to attend who is on his or her way, as you can tell, I don't know who it is yet. So I hope he or she is on their way.

But in the meantime, we would like to begin and try to keep to some sort of the schedule. Gentlemen on the panel, I welcome you here this morning on behalf of the full Subcommittee and the full Committee, for that matter. I am impressed that you were here for the early part to hear the other testimony. It's helpful to you, I hope and to all of us.

I think everybody knows our ground rules. We have your written testimony, all of it. We'd like you to keep your oral remarks to about five minuets or so. We're going to start here and work our way across. Then when everybody has had a chance, we'll move to the question period. So we'll hold our questions to the end.

If that's okay with you, sir, introduce yourself and begin. We're glad to have you here.

TESTIMONY OF TERRY HUVAL, DIRECTOR OF UTILITIES, CITY OF LAFAYETTE, LOUISIANA; STEVEN D. STREGE, PRESIDENT, NORTH DAKOTA GRAIN DEALERS ASSOCIATION; CHARLES E. PLATZ, PRESIDENT, BASELL NORTH AMERICA, INC.; JOHN FICKER, PRESIDENT, NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE; WILLIAM J. RENNICKE, MANAGING DIRECTOR, MERCER MANAGEMENT CONSULTING, INC.; AND CURTIS GRIMM, PROFESSOR OF TRANSPORTATION AND LOGISTICS, UNIVERSITY OF MARYLAND

Mr. HUVAL. Thank you, Mr. Chairman. My name is Terry Huval, I'm from Lafayette, Louisiana, and I'm the Director of the Lafayette Utility System, which is a publicly owned utility system owned by the community.

Mr. QUINN. Excuse me, sir, don't tell me you're going to pick up where Mr. Baker left off.

[Laughter.]

Mr. HUVAL. No, sir, I think he represented it well.

Mr. QUINN. He's a great member, he really is. You should be proud to have him.

Mr. HUVAL. Very proud, very proud. I'm representing here not only the Lafayette Utility System but also the Louisiana Energy and Power Authority, which is a joint action agency of some 20 municipally owned utilities in the State of Louisiana, the American Public Power Association and of course, Consumers United for Rail Equity, or CURE.

Let me tell you a little bit about Lafayette, Louisiana. We're a community of about 110,000 people who decided in 1896 that they were going to set their own destiny for providing the commerce of the future and established their own electric utility system. We have a city council that sets our rates, sets our policies. And we have been very successful being able to offer very competitive electric services to our customers, having for many years the lowest rates in the State of Louisiana.

Most of our power generation came from natural gas until the early 1980s, at which time we invested in a coal-fired plant which we co-owned with two other owners. And the issue I'll bring before you today is the very clear unfairness we feel there is in the pricing polices of the rail transportation providers. We are a bottleneck captive shipper, as was discussed earlier today. I have a map that kind of indicates to you how we get our coal today, and it's through the red line, as was indicated on the map, from the Powder River Basin in Wyoming to Alexandria, in the center of Louisiana, and another 19 miles to get to our power plant.

We have a competitive choice between the Powder River Basin and Alexandria, some 1,506 miles. But that last 19 miles, that last 1 percent of the route it takes to get to our plant, costs us an additional 50 percent in transportation costs, at a minimum. We don't understand how national policy can be served in providing the best thing for the consumer as a whole to build that sort of price impediment.

In order to get relief, of course you've heard all the different remedies for relief, really the only true remedy is to build some duplicate sidings to get the coal to our power plant. In our particular case, building a siding is going to have to go over a navigable river and an interstate system, some $50 million worth of cost that we would have to pay to be able to do that. At that time, then we could have a competitive choice. Until that time, we have none. It just seems ridiculous to have to expect that a utility system or any entity is going to have to increase its costs to consumers to build something that may never be used, because it may turn out that the existing provider then actually comes to realism on the price.

I had the opportunity to testify a couple of years ago to a Senate committee on the same issue. Shortly after my testimony, I got to hear the CEO of one of the major railways comment that because the competitive business was so marginal from a profit perspective, they had to rely on the captive shippers to bill to make the financial stability of the railroad continue. It almost sounds like price gouging. It almost sounds like where we have to compete we're going to compete and where we don't have to compete, we're going to go for all that we can.

In our particular case, and almost every utility system, passes on the price of fuel to their customers, which means that every customer that we have, certainly in our system and many other utility systems, is paying the cost for this price gouging. When we talk about economic development, when we talk about how commerce remains in the community, the cost of electricity becomes a very significant part of that. Unfortunately, because of the national policies that we have today, we have a situation again that causes us to pay a 50 percent increase in cost to the existing rail provider for 1 percent of the track that's not competitive. That means $6 million a year lost to our economy locally to do that, and I would expect it's in the billions of dollars when you look at it from a national perspective.

We're asking for relief. We're asking for help. We don't think it's fair, we don't think it's appropriate. I've heard all the arguments made earlier today, and I would like to see what all the numbers actually are.

I think there's two sets of books being kept, one for competitive and one for non-competitive arenas. And what we're living in is essentially an unregulated monopoly. Whereas if the pricing can be charged in such a way that the gain displayed is such that you cannot get a competitive offer from a competitive provider, so that you can make a reasonable business decision. Who wants to spend $50 million to build another siding when you don't even know what the benefits are going to be in the end as far as what the costs are going to be to the utility system?

We certainly are big supporters of the House Bill 2924, and believe that it's actually not re-regulating, it's actually providing for more competition. It's providing for more access and so that entities such as our own can make reasonable decision of how to invest the money of our consumers. Again, this is calling for more competition.

And we certainly appreciate the opportunity to testify before you today and look forward to your support in trying to get some appropriate resolution to this issue.

Mr. QUINN. Thank you so much. I appreciate your keeping our time in your mind.

Mr. Platz, I might ask you if as a courtesy you might allow us to go out of order. We're joined here this afternoon by our esteemed colleague, Mr. Earl Pomeroy from the great State of North Dakota, here to introduce one of our speakers this morning. So we're going to ask you if you would hold, Mr. Platz, and I'd like to yield to Mr. Pomeroy. Welcome.

Mr. POMEROY. I thank the Chair. I'm sorry I was not here a couple minutes ago as the panel started. I've been trying to be three places this morning, as undoubtedly you have.

Mr. QUINN. We're glad you're with us any time you can be here.

Mr. POMEROY. Thank you so much.

I'm here to introduce Steve Strege, who is the President of the North Dakota Grain Dealers Association. He has been with the North Dakota Grain Dealers Association for 28 years. This is the association that represents better than 90 percent of the State's grain elevators. Just think for a minute about what he has had to deal with during this time. North Dakota is a State located far from many major markets. Our major product is bulk commodities. Our dependence upon rail shipping is significant.

So what has Mr. Strege seen during his years as executive vice president? He has seen diminished competition, he has seen the demise of regulatory oversight, and yet the fundamentals are still the same. The result has been diminished service, increased complaints, higher rates and a completely unacceptable market situation in North Dakota.

We have this past year, seen our major carrier, BNSF, at times have as many as 4,000 rail cars past due, leading to grain stacking up outside the elevators. We hit a milestone with April 1st, now the company is only 1,000 rail cars past due. Usually, our last year's harvest would have long been cleaned up by this time of year, but this year we are still making our way.

In the middle of all this, the BNSF has run not just one, but two, rate increase proposals on the already frustrated customers with grain piled outside their elevators. So--insufficient service, higher rates for it--this is why we come to the table. Mr. Strege and I are of one mind, that we need to provide a greater dimension of consumer protection in this area.

The laws of the marketplace are: let competition have its will and you don't need much of a regulatory structure, to the extent that competition is not present, you'd better step up your regulatory oversight. Here we don't have competition, yet we also don't have sufficient regulatory oversight. Mr. Strege's words to you, I think, will reflect the grass roots view of North Dakota.

I thank you, Mr. Chairman.

Mr. QUINN. Thank you. I appreciate your being here.

Mr. Strege, would you like to take your five minutes now, after that introduction? You're up.

Mr. STREGE. Thank you, Congressman Pomeroy, for being here. You've been a great supporter over the years of country grain elevators. Thank you for inviting me to be a witness at this hearing, Mr. Chairman. I think Mr. Pomeroy has described our association as representing country elevators in North Dakota. They receive grain from farmers, they clean it, blend it and ship it into export or on to domestic processors.

Our association is also part of the Alliance for Rail Competition, which is part of the Rail Customer Coalition, which together represents 55 percent of freight rail revenues. Grain shippers who do not have effective competition alternatives are being taken advantage of on rail rates and service. Many of these customers are being frozen out of the marketplace because railroads give preference to other customers.

We have various sizes of grain shippers, those that load up to 24 cars at a time, those that load trains of 25 to 27 cars, others that load trains of 50 to 54 cars. Now the railroad wants bigger, in the 100 to 110 car range, commonly called shuttle trains. Our recent experience, particularly with the BNSF, is that it concentrates it service in the shuttle train segment, while others are left to wait 30 to 50 days, taking them out of the market at great cost to the elevators and farmers.

Now, here's an everyday analogy. It would likely be more efficient for grocery stores to sell their potatoes in 100 pound sacks only. But consumers, customers want 5 pound, 10 pound, 20 pound sacks. If a grocery store went to a policy of 100 pound sacks only on time and all others 30 days late, its customers would go elsewhere. That's the benefit of competition. But in the case of these railroad customers, there is no competitive alternative, so they can only sit and wait, absorbing associated costs in the process.

The law says shippers are entitled to service on reasonable request. Railroad delivery of unit trains 30 to 50 days late is not reasonable. It is a violation of law. When a violation of law is committed, there should be consequences. The Eighth Circuit Court of Appeals reversed the ICC in 1993, saying that if a particular railroad car distribution process so reduces the number of cars available for other shippers that it unduly impairs the railroad's ability to meet its common carrier obligation, then the preferential program is unlawful. The STB refuses to follow that decision in this current circumstance.

Just recently, BNSF announced that while it continues auctions of shuttle trains, it is shutting off orders to its assured service program for all other sizes of trains.

Another example of how farmers and elevators in our region have been deprived by railroad practices of an opportunity to sell grain is through inverse pricing. Under this practice, farmers and captive elevators who are closer to a consumption point and who should have a natural locational advantage in freight rates are put out of that market by cheaper rail rates to that market from a more distant point that is less captive.

Those who cannot obtain service and rates for months on end will be weakened financially and eventually put out of business. Branch lines will be abandoned through railroad discrimination and neglect. And the grain elevator industry will be forced to concentrate into fewer mega elevators. Farmers will lose competition for their grain and have to truck it farther.

You are considering a highway bill of several billions of dollars. Add some more as railroads shift grain gathering to the roads and public sector.

North Dakotans, including our Governor, met last winter with STB Chairman Nober about this situation. We learned at those meetings that the discrimination in the distribution of grain cars between shuttle trains and other train loaders was not of concern to the STB. This leads our shippers to believe that the agency here in D.C. that is supposed to be watching out for our interests will not take assertive action to protect them.

Mr. Nober said here earlier that the parties—the North Dakota parties and the railroad—agreed to a set of steps. I would describe the outcome more as the railroad telling us what it was going to do.

Recently, BNSF said it was caught up on grain cars in North Dakota. Maybe, maybe not. But catching up does not undo the millions of dollars in economic harm done to customers across its whole system by failure to make timely delivery of pre-booked and in some place partially pre-paid cars. BNSF also promised us an ombudsman for our problems to be in place by early March. Nothing has happened in regard to that.

There is a chart on page 10 of my written testimony showing how we in the northern plains, shippers who are the most captive and pay the highest rates in the country are also the farthest behind in service. Grain in the northern plans and other captive areas sits until the railroad gets around to moving it. The best marketing opportunities have often evaporated by then.

Mr. Chairman, I would like to submit copies for the record of an article from the March 27, 2004 Bismarck, North Dakota Tribune called Rail Backlog Means Empty Pockets. It describes how BNSF's failure to deliver the promised rail cars to shippers, a practice apparently condoned by the STB, costs farmers and grain elevators hundreds of thousands of dollars.

Mr. QUINN. Without objection, so ordered.

Mr. STREGE. In addition, Mr. Chairman, I have letters of support here for H.R. 2924 from growers and shippers across the country, which I too ask be put in the record.

Mr. QUINN. Without objection, that's ordered as well.

Mr. STREGE. Captive traffic has always paid higher rates and we don't disagree with the concept of differential pricing. But when rates are three or four times the railroad's variable cost and there is no effective remedy, something must be done. At present, shippers have to gamble on an uncertain, expensive and arduous process to seek rate relief. And there is no certainty that anything will change.

Under Staggers, where competition is lacking, regulatory oversight is called for. Unfortunately, that has not happened. Mr. Hamberger said this morning that we have to move to the shuttle trains to keep our farmers efficient in a world market. Why then do the major carriers in our State charge rates at 350 percent of variable costs to move that grain to market? We have called on them to reduce rates, but they do not.

Shippers put up with slow service, high rates and dictatorial practices. Railroads are huge companies, but most grain shippers are not. Rail dependent businesses must bend their ways to the railroad's will or be put out of business. We urge you to take action quickly to end such practices.

Let me also make one other comment for the record regarding a question that was asked this morning. Mr. Moran asked about rate levels and what had happened since Staggers. I can tell you that we have not been the beneficiary of 50 percent rate reductions as Mr. Hamberger commented on.

But let's also talk about costs. Since 1980, the rail industry has shifted must cost to the grain industry through the investments and ongoing additional expense of loading ever larger and larger trains. Rail lines have been abandoned, saving railroads money, but also shifting costs to farmers and the public road system.

Some of these changes have been good. But let's tell the whole story about rail rates and costs. I know that the railroads want to talk about Wall Street and their stock prices. Let's talk about Main Street and let's talk about the customers who pay the bills. There's a frustration, and I saw it with Mr. Baker—

Mr. QUINN. So did I.

[Laughter.]

Mr. STREGE. I was here 20 months ago today, and three of us, these three, were testifying over in the Senate. We were told something was going to be done. Nothing gets done. Meanwhile, our shippers die on the vine. Thank you.

Mr. QUINN. Thank you very much, Mr. Strege.

Mr. Platz, we'll go back to you and get back in order. Thank you for your patience.

Mr. PLATZ. Mr. Chairman, members of the Subcommittee, my name is Charles Platz, and I'm President of American Cooperative, and thank you for the opportunity to testify.

I also have some letters from members of CURE and the ACC which I'd like to put into the record, and also within the 30 day period.

Mr. QUINN. Without objection, so ordered.

Mr. PLATZ. I appear no behalf of the employees and shareholders of my company and the American Chemistry Council and Consumers United for Rail Equity, on which I serve as a co-chair. Basell North America has its headquarters in Elkton, Maryland, offices in Lansing, Michigan. We have manufacturing facilities in Texas, Louisiana and Tennessee. We market and manufacture in Liggon, New Jersey.

I'm here because our business is wholly dependent upon rail transportation. I believe if Mr. Nober was still here, he would acknowledge the truth of that fact. We load 100 percent of our products, made at world scale production facilities, directly into rail hopper cars for transportation to our customers, and by the way, our customers demand delivery by rail. We are deeply invested in rail infrastructure. We own or lease and maintain 4,000 hopper cars with a replacement value of over $260 million.

So as you can see, rail is not just a vital to my business, it's actually an integral part of how we do business. That's why I'm here to talk about the serious flaw that exists in our current national rail policy, which is devastating the ability of many chemical companies in this Nation to remain competitive. The problem? Current rail policy allows railroads to deny their customers use of existing rail competition. I believe this policy will contribute to the export of the United States manufacturing jobs if it remains unchanged.

In fact, during both 2002 and 2003, for the first time in the history of our industry, the United States spent more money importing chemicals than we earned from exporting chemicals. The trend lines are not good, and the ramifications are serious. Soon, besides exporting U.S. dollars, we will be exporting jobs.

Here's an example of the problem that Basell faces. Only one railroad line serves Basell at its Bayport, Texas plant. A junction with competitive rail carriers exists just five miles away. But amazingly, the STB has given our single line rail carrier the unmatched power to prohibit us from directing delivery of our hopper cars to a competing carrier at that junction. So instead of being captive for five miles, the STB policy makes us captive for movements of up to thousands of miles, where competition options exist. We're just not allowed to use those options.

Let me explain how the bottleneck impacts Basell. Our railroad transportation costs at our captive Texas facility have been grossly out of proportion. In fact, the rail transportation costs were actually equal to or greater than the fixed costs of producing a product. This meant transportation rose to the level of being the largest cost component after the cost of our raw materials. This level cannot be sustained.

We have tried everything to keep our Bayport plant viable. Unfortunately, I have learned that the problems created by our rail captivity cannot be solved by any method available today. But in an effort to keep our Bayport plant as a viable site, my company has explored all the options. We've tried direct negotiations with the railroads, but to no avail. They were not even compelled by the potential loss of business in the event the site was no longer viable.

We've considered bringing a rate case to the STB, but that's a non-starter. No chemical company has ever succeeded, and all of our advisors told us we would lose. Even Mr. Nober has said they aren't viable because they cost $60,000 plus to file, more than $3 million to try and take years to decide.

We even played the role of good citizen and tried a buildout. But that's not working either. The local community was upset with the prospect of a redundant line which they viewed as a waste and as disruptive to the local community. Now three years later, we find ourselves mired in a State court with no progress towards competition.

For me, all of this leads to only one conclusion, that in all aspects, the current STB policies are designed to keep captive customers captive and to increase the level of captivity. The only alterative for businesses subjected to those policies is to close down plants and move. And that cannot be what Congress had intended.

Congress must act because no other way for change exists. This is my fourth time testifying on this issue in the past two years, and my company has been here over the last 10 years on this issue. So twice in the Senate I've testified and now twice in the House. During this time, we've tried to talk to the CEOs of the railroads and we've addressed some very business specific issues. But they have made it clear, as railroad CEOs, that they will not discuss policy change.

We've also pressed the STB to act, but the STB has made it clear that it too will not act. Indeed, Mr. Nober believes his agency must take a position against any policy change.

Now, I do support and applaud the effort he's making that he talked about today, but it's not sufficient. Therefore, Mr. Chairman, it is left squarely in the hands of Congress, and we believe that it is imperative that this Congress address the problem immediately. And why should you act now? I think the answer is relatively simple. Congress will deal with this issue sooner or later. It may choose to deal with it now through policy change that puts it back in the hands of business and industry to sort it out and work through. Or it will have to deal with it later when captive shippers have fled, the jobs are gone and the current railroad business model has failed.

Since railroads are an integral part of our economy, you will then have to conduct a bailout at great expense to taxpayers. Clearly, the better course is to act now. At a minimum, Congress should immediately require railroads, when requested by customers, to provide in writing a rate to a point on the railroad system where the customer can gain access to rail competition. The provision does not dictate the level of the rate or even require that the rate would be reasonable, but only that a rate be provided so that the rail customer can gain use of existing rail competition.

Correcting this fundamental flaw will go a long way toward preserving the competitive viability of American manufacturing facilities and help keep manufacturing jobs in the country.

Thank you, Mr. Chairman and members of the Subcommittee for the opportunity to bring this vital issue to our attention.

Mr. QUINN. Well, Mr. Platz, we appreciate your return to the Subcommittee and, as we said to Mr. Pomeroy, we appreciate your input at all times.

Mr. Ficker.

Mr. FICKER. Thank you, Mr. Chairman.

This is my first time testifying before the Committee, and I do want to congratulate Frank on his position as well, and good luck in the confirmation process.

I'm currently the President of the National Industrial Transportation League, which is the oldest and largest association representing those involved in the movement of freight. On behalf of the 600 members of our organization, I'd like to commend the Committee for holding these important hearings and giving me the opportunity to testify.

In a few weeks, I'll be celebrating 34 years in the transportation industry. Of those 34 years, I spent 13 actively working in the railroad industry. In fact, I just was acquainted with my co-presenter, co-testifier here, we actually worked in the same railroad at the same time. So we're going to share some stories later.

Following that, I spent 20 years operating in various transportation management functions for shippers across the country, using all sorts of modes of transportation, including rail. So I've had a chance to see the entire rail industry and the transportation industry and the challenges faced and met over the last 30 years.

I'd like to direct my comments today to the importance that has already been stated of the rail industry to our economy and ways for the rail industry to increase their portion of the freight carrying business of our country. I will also show that there need to be changes made to the rail transportation policy and to the rail's current economic model. Specifically, the infusion of greater competitive forces in the rail industry to more effectively meet the growing needs of the transportation of our country.

Before I start that, I'd like to make one thing very clear. Shipper members of the National Industrial Transportation League are some of the staunchest supporters of the rail industry in the United States. Our members understand this industry very well, and understand especially the large capital requirements that are necessary to maintain their networks.

However, shippers will move their freight and move their cargo in a way that most expeditiously meets their business needs. Those who have an option to choose between rail and other forms of transportation will utilize that mode of transportation that best provides them the combination of service and price to meet their customers' needs. Even shippers who are served by only a single railroad and who must, because of the nature of their commodities—and we've heard this mentioned earlier—use rail in the short-to medium-term, if the service and price is unsatisfactory, may over the long term, and again we've heard this this morning, reduce their use of rail service by shifting production potentially overseas or totally redesign their manufacturing and distribution patterns to meet those needs.

In the course of this debate, a great deal has been made about the captive shipper. And I won't go into any more detail, because I think the fellow panelists here have made a very good case about that. But the important thing to understand about a captive shipper is it's not just one end of the chain that is required to be competitive. Both ends of the chain must be competitive. The origin must have options and the destination must have options. Or in fact, the bottleneck process comes into play and shippers are stymied in their ability to get a competitive alternative.

I'd like to make a quote from Senator Kay Bailey Hutchison, who last October in the Senate Subcommittee on Surface Transportation and Merchant Marine, made the following statement, and I quote: "Today there is a severe shortage of competition in the freight rail industry." But competition is at the heart of the American economy. It's the engine of innovation, creativity, efficiency and ultimately profitability. It might be characterized as the engine that could.

One of America's most famous management consultants, Tom Peters, in his new book, Reimagine, which I recommend to all of you, makes the following statement about competition: "There is no greater blessing than an extraordinary competitor. Great competitors keep you on your toes. Alas, none of us improves without someone who pushes us." I think most members of Congress can appreciate that when election time rolls around.

The need for a strong and more competitive retail system has never been more important than now. Although the country needs an expanding rail industry, there are some very disturbing signs which concern us and point to the direction that maybe we're not growing int eh right direction. From 1993 to 2001, the trucking industry grew from $90 billion in annual revenue to a little less than $310, or 63 percent growth. In that same time frame, the rail industry grew from $3 billion to $36 billion, just 19 and a half percent. In that same period, the rail dependence on one single commodity, coal, grew from 38 to 44 percent, or a 14 percent increase. And I was delighted to see that Mr. Hamberger brought forward the AASHTO report, the Association of State Highway and Transportation Officials report, called the Freight Rail Bottom Line report. In that report, the estimates are that freight transportation in this country will increase by 50 percent by the year 2020.

If you take that volume and project that volume based on the 1993 to 2002 numbers that we just mentioned, that would indicate the trucking volume in this country will more than double by 2020. And frankly, I think you're voting on another bill in a few minutes, I don't believe that the infrastructure of this country can handle that growth.

It's clear that the status quo for railroads does not describe a model that will result in the rail industry growing to meet the transportation needs of our country, and frankly, there must be change. In all other modes of transportation, shippers have service providers competing strongly for their business. The Motor Carrier Act of 1980 freed the trucking industry from unnecessary competition and fostered intermodal competition. These competitive forces have been of benefit to both the shippers and the carriers as the industry became more efficient and more customer focused.

These competitive forces did not result in stagnation or financial disasters for the trucking industry, but rather growth and efficiency. It's now time to put those same competitive forces into the rail industry. The proposals outlined in H.R. 2924 and S. 919 allow for such change and will foster growth by instilling competition.

Such change also encourages transportation suppliers and their customers to become partners, to eliminate inefficiencies. I'm delighted that Chairman Nober has taken a positive step to open the regulatory process and begin to streamline processing of cases. But while these changes are necessary and welcome, Congress itself needs to act to set a more proactive, pro-competitive, rail policy for the United States and to provide substantive change to the governing statutes and the policy directions of the agency.

Finally, since assuming my current position in September, I have stressed the importance of collaboration among all transportation interests, and here is the perfect chance for collaboration. I know there's been frustration in the past by those who have attempted this, but I think that effort still needs to be made. It will require hard work, it will require openness to innovative ideas, and most importantly, it will require a willingness to compromise.

The NIT League standards ready to dialogue any time, any place and with any one to open these discussions up. I look forward to the opportunity to answer any questions. Thank you.

Mr. QUINN. Thank you, Mr. Ficker. Thank you very much.

Mr. Rennicke.

Mr. RENNICKE. Thank you. My name is Bill Rennicke and I'm a Managing Director at Mercer Management Consulting and I thank you for the opportunity to come and make some comments today.

Just a little bit of background, I worked in the railroad business since the early 1960s, back in the days when the New Haven Railroad was an entity, bankrupt at the time, but that's where I started the business. In the last 20 years at Mercer, we've worked extensively not only in North America but restructuring railroads around the world. In most cases, those were railroads who wanted to move from being public or taxpayer funded properties into the private sector. So whether it's the Mexican system, which is probably the biggest success we have, or the ones in Australia, or at the present time, we're actually privatizing the Hong Kong subway system and commuter system. There is a real envy of our private sector system, it's something that I think we should try to as much as possible preserve.

I'll make references to the document I passed out, I don't think anybody needs to actually refer to them, but I can just cross reference the page numbers. I think one of the interesting points, if you look at page four where it shows the operating ratios for the railroads and the larger class railroads in the U.S. in 2002, most of them were in the low 80s. That is a really impressive factor. In fact, when you work in this business and you work in a private sector economy, and I will throw Canada into the pot, too, because they have probably the best performing railroad right now in North America, CN, sometimes you take for granted what a low operating ratio does for you.

The interesting factor is that the North American railroads produce the transportation services they do for something less than 100 cents on the dollar. So they're making money. That is rare in the world. There are very, very few places where you can find positive, profitable and in many cases positive cash flow railroads. It's changing, some in Australia, as I mentioned, and in Mexico. But I think that's something that has to be looked at.

What's even more amazing is if you look at the page I had on, Roman number II-12, and it shows that since Staggers Act, there has been almost a 200 percent increase in the unit cost of everything that railroads have purchased. A t the same time, whether you use nominal dollars, there's been roughly a 10 percent decrease in revenue in cents per ton mile, and there's a 60 percent decrease if you look at that in real dollars. Some of that occurs from shifting responsibility for providing rail cars to the customers, but the fact that there's a 200 point spread between what inflation is doing and what the railroads are charging their customers is a unique phenomenon to the U.S. In fact, we use this all over Europe with the freight railroads over there who are trying to establish themselves as viably commercial businesses.

I think if you look page II-6, where we show what have been the productivity changes that have occurred, and we just picked four. If you look at 2002, which is the last year we have totally full numbers, the productivity of a mile of railroad has gone up 162 percent. So that means if you consider a mile of railroad as a pipe, you're pumping 162 percent more traffic through it. If you look at the individual productivity of the work force, it's gone up 380 percent, locomotive productivity, fleet productivity, the use of rail cars, 56 percent.

Now, that productivity in the figures I mentioned before with inflation and the fact that inflation has gone up 200 percent, it creates an environment where certain difficult decisions which I think are the subject of a lot of the comments that have to be made, you need bigger rail cars, you need to find massive amounts of cost savings if you're going to stay ahead of inflation, and it leads you sometimes to operating practices that sometimes are more difficult, or it means larger trains, larger cuts of cars, in some cases larger cars, period.

The industry itself, from recent research we've done, and I think the overall growth in transportation factors is important, but even things like intermodal, if you compare 1990 to 2005, just the intermodal growth of the industry might even be 2.5 percent. That's without a massive transfer of traffic off the highway to the railroads from changes in work rules.

I think as the AAR pointed out, collectively there's been about $300 billion of private investment, the railroads each year put about 15 to 20 percent of every dollar that comes in the door into capital. We've done research and work in many other businesses, steel, electricity, retail, and nobody is putting that level of private capital into the business.

I also have mentioned just to demonstrate some other issues and challenges that will come up in terms of requirements that there's going to be a whole revolution in communication and data that the shippers are going to force, and it's going to call RFID, it's called

RFID, Wal-Mart, Target, the big companies right now are making that a method of communication. Somewhere along the line the railroads have RFID tags on their rail cars today. That's a process that works in essence like an easy pass on your automobile going through a toll booth. Probably by the year 2010 or 2020, every product that goes into a store anywhere will have some kind of RFID coding, and it will have to be tracked, and that means if the railroads want to participate in that business, they're going to have to even get into what's called new classes of technology.

One of the things we also do is spend a lot of time working with banks and financial institutions assessing the risks on investments and railroad cars and just basic equity investments in railroads. I'll just add some comments to the questions this morning about dividends. The dividends or interest are nothing more than the cost of money. You could, if there wasn't such a thing as leverage, it's not inconceivable that you could have 100 percent debt on a railroad, and I don't know whether they would complain about the amount of interest rates that they're paying.

But in looking at the ability of Wall Street and investors to put their money into railroads, there are many risks that they look at. One of them is drastic change in regulation. I think there's more private money interested in the railroads since 1980, I think Wall Street investors will go along with reasonable levels of changes in regulation, things that get very complex and become very different. If the playing field gets changed, I think some of this private capital that has supported the industry may go away.

And I'll just add a couple of other comments. For other reasons, we have looked over the years at the prices, not only railroads but trucking companies, airlines and truck load carriers charge their customers. We have a process where we look at yield management. In looking at those prices, it is interesting that while there may be an appearance, and there are certainly cases under the philosophy of Ramsey pricing or differential pricing that people pay different rates.

From the research we did, and it wasn't 100 percent across every railroad, and it was actually several years ago and again, for a different reason, we did not find a significant pattern of discrimination against either big shippers or small shippers, or big shipments or small shipments. And when you plot them out, and I have provided some disguised exhibits in there that albeit are several years old, it's a very interesting phenomenon. You always find somebody that's paying more, you always find somebody that's paying less. And these are people who under the same circumstances have in many cases similar circumstances.

The last comment I will make is on the effect of something that has been affecting the banking industry, and I think there have been some comments today. There is a process called Basel Two, where a whole new set of international regulations on banking are going to affect the capital reserves for people who lend to railroads. There is a very high probability that the cost and risk to railroads, which is in the same bucket as airlines under this process, will get much higher.

So this morning I heard comments about today's interest rates. The railroads are going to have to do, and people how invest in railroads are going to have to pay very close attention to how they bring their capital projects document and validate their capital projects, so that they wind up in a cheaper risk bucket than the airlines.

I thank you.

Mr. QUINN. Thank you very much, Mr. Rennicke.

Dr. Grimm.

Mr. GRIMM. Good afternoon. My name is Curt Grimm, and I'm Dean's Professor of Supply Chain and Strategy at the University of Maryland.

I appreciate the opportunity to meet today and provide my views on this very important issue. And I note that I'm not testifying today on behalf of any group or organization.

My remarks draw on my almost 30 years of experience in rail policy matters, including extensive academic research in this area. Rail deregulation has clearly been a very successful policy. However, in my view there are two problems which remain, and these problems need attention. One, in the aftermath of the 1990s rail merger wave, the industry is now dominated by four large carriers. These four now dwarf smaller Class Ones, regional railroads and short line railroads. This size disparity has created a competitive imbalance amongst U.S. railroads, in many cases limiting the ability of the smaller railroads to provide effective competition.

The second problemis that approximately 20 percent of rail customers are captive to a single railroad, and they don't have effective competition from other modes. These captive shippers pay on average about 21 percent higher rates. Both of those numbers are drawn from work that I've done with Cliff Winston of Brookings Institute.

The solution to both problems: empower smaller railroads and provide competition to captive shippers. A variety of means are available to accomplish these dual objectives and a variety of means could accomplish these objectives in ways that would impose very little administrative burden on regulators or anyone else. For example, removal of paper barriers would provide meaningful competition for many captive shippers, while extending the competitive reach of short line railroads. Requiring railroads, particularly the four large ones, to quote rates to points of competition would also be a positive step. Mandatory interswitching within a prescribed radius, as has been practice in Canada since 1908, also merits consideration.

Importantly, I believe that stimulating rail competition would strengthen, not weaken, the rail industry. First, resolving the captive shipper issue will ease railroad shipper tensions. It's not healthy for the railroad industry to be at war with many of their best customers year in and year out. Resolution of the captive shipper issue would allow railroads and shippers to focus on achieving logistics efficiencies as partners.

Today these mutually beneficial supply chain collaborations, which are very effective throughout the economy, are far more prevalent between shippers and trucking firms, where economic deregulation is complete. Second, resolving the captive shipper issue would extend the success of the Staggers Act. Why was the Staggers Act successful? Railroad deregulation has had positive effects on the rail industry because it substituted competition for Government regulation for most rail customers. Staggers stimulated competition and gave the railroads freedom to compete.

When faced with new competition, railroads cut costs, increased productivity and improved service quality. Additional moves to increase rail competition will further strengthen the industry. Competition provides a built-in accountability mechanism. Firms and managers who are best able to compete by cutting costs and improving service quality will emerge with a more prominent role in the industry.

Now, importantly concern about short term rail revenue diminution is no reason to accept the status quo. First of all, railroad estimates of this diminution are exaggerated, to say the least. Based on my Brookings work again, the total transfer from captive shippers to railroads is about $1.3 billion annually. That's multiplying the total captive shippers, shipper traffic, times the 21 percent differential between competitive rates and captive shipper rates.

The measures that are being contemplated would only give partial competition to some of these captive shippers. So the number would be well below $1.3 billion, even before we start talking about the adjustments of cutting costs and improving service and increasing productivity that would appear if we stimulated competition.

In any case, even if there is concern about a modest short term revenue loss, policy makers could dovetail increased competition for captive shippers with financial assistance for railroads in the form of infrastructure grants or tax policy changes. Both these options have been proposed, but not yet linked to the captive shipper issue. I'm sympathetic to railroad industry arguments that other modes are unfairly subsidized to the detriment of rail. I propose that we level both playing fields; couple assistance to rail with competitive relief for captive shippers.

Now, importantly, extending competition to captive shippers would be deregulation, not re-regulation. Railroads have consistently characterized these changes, of course, as re-regulation, and it's clearly a misnomer. The core of remaining STB regulation involves a determination of maximum rates for captive shippers. Reducing the number of captive shippers and concomitantly reducing the purview of the STB would further deregulate, not re-regulate, the rail industry. And it would of course have the added benefit of easing the very large STB work load with all these maximum rate cases, as we heard about earlier.

To conclude, rail deregulation is now 80 percent complete, and it's clearly been a success. Policy makers should move further down the deregulatory road by extending competition wherever feasible to captive shippers. Railroads and shippers should be encouraged to work together on this, try to come up with a win-win solution to this issue themselves if at all possible; that would be the ideal, with public assistance potentially available as part of the package.

In my view, addressing the captive shipper issue is essential if railroads are to continue their vital role in our Nation's economy. Thank you.

Mr. QUINN. Thank you, Dr. Grimm, and let me thank all of our witnesses this afternoon. The presentations, both the ones we received in here and at the table were very, very helpful.

Just a couple of questions for clarification, and then I'll yield to my good friend who's joined us, Mr. Blumenauer. Dr. Grimm, you talked about the 20 percent number of shippers that are considered captive. That seems a little lower than what we might sense from some of the testimony we've heard. And might I add, while Mr. Baker was here earlier, I had a similar situation in Buffalo, New York, the district I represent, over the years. So it's nothing new to me, either.

How recent is your research where you arrive at the 20 percent number captive and 21 percent differential?

Mr. GRIMM. This was based on research originating with a survey, an extensive survey of railroad shippers. It was done in 1998. And we asked shippers all kinds of questions, including about their rates and their competitive circumstances. There are different ways, of course, to define captive shippers, and you're going to get different percentages based on that. We chose a definition of, if a customer was served by one railroad, had no other railroad within 50 miles and had no access to or feasible access to truck or water. So again, it's a little bit arbitrary what is and isn't a captive shipper, and it's possible that one could get a larger number if you defined captivity a little bit differently.

Chairman Nober talked about 15 to 20 percent was his estimate of the amount of captive shippers. So our number is consistent with that, but again, a little bit different definition.

Mr. QUINN. That's why I asked the question, because when Chairman Nober was here, his response was about 15 or 20. So you're in the ballpark, at least.

Mr. GRIMM. Right.

Mr. QUINN. And those numbers would be, if Mr. Nober's information is more recent than your survey in 1998, that those numbers hold?

Mr. GRIMM. I don't know, the industry has been pretty static, at least in terms of the degree of competition since 1998. It's also worth noting that there was a GAO study a few years back that estimated about 30 percent of traffic moved from shippers who were captive. Again, that's also a consistent number in that these 20 percent of the shippers do tend to be large shippers, shipping bulk commodities like coal or chemicals.

Mr. QUINN. Sure. Thank you very much.

And Terry, a question for you on your original chart that's here. The last 19, I think it's 19 miles, in order to get to where it needs to get, created an increase of about 50 percent. Can you put some real life numbers to those for us, giving an example of the cost you're looking at?

Mr. HUVAL. For some of the information is, confidentiality issues are raised. But just to kind of explain how we came up with that, our experts have told us that if we had a competitive rail provider that we could probably save at least 50 percent on our cost of rail, or we're paying 50 percent more than what we should be paying. So what I'm saying is that if we had that 19 miles, if we had a duplicate set, another rail provider or another way to get to them, that that would affect our rates by, I guess if it was 50 percent higher, it would be 33 percent less. So that's how we come up with the numbers. And in the end, it comes up to about $5 million or $6 million a year.

Mr. QUINN. Thank you. Again, in my situation in my own district that I represent, we talked to a number of shippers about some numbers and what it means to the bottom line. I understand how some of that is confidential, corporate confidential I guess. But in a sense, when all of you say you've testified before, you've been here and what happens or nothing has happened, that's why people like Mr. Baker and others sponsor the legislation, that's why there's a bill over in the Senate. I think Senator Coleman has sponsored it. That's the reason that legislation is there.

And I'm always interested to put numbers to that, to give us a sense of just what this means at the end of the day. It's substantial, is what you're all saying, and I would feel safe to paraphrase all of you. Thank you very much.

Earl?

Mr. BLUMENAUER. Thank you, Mr. Chairman.

Dr. Grimm, talking for a moment about the mandatory interswitching in Canada, you indicated it had been in operation for 95 years or something of that nature, how would that be implemented here and what do you think the consequences would be?

Mr. GRIMM. The provision in Canada calls for mandatory interswitching within a 30 kilometer radius, which is of course about 20 miles. The idea is, mandatory inter-switching within an urban area or when there is a competitive railroad somewhat nearby. That actually has worked very well in Canada and could be implemented here very easily. One of the beauties of the system is that all you need to do because the inter-switching is over a relatively small segment and it's pretty consistent in terms of just the number of cars, the distances, the cost structure is not real complex for working that out.

And much of the inter-switching in Canada would also be the same case here, it's reciprocal. In other words, one of the major railroads switches 100,000 cars, e.g. the BN switches 100,000 for UP, UP switches was 100,000 for BN. So if you don't have the costs 100 percent exactly right, a lot of this washes out.

The cost structure in Canada is determined on a simple matrix of cost per car based on the number of cars. It's based on providing coverage and compensation, fair compensation in terms of variable cost, plus a return to investment. And it's just a simple matrix which is revisited once a year for updating for any changes in rail costs, inflation and so on.

And I participated in those proceedings in Canada where those costs were updated. So you can get the inter-switching, which would just eliminate many, many of our captive shippers very easily with no administrative burden, minimal administrative burden and a far less administrative burden, of course, than what now is happening with these captive shipper rate cases, as we've heard, are $3 million a pop. So there's no question that you could do something modeled after the Canadian inter-switching that would be very effective, little administrative burden and would move us in a direction of deregulation, not re-regulation.

Mr. BLUMENAUER. I'm curious, Mr. Chairman, if any of the other witnesses have observations about the implementation of an approach like this State-side.

Mr. FICKER. If I could, Congressman, the one comment I would make is I believe the doctor is right in his assessment, this would be a low administrative burden. In fact, in my view and in some counsels' view, this can be done by the agency today if they so chose. There is not a requirement that Congress would pass legislation to do this, however, Congress should direct the agency to move in that direction.

I think the reality of it is, when you look at the return on investment and the operating ratios of the Canadian railroads, they are the best in North America, period. Canadian National clearly has the outstanding railroad with scheduled railroad service that operates very successfully. And the economic fallout that is predicted as a result of this kind of change just is not true in that model.

Mr. PLATZ. I'd just like to make one comment. The system actually in Canada, we have two plants in Canada, that actually has a number of elements. One is competitive line rates, where traffic can in fact move over a line, there's a system behind it, a method for arbitrating rates as well as arbitration. A lot of these systems are in place, but they're actually not used, because there is a backup to the kind of negotiations that would take place directly between the customer and the railroads, the customer and the supplier.

That's really what we want. Everybody wants to have that kind of relationship between their supplier and their customer. But without that type of structure behind it, as the situation we have here in the United States, you can't get that kind of relationship going.

In one case, we were thinking about using the arbitration process in Canada, but when we went and talked with the railroad about it, we found a solution. Because we had this kind of backup behind us, something that we could all fall back on. Here we don't have that, and that's what creates a lot of this tension that's taking place here in North America, in the United States.

Mr. GRIMM. If I might just clarify, there are a number of structures in place to provide rail competition in Canada. Mandatory inter-switching only applies if you have competitive rail service within 30 kilometers. That particular structure does work very well and is used to switch several hundred thousand cars a year.

Now, there are also other provisions if you don't have a competitive railroad within 30 kilometers. That's where we get into the competitive line rates and the final offer arbitration and so on. And it is true that those other mechanisms, which generally require the collaboration of the competitive railroad to take effect, don't work very often and don't work very well except as a backup. But I do want to contrast that to the mandatory inter-switching, which works automatically and is very effective at providing rail competition.

Mr. BLUMENAUER. Other thoughts or observations from our panel?'

Mr. Chairman, I've been dealing with people in the Pacific Northwest wrestling with some of these questions on the local level. I do think that there are some simple, common sense steps that with your help and that of the Subcommittee we may be able to give a nudge. I think this is an example of one that I think has great appeal, and I would invite any of our witnesses to submit further observations, examples, that would help inform and refine the thinking on this.

Mr. QUINN. Thank you, Earl, and thanks for joining us this afternoon.

I have no further questions, but would observe along the lines that you have that we said when we began this afternoon that we would keep the record open for 30 days. I know there were at least two or three members who were here for a while who will have further questions. If we could get that information back from you, there are probably going to be some meetings scheduled following today.

So I think it was a good session all in all, to get the ball rolling, get it started. And if we have to have you back, Mr. Platz, a fifth time, we'll somehow make it happen.

So from all of us here, Dr. Grimm, thank you for your—you probably should have been at a separate table over there, I understand, but we appreciate your objective academic view on all this, and appreciate the time. I know that all of you spent an awful lot of time preparing for today, traveling from all parts of the country to get here. It happens to be where we work. I always like to mention that all of us, from staff on to the members, appreciate your efforts to get here to Washington, to take time out of your busy schedule from your companies and your families to be with us. So thanks for doing that, and we'll get to work on it.

Hearing no further business, I am going to adjourn the meeting.

[Whereupon, at 1:35 p.m., the subcommittee was adjourned, to reconvene at the call of the Chair.]

TESTIMONY OF

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

Before the
Subcommittee on Railroads
Committee on Transportation and Infrastructure
U.S. House of Representatives

Presented by

Mr. John B. Ficker, President
The National Industrial Transportation League

Concerning

The Status of the Surface Transportation Board and Railroad Economic Regulation

The National Industrial Transportation League is one of the nation's oldest and largest national associations representing companies engaged in the transportation of goods in both domestic and international commerce. The League was founded in 1907, and currently has approximately 600 company members. These members range from some of the largest users of the nation's transportation system, to smaller companies engaged in the shipment and receipt of goods. League members use all forms of transportation for the shipment and receipt of goods of all kinds, to literally thousands of points in the United States.

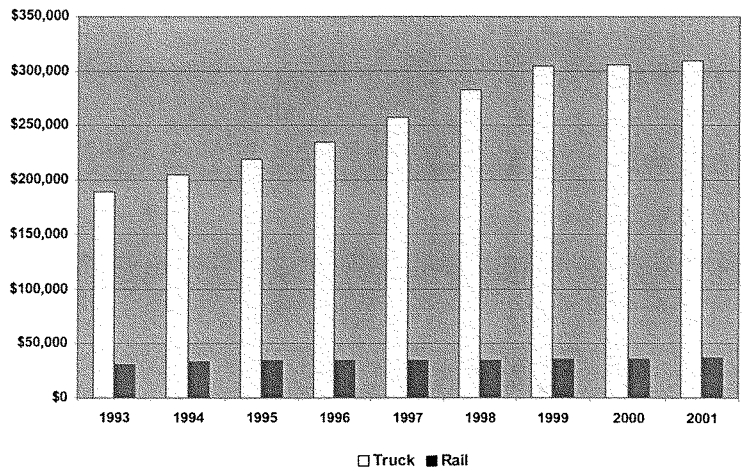
Many members of the League utilize rail transportation, and thus have a very substantial interest in federal policies relevant to rail carriers, including the status of the Surface Transportation Board and railroad economic regulation. Indeed, many League members are dependent on rail carriers to move their goods, and therefore need a safe, secure, efficient and financially healthy rail industry. For this reason, over the years the League has been a staunch supporter of the rail industry. Many League members are eager to increase their utilization of this vital industry, in order to meet their own and the nation's transportation needs. In fact, the ability of American manufacturers to compete in a world economy and the creation of jobs in the United States, depends in substantial part on the existence of a competitive and efficient rail industry. Rail transportation is thus not simply a matter of private interest between rail carriers and shippers, but appreciably contributes to our nation's overall economic health. Rail transportation also helps to alleviate congestion on our highways, and thus adds to the overall efficiency and safety of our nation's entire transportation system.

Moreover, the League well understands the capital-intensive nature of the rail industry and its large capital needs. Rail shippers depend on those infrastructures for the safe and efficient transportation of their goods. Almost exactly one year ago, the League appeared before this Subcommittee and urged the Congress to take steps to provide funds to improve the nation's rail infrastructure and to reduce the amount of taxes that the nation's rail carriers pay so that additional monies can be directed toward improving rail infrastructure.

Shippers will utilize the transportation modes that best meet their business needs. Shippers who have the option to choose between rail transportation and other modes will utilize the mode that provides them the best combination of service and price. Even shippers who are served by a single rail carrier and who must, because of the nature of their commodity or their situation, use rail in the short to medium term, if service or price is unsatisfactory may reduce their use of rail service by shifting production overseas or redesigning their manufacturing or distribution processes. Although the nation absolutely needs an expanding and vital rail industry, there are signs that the rail industry has not kept up with the nation's growing transportation needs.

The chart below shows one aspect of the situation. In 1993, according to data published by the Association of American Railroads ("AAR"), railroads intercity freight revenues were $30.7 billion. In that same year, trucks' intercity freight revenues were $189.7 billion. By 2001, trucks intercity freight revenues had grown to $309.4 billion, an increase of 63%. In contrast, by 2001, railroads intercity freight revenues had grown to $36.7 billion, an increase of just 19.5% over the same time frame.[1] In other words, in the 1993-2001 timeframe, the trucking industry's percentage of intercity freight revenue had grown over three times faster than that of the rail industry.

Modal Revenue Growth 1993-2001



Moreover, between 1993 and 2002, U.S. Class I railroads' dependence upon a single commodity – coal – grew from 38.2% of all tons carried to 44.4% of all tons carried, a 16.4% increase.[2]

Another aspect of this situation is shown in the growth of rail carriage compared to the growth in U.S. industrial production. According to AAR figures, between 1993 and 2002, the number of carloads originated by Class I railroads grew by 28.6% and tons originated grew by 26.5%. Yet, in this same period, U.S. industrial production grew by 36.8%.[3] In other words, over an entire decade, U.S. industrial

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[1] Source: "Railroad Ten Year Trends 1993-2002," Volume No. 20, Policy and Economics Department, Association of American Railroads, p. 26 ("Railroad Ten Year Trends").

[2] Id. p. 51.

[3] Id. pp. 43 and 44.

production grew about twenty-five percent faster than railroads' traffic.[4] Even using ton-miles, the measure of production most favorable to railroads (which measures not only the number of tons transported but also how far those tons are carried), railroads' growth still had not kept pace with U.S industrial production.[5] In other words, today railroads are carrying things – primarily coal – farther than they carried those things ten years ago, but the number of carloads they carry is failing to keep pace with the growth in the U.S. industrial economy.

As mergers took place over the decade from 1993 to 2002, the number of Class I railroads declined from twelve carriers to just seven carriers. These mergers reduced routing options and a variety of other forms of competition for shippers. Yet, these mergers do not seem to have produced the dramatic improvements in service promised: according to AAR figures, the average freight train speed of Class I rail carriers in 2002 was lower than the average freight train speed of a decade earlier.[6] Nor have these mergers apparently produced the financial results hoped for: according to AAR figures, the rail industry's rate of return on net investment in 2002 (7.0%) is almost precisely where it was a decade earlier (7.1% in 1992) and its return on equity was lower (8.3% in 2002 versus 9.4% in 1993).[7] In fact, on average, both the railroads' rate of return on net investment and their return on equity were higher in the first five years of the decade than they were in the most recent five years of this ten-year period.[8]

Shippers need railroads to provide proven, reliable, consistent freight service, and they will pay for such service. This is because value consists of consistent service, competitive pricing, market innovation, and competitive choices. In a global economy, shippers are becoming more demanding of their transportation suppliers -- even more timely freight service, at even more consistent levels, at an

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4 Id. U.S. industrial production grew 27.8 percent faster than carloads originated by Class I rail carriers, and 22.2% faster than the tons originated by Class I railroads.

5 Id. p. 44. In the ten-year period from 1993 to 2002, U.S. industrial production grew by 36.8%, and Class I railroads' ton miles grew by 35.9%.

6 Id. p. 132. The AAR reports that the average freight train speed in 1993 was 23.1 miles per train hour, while the average freight train speed in 2002 was 20.9 miles per train hour.

7 Id. p. 86, 90.

8 Id. p. 86, 90. Between 1993 and 1997, rate of return on net investment averaged 8.1%, while between 1998 and 2002, ROT averaged 6.8%. Return on equity from 1993 to 1997 averaged 10.3%, while from 1998 to 2002 it averaged 8.5%.

even more competitive price. They are becoming more demanding of their freight transportation suppliers because shippers' customers are becoming ever more demanding in an increasingly competitive global economy.

While the economic and services bar is being raised higher, the data suggests that, though the freight railroad industry is in far better financial shape than it was in the 1970s, it has not been able to maintain or expand its share of intercity freight transportation. Freight transportation overall is expected to grow significantly over the next decade. According to the report entitled "Freight – Rail Bottom Line" published by the American Association of State Highway and Transportation Officials (AASHTO) in 2000, freight volume is expected to grow fifty percent between 2000 and 2020. Freight railroads need to be part of that growth. But if the trends of the past ten years discussed above are projected into the nation's future in 2020, trucking activity will more than double, while the railroads' share of intercity freight revenues will grow only slowly. Such a situation would result in a massive challenge to the nation's existing highway infrastructure. The status quo thus does not appear to be a model that will result in a rail industry that will fully participate in the growth required to meet the nation's increased transportation needs.

This leads to the issue of this hearing – the status of the Surface Transportation Board and railroad economic regulation, including the impact of the current railroad regulatory environment on railroads and shippers. The League believes that a national transportation policy should recognize the inherent value of each mode of transportation; provide incentives to all modes to improve efficiencies and productivity, and encourage not only competition between and within modes, but also cooperation to take advantage of the inherent advantages of each mode.

In all other modes of transportation, shippers have service providers competing for their business. The public roads over which trucks travel are open to all trucks, and the trucking companies strongly compete between themselves for the business of shippers. Indeed, one of the major benefits of the *Motor*

Carrier Act of 1980 was to free the trucking industry from unnecessary federal regulation, and to permit more competition between trucking companies over the public roads. The trucking industry's strong competition for shippers' business has, the League believes, strongly benefitted both motor carriers and shippers, as the industry has become increasingly efficient and customer-focused.

But this competitive model also promotes cooperation between shippers and carriers. In the operational arena, shippers and motor carriers work together to figure out ways to reduce costs and drive efficiencies. And in the public policy arena, reliance on a thoroughgoing competitive model has also meant that the trucking industry and shippers are on the same "side" when it comes to public policy. Instead of fighting each other, shippers and motor carriers have increasingly cooperated in the public policy arena to fight for improvements needed to make the industry stronger. For example, shippers and motor carriers have cooperated in the Department of Transportation rulemaking reforming the industry's hours of service rules.

The League strongly believes that federal economic policy should similarly encourage and promote rail-to-rail competition, and that there should be legislative changes to bring about increased rail-to-rail competition. The reason for this is directly linked to the nation's overall transportation needs and the extremely favorable experience that has come about through increased truck competition as a result of the Motor Carrier Act. Unlike the trucking industry, the vast majority of League members, and indeed rail shippers in general, are only served by a single railroad. A significant portion of the nation's shippers must use rail service for at least a portion of their transportation needs. If a shipper is unsatisfied with the rail service that it receives or the price, it cannot use another railroad, sometimes for even the portion of the move for which another railroad could provide competitive rail service.

Competition drives efficiencies and innovation. It leads to a fundamental shift in thinking, away from a static and ultimately counterproductive effort to protect a "franchise," toward a positive effort to grow business opportunities and eliminate costs. Competition promotes cooperation between transportation providers and their customers as both become partners in an effort to eliminate inefficiencies and improve their market opportunities. The result of these efforts is increased demand for the service – that is, growth.

In her opening statement to the Surface Transportation and Merchant Marine Senate Subcommittee last October, Senator Kay Bailey Hutchison of Texas said, "There is a severe shortage of competition in the freight railroad industry."

It is because the League believes so strongly in the benefits of competition that it has endorsed H.R. 2924 and its companion bill in the Senate, S. 919, the "Railroad Competition Act of 2003." While the League believes that there is room for shipper and carrier interests to discuss and arrive at points of common ground for instituting beneficial changes to this vital industry, the League sees three key provisions of the bill. These are: the modifications to existing STB rules on competitive switching; the requirement of rail carriers to quote a rate to and from any point on its system, and a provision for mandatory, expedited arbitration of rail rate and service disputes. These provisions in particular represent sound steps that can be taken to improve rail-to-rail competition consistent with national transportation policy.

In 1980, the Staggers Act amended the law to provide that the Interstate Commerce Commission could require rail carriers to require competitive switching where it finds such switching to be "practicable and in the public interest" or where such switching was "necessary to provide competitive rail service."[9] Yet, in the more than twenty years since the passage of the Staggers Act, the ICC and the STB have never ordered competitive switching when requested by a shipper. On the contrary, the agency, through administrative interpretation, has as a practical matter written this broad pro-competitive provision out of the statute through the use of a "competitive abuse" test found nowhere in the law. H.R.

[9] See 49 U.S.C. §11102(c)(1).

2924/S. 919 would eliminate this "competitive abuse" test to restore the effectiveness of the statutory language promulgated by Congress in 1980.

H.R. 2924/S. 919 would also require a rail carrier to quote a rail rate to a shipper from and to any point on the rail carrier's system. Under the agency's current interpretation of the law, a rail carrier may lawfully refuse to quote a rate to a shipper from the shipper's facility to an interchange point with another rail carrier that may provide competitive rail service over at least a portion of the total movement. The STB's interpretation has the paradoxical effect of eliminating possible rail-to-rail competition even where it is now physically possible.

Litigation under the agency's administrative processes is slow, complex and expensive. H.R. 2924/S. 919 would provide for mandatory, expedited arbitration to resolve rail rate and service disputes quickly and efficiently.

Railroads claim that these changes are "re-regulatory" and they would devastate the rail industry economically as rail carriers would compete themselves into financial distress. But these changes are not "re-regulation" and they don't cap rates at any level. Rather, they would permit competition to determine service and set rates – not regulation. These three provisions are similar to the regulatory model that exists for railroads today in Canada. Canadian carriers, far from suffering under this competitive model, have prospered.[10] Most importantly, the League believes that these changes would move the industry toward a competitive model in which railroads completely focus on their growth and the growth of their customers, rather than an attempt to protect their piece of an existing pie.

The League believes that Chairman Nober of the Surface Transportation Board has taken very positive steps at the Board to open the regulatory process, and to begin to streamline the processing of

[10] For example, the operating ratio of both Canadian carriers in 2002 was better than the operating ratio of the U.S. Class I freight railroads by significant margins. The operating ratio for U.S. Class I railroads in 2002 was 83.77%, according to the AAR. Railroad Ten Year Trends, p. 65. The operating ratio of Canadian National Railroad in 2002 was 76.0% and Canadian Pacific was 76.6%. See 2003 CN Annual Report, p. 8; CP 2003 Annual Report, p. 6.

cases. At a League's meeting last week, Chairman Nober told League members that the STB's "top priority" in the coming year will be to reexamine the agency's "small rate case" rules, both from a substantive and a procedural standpoint. The League believes that substantial changes in those rules and standards are necessary. It welcomes the re-examination mentioned by Chairman Nober, and looks forward to participating in the administrative process. But while administrative changes are indeed necessary, Congress itself needs to set a more pro-competitive policy for the U.S. rail industry, to provide both substantive changes to the governing statute and policy direction to the agency.

Finally, the League recognizes that the best solutions are reached through a collaborative effort that includes all freight industry stakeholders. Over the course of the last 25 years we have all witnessed the benefits that enhanced competition has brought to the highway, air and ocean industries. And while rail transportation is different in some ways from these modes, the underlying principles are constant. Competition enhances efficiency and this can occur without reducing the revenue needed to maintain investment in infrastructure. Users as well as service providers have an important interest in that objective. But none of this may be accomplished without a free and open dialogue. We would welcome the assistance of this sub-committee to help facilitate private sector discussions. The League is ready, willing and able to enter into serious discussions with representatives of the nation's rail carriers to develop positive, pro-competitive changes to the economic model that will serve the freight needs of our country.

Testimony of

Curtis M. Grimm
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To

U.S. House of Representatives
Committee on Transportation and Infrastructure
Subcommittee on Railroads

March 31, 2004

2167 Rayburn House Office Building
Washington, D.C.

Introduction

My name is Curtis M. Grimm, and I am Dean's Professor of Supply Chain and Strategy, Robert H. Smith School of Business, University of Maryland at College Park. I have been a member of this College since 1983. I received my B.A. in economics from the University of Wisconsin-Madison in 1975 and my Ph.D. in economics from the University of California-Berkeley in 1983. My Ph.D. dissertation investigated competitive impacts of railroad mergers.

In my background, I have extensively addressed public policy issues regarding transportation. I have previously been employed by the Wisconsin Department of Transportation, the U.S. Interstate Commerce Commission, and the Australian Bureau of Transport and Communication Economics, and I have provided consulting services to several other government agencies and private firms regarding transportation issues. I served as Assistant to the Chief of Intercity Transport Development, Planning Division, Wisconsin Department of Transportation in two separate stints between 1975 and 1978, with a focus on rail policy issues such as abandonments and the creation of shortline railroads. While serving as an economist at the ICC's Office of Policy Analysis from January to December 1981, my duties included analysis of competitive effects for the Union Pacific-Missouri Pacific-Western Pacific ("UP-MP-WP") merger.[1] During 1982, I served as a consultant for the Commission while the UP-MP-WP decision was being drafted and subsequently consulted for the ICC with regard to the Ex Parte No. 347 decision ("Coal Rate Guidelines - Nationwide").[2]

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[1] Union Pacific Corporation, et al., -- control – Missouri Pacific Corporation and Missouri Pacific Railroad Co., Finance docket No. 30,000, 366 I.C.C. (ICC decided September 24, 1982).

[2] Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520 (1985), aff'd sub nom., Consolidated Rail

I have subsequently participated in several ICC and STB proceedings, including rate cases and a number of rail mergers, with a focus on the competitive consequences of these transactions. On November 8, 1995, I provided testimony regarding competitive issues in rail mergers to a Joint Meeting of the United States Senate and House of Representatives Committees on Small Business.

My research has involved deregulation, competition policy, competitive interaction and management strategy, with a strong focus on transportation. This research has resulted in over 80 publications, including articles in leading journals such as Journal of Law and Economics, Transportation Research, Transportation Journal, Logistics and Transportation Review, Academy of Management Journal, Management Science, Strategic Management Journal, and Management Science. More than two dozen publications have dealt specifically with the railroad industry, mainly on economic and public policy issues. I have also co-authored four monographs, including *The Economic Effects of Surface Freight Transportation* (1990) with Cliff Winston, Thomas Corsi, and Carol Evans.

In summary, I have had extensive experience over almost 30 years on rail policy issues. I am very pleased to have the opportunity today to provide input on this important issue and would like to make clear that I am not testifying on behalf of any group or organization. My purpose is to draw on my experience to provide views on several overarching issues with regard to the current regulatory environment on railroads and shippers, and to provide information from the research I've conducted in this area. I can summarize my position as follows: The Staggers Act has substituted market competition for government regulation across much of the rail industry. This deregulation has

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Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987).

resulted in substantial benefits to the railroads and to many rail shippers. Policymakers can preserve and extend the benefits of deregulation by increasing the level of rail competition; particularly important is to provide rail competition to captive rail shippers wherever feasible.

Railroads play a vital role in our nation's economy

Railroads are and will continue to be an essential component of our nation's transportation system. As highway congestion worsens over time, railroads become even more vital. Railroads also have advantages over other modes with regard to energy efficiency and safety. Clearly, public policy should facilitate a strong and healthy railroad industry.

Railroad deregulation was designed to improve the health of the railroad industry.

The U.S. railroad industry was largely deregulated because of its poor financial performance under regulation. Rail's ton-mile share of the U.S. intercity surface freight market declined from 65 percent to 35 percent in the post-WWII decades.[3] Correspondingly, most major railroads' returns on investment were very poor.[4] After a number of railroad bankruptcies in the early to mid 1970s, partial deregulation began under the Railroad Revitalization and Regulatory Reform (4R) Act of 1976. The 1980 Staggers Act further deregulated the industry.

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3 Robert E. Gallamore, "Regulation and Innovation: Lessons from the American Railroad Industry," in Jose Gomez-Ibanez, William B. Tye, and Clifford Winston, editors, *Essays in Transportation Economics and Policy: A Handbook in Honor of John R. Meyer* (Brookings, 1999).

4 Theodore E. Keeler, *Railroads, Freight, and Public Policy* (Brookings, 1983).

Railroad deregulation has had positive impacts on the rail industry because it substituted competition for government regulation for most rail customers.

U.S. rail deregulation provided a greater reliance on free markets to promote railroad profitability and public benefits. By increasing operating freedom and stimulating competition, deregulation spurred the railroad industry to shrink its physical plant and work force to better match available traffic.[5] As discussed by Grimm and Winston (2000): "The industry abandoned roughly one-third of its track and reduced crew sizes; used contracts to align cars and equipment with shippers' demand and to reduce its vulnerability to problems caused by overcapacity; and expanded the use of intermodal operations, double stack rail cars, and computer systems to provide faster, more reliable service. Real operating costs per ton-mile have fallen steadily, and, as of 1998, were 60 percent lower than when deregulation began. Some of the cost decline can be attributed to the long-run trend in rail's traffic mix to include a greater proportion of low-cost bulk traffic, but deregulation's contribution is substantial.

Cost reductions and productivity improvements stemmed the long-run erosion in market share. And rail traffic grew. After reaching a post-war low in the mid-1980s, originating rail carloads have grown from 19.5 million in 1985 to 25.7 million in 1998.[6] All of these factors have boosted profitability. During 1971-80, the industry's return on

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[5] This section draws from Curtis M. Grimm and Clifford Winston, "Competition in the Deregulated Railroad Industry: Sources, Effects and Policy Issues," in Sam Peltzman, editors, *Deregulation of Network Industries* (Brookings, 2000), and Curtis M. Grimm and Robert Windle, "The Rationale for Deregulation," in James Peoples, editor, *Regulatory Reform and Labor Markets* (Kluwer Press, 1999).

[6] Association of American Railroads, *Railroad Facts*, 1999 edition, p. 24.

equity was less than 3 percent; during the 1990s the industry's return on equity averaged 10.7 percent.[7]" Rail deregulation has clearly been a successful policy; however, there are two salient issues which deserve attention by policymakers.

Issue 1: In the aftermath of the 1990s rail merger wave, the industry is now dominated by four large carriers.

Rail mergers since the Staggers Act have occurred in waves. As discussed by Grimm and Winston (2000), in the early 1980s, Chessie System and Seaboard Coast Line formed CSX, Norfolk and Western and Southern Railroad formed Norfolk Southern, Missouri Pacific and Western Pacific became part of Union Pacific, and the St. Louis-San Francisco Railroad along with Colorado Southern and Fort Worth Denver formed part of Burlington Northern. The next merger wave began in the mid-1990s. The Burlington Northern-Santa Fe and Union Pacific-Southern Pacific mergers left only two major railroads in the western United States while Norfolk Southern's and CSX's joint acquisition of Conrail left only two major railroads in the east. These four railroads now dwarf smaller Class I's, regional railroads, and short line railroads in the U.S. Operating revenues in 2001 for these four were: Union Pacific - $10.6 billion; BN - $9.2 billion; CSX - $6.4 billion, and NS - $6.1 billion. All other railroads in the U.S. have annual revenues well under $1 billion. (Extending the view north of the border, Canadian National has annual revenues of $3.6 billion, while Canadian Pacific has annual revenues of $2.3 billion.) This size disparity has created a competitive imbalance amongst U.S.

[7] United States General Accounting Office, *Railroad Regulation: Changes in Railroad Rates and Service Quality Since 1990*, April 1999.

railroads, in many cases limiting the ability of the smaller railroads to provide effective competition.

Issue 2: Approximately 20% of rail customers are captive to a single railroad and do not have effective competition from other modes.

While many rail shippers have benefited from the competition unleashed by the Staggers Act, a small but important customer segment of captive shippers remains. An example would be a shipper of coal where a utility is located on just one railroad. Work I have done co-authored with Cliff Winston of Brookings (Grimm and Winston, 2000) estimates that approximately 20% of shippers are captive, and that captive shippers pay on average 20.9 percent higher rates. Multiplying the total captive traffic times the 20.9 percent rate differential, we found that the total transfer from captive shippers to railroads is about $1.3 billion on an annual basis.

Solution: Empower smaller railroads and provide competition to captive shippers.

Effective remedies to address the captive shipper issue and empower smaller railroads are readily at hand. A variety of means are available to accomplish these objectives with little administrative burden. For example, removal of "paper barriers" to competition between major railroads involving short line and regional carriers would increase their competitive vitality and provide meaningful competition for many captive shippers. Requiring railroads to quote rates to points of competition would be a positive step. Mandatory interswitching within a 30 kilometer radius, as has been practiced in Canada since 1908, would also be an effective policy prescription.

New legislation to stimulate competition would clearly benefit captive shippers, but would also strengthen the railroad industry.

As did the Staggers Act, additional moves to increase rail competition will strengthen the industry. Like every other industry, when faced with new competition, railroads will cut costs, increase productivity and improve service quality. Firms and managers who are comfortable with a competitive environment and able to compete effectively will emerge with a more prominent role in the industry.

The railroad industry will not lose its ability to invest in infrastructure, as has often been asserted. The starting point for delineating an upper limit on rail revenue diminution is the $1.3 billion differential between captive and competitive shippers. However, the measures now contemplated would only provide partial competition to some of the captive shippers. So the expected rail revenue losses are well below $1.3 billion, even before we factor in the competitive response of railroads to cut costs and increase productivity. Also, traffic would be drawn from other modes if rail rates were reduced as a result of additional intrarail competition. Importantly, if there is concern about potential short-term revenue effects on the rail industry, policy makers could dovetail increased competition for captive shippers with financial assistance for railroads in the form of infrastructure grants or tax policy changes, both of which currently are being discussed.

Addressing the captive shipper issue will strengthen the rail industry by mitigating railroad/shipper tensions.

Resolution of the captive shipper issue would allow railroads to focus on improving their efficiency and customer service instead of fending off the legislative efforts of aggrieved shippers. As stated by Grimm and Winston (2000), "shippers and railroads could extend the benefits they have already achieved through contractual negotiations by achieving additional logistics efficiencies as partners, instead of quibbling over the distribution of an ever-shrinking pie as adversaries. Acrimonious relations between shippers and railroads have greatly inhibited the type of mutually beneficial just-in-time inventory collaborations that routinely occur between shippers and trucking firms."

Extending competition to captive shippers would be deregulation, not re-regulation.

Railroads have consistently characterized legislative changes such as embodied in the Railroad Competition Act of 2003 as "re-regulation." They have argued that such moves would return us to the pre-Staggers era of onerous and counter-productive government regulation. This is quite frankly not an accurate characterization (a "strategic misnomer" on the part of the railroads?). The remaining STB regulation involves the determination of maximum rates for captive shippers. The STB only has authority to set rates where railroads have market dominance. And there are many such cases now pending at the STB. If we take steps to reduce the number of captive shippers, we will simultaneously reduce the scope of STB regulation. Reducing the number of captive shippers and concomitantly reducing the purview of the STB would further *deregulate* not -- *re-regulate* -- the rail industry.

Conclusion

Rail deregulation, now 80% complete, has clearly been a success. Policy makers should move further along the deregulatory road by extending competition wherever feasible to captive shippers. This would position the railroad industry to continue their vital role in our nation's economy.

STATEMENT OF

EDWARD R. HAMBERGER

PRESIDENT & CHIEF EXECUTIVE OFFICER

ASSOCIATION OF AMERICAN RAILROADS

BEFORE THE

HOUSE COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE

SUBCOMMITTEE ON RAILROADS

HEARING ON

THE STATUS OF RAILROAD ECONOMIC REGULATION

MARCH 31, 2004

On behalf of the members of the Association of American Railroads, thank you for the opportunity to appear here today to discuss issues related to freight railroad regulation. AAR members account for the vast majority of freight rail mileage, employees, and revenue in Canada, Mexico, and the United States.

Overview

The economic prosperity of the United States and our ability to compete effectively in the global marketplace depend on the continued viability and effectiveness of our freight railroads. Today, the more than 550 U.S. freight railroads account for 42 percent of the nation's intercity freight ton-miles — more than any other mode. Over a network spanning some 142,000 route miles, U.S. freight railroads connect businesses with each other across the country and with markets overseas. Our freight railroads are a vital link to our economic future.

The current system of economic regulation of U.S. railroads — put in place by the Staggers Rail Act of 1980 — relies on competition and market forces to determine rail rates and service standards in most cases, with maximum rate and other protections available to rail customers who truly need them. This approach, which substantially diminished more than 90 years of failed government regulation, strikes a reasoned balance between providing railroads the freedom to compete effectively in the marketplace and protecting shippers from abuse of railroad market power in the limited cases where railroads do not face effective competition. I respectfully submit to you that the benefits of the current regulatory system — for the railroads, their customers, and the nation — are far too great to be sacrificed in favor of a return to excessive government regulation, which would cause immense harm by preventing railroads from making the massive investments they need year after year to meet the freight transportation needs of our nation

Specifically, H.R. 2924 and its companion bill in the Senate (S. 919) — the so-called "Railroad Competition Act of 2003" — represents exactly the wrong approach to sound economic regulation of railroads. The legislation re-injects government control over wide areas of freight rail operations. It is based on misunderstandings or misrepresentations regarding the extent of the competition railroads face. And most importantly, it dooms freight railroads to a state of perpetual capital starvation. By preventing railroads from earning enough to sustain their systems, this bill would inexorably lead to deteriorating rail infrastructure, declining rail service, fewer rail jobs, and eventually the loss of rail service completely on an increasing number of rail lines. Such an outcome is not what our nation needs or deserves.

It can be avoided, though, by maintaining the successful deregulatory system ushered in by the Staggers Act.

Railroads Since the Staggers Act

Before I explain in detail why excessive regulation in general and H.R. 2924 in particular is so pernicious to railroads and to our nation, it is important to dispel the myth that "...the business model that [railroads] have followed since 1980 ... does not seem to have been successful."[1] Consider:

- Rail intercity freight market share (measured in ton-miles) has been trending upward over the past 15 years, after decades of steady decline prior to Staggers.

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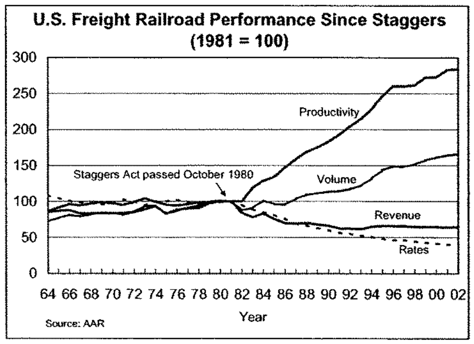
[1] "The Truth About Railroad Claims of Re-Regulation and Their Fear of Competition," prepared by Consumers United For Rail Equity, July 11, 2003.

- Prior to Staggers, railroads lacked capital to properly maintain their tracks. More than 47,000 route-miles had to be operated at reduced speeds because of dangerous track conditions, and the amount of deferred maintenance was in the billions of dollars. Through 2003, Class I railroads alone have been able to spend well over $320 billion since Staggers on infrastructure and equipment, and rail infrastructure investments per mile of road have risen some 28 percent in inflation-adjusted terms. Today, the Class I freight rail network is in better overall condition than ever before.
- Rail productivity rose 183 percent from 1980 to 2002, compared to 10 percent in the comparable pre-Staggers period.
- Nearly all of these productivity gains have been passed through to rail customers (including proponents of S. 919/H.R. 2924) in the form of sharply lower rates — down 60 percent in inflation-adjusted terms from 1981 to 2002 — saving shippers, and ultimately all of us, billions of dollars per year.



Numerous studies have confirmed the sharp drop in rail freight rates. For example, a June 2002 U.S. General Accounting Office (GAO) report analyzed rail rates from 1997 to 2000. The GAO found that "From 1997 through 2000, rail rates generally decreased, both nationwide and for many of the specific commodities and markets that we examined."[2]

The GAO noted that "[t]hese decreases followed the general trend we previously reported on for the 1990-1996 period and, as before, tended to reflect cost reductions brought about by continuing productivity gains in the railroad industry that have allowed railroads to reduce rates in order to be competitive." In a December 2000 report, the Surface Transportation Board (STB) found that "inflation-adjusted rail rates have fallen 45.3 percent" from 1984 to 1999. The STB also observed, "It is important to note that all types of rail customers, and not just those with competitive transportation alternatives, must have received some portion of the rate reductions we have measured here."[3]

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[2] U.S. General Accounting Office, Changes in Freight Railroad Rates from 1997 Through 2002, June 2002.

[3] Surface Transportation Board, Rail Rates Continue Multi-Year Decline, December 2000.

- The rail accident rate has fallen 68 percent since Staggers, and the employee injury rate is down 74 percent. Prior to Staggers, rail safety was generally worsening.
- Rail traffic volume (measured in revenue ton-miles) is up more than 60 percent since Staggers, far higher than comparable pre-Staggers traffic growth.
- By the 1970s, virtually every major railroad in the Northeast, including the giant Penn Central and several major Midwest railroads, had filed for bankruptcy. Most other railroads were financially weak. Since Staggers, railroads have improved their financial performance considerably, though as a whole they still fall well short of earning their cost of capital.

This is not failure by any definition. Thanks largely to the deregulatory structure instituted by the Staggers Act, the U.S. freight rail system today is universally recognized as the best in the world. From a public policy viewpoint, it makes no sense to make fundamental changes to a system that has delivered such large, widespread benefits.

Railroad Market Power

Proponents of more extensive regulation of railroads typically maintain that the only competitive force that matters is rail-to-rail competition, and that service to a shipper by a single railroad is equivalent to monopoly power by the railroad over the shipper. This view overlooks the fact that railroads face extensive competition for the vast majority of their business, including cases where a shipper is served by only one railroad.

Railroads compete not just among themselves, but in the larger market for freight transportation services. Most shippers, including most of those served by only one railroad, are able to negotiate competitive rates for rail service. Shippers' considerable market leverage results from a combination of powerful competitive forces. It is unreasonable to pretend that these forces do not matter. These forces include:

- *Intermodal Competition.* Shipment via trucks, barges, or pipelines is a competitive option for most rail customers. Though railroads currently account for 42 percent of total intercity ton-miles, they receive less than 10 percent of intercity freight revenue. The rail revenue share has been trending downward for decades — a trend hardly indicative of excessive market power.

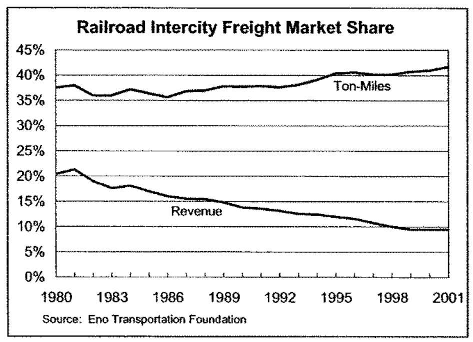
Railroads face significant competition from other modes even for commodities that some claim are "captive" to railroads. For example, U.S. Department of Agriculture figures indicate that trucks are the primary transportation mode for grain, and the chemical industry's own statistics show that railroads account for just 20 percent of chemical tonnage that is transported.

- *Product Competition.* Since the demand for rail services is derived from the demand for the products of rail customers, competition faced by rail customers in downstream markets often constrains railroad pricing.

  For example, the rates railroads can charge for hauling coal to electric utilities must be low enough to keep the electricity generated from the coal competitive, or utilities will generate (or purchase) electricity from sources other than coal. This end-product competition exerts substantial pressure on railroads to keep prices as low, and service offerings as appealing, as possible.

  If a shipper has the option of substituting different products for those that require rail service, then the shipper can use this product competition to constrain rail rates. For example, if railroads attempt to raise soda ash rates too high, manufacturers of phosphate feeds and fertilizers can substitute caustic soda — which can easily move by truck — for the soda ash.

- *Geographic Competition.* The ability of many railroad shippers and consignees to obtain the same product from (or ship the same product to) a different geographic area also constrains rail pricing. For example, a poultry producer in, say, North Carolina can play a railroad delivering feed to it from Ohio off against local feed producers. Likewise, a railroad serving a Louisiana plastics facility must price its transportation service at a level that makes the plastics produced at that facility competitive at destination compared to plastics sourced from different states — or different countries — and transported by other carriers or modes.



  If a railroad that serves a particular facility prices its movements or limits its service offerings in such a way as to render what is produced there uncompetitive with products made elsewhere, the railroad would lose the traffic entirely. Since such an outcome is contrary to the best interests of the railroad, a railroad will do whatever it reasonably can to avoid it.

- *Countervailing Power.* Many railroad customers are large industrial shippers with multiple plants and multiple products, some of which are served by other railroads and/or modes. These shippers can obtain price or service concessions by shifting or threatening to shift traffic among plants, causing the railroads that serve them to compete against each other or the other modes serving the plants.

For example, significant consolidation among electric utilities in recent years increasingly permits bundling the traffic of many plants into one large "package." A utility with such a package can enhance its leverage for service to all its facilities, including those served by a single carrier. The threat of losing the business is likely to generate price or service concessions by a railroad wanting to keep or win the contract, or to expand its current or future traffic volume. In recent years, consolidation in many other industries such as chemicals, coal, forest products, and steel has improved shippers' bargaining power over railroads.

It is not unusual for a single customer to account for a large percentage of a particular railroad's revenues, especially within a specific commodity category. This relative importance and threatened loss of railroad revenues substantially increases the likelihood that a particular rail customer will be able to successfully exercise countervailing power in its negotiations with rail carriers.

- *Plant Siting and Long-Term Contracts*. Shippers can generate competition between railroads before a plant is built by considering transportation options and negotiating favorable contracts when evaluating potential plant locations. For example, rail access was an important consideration for Toyota when it recently decided where to locate a new U.S. auto plant. Moreover, over the long term, shippers can locate or relocate plants on the lines of different railroads.
- *Technological, Regulatory, or Structural Change*. Potential changes in the technology, regulation, and/or structure of a shipper's industry over time could provide leverage over railroads. For example, the siting of agricultural processing plants in or near production areas reduces demand for rail transportation and increases pressure on railroads to remain competitive.

Moreover, rail-to-rail competition today is vigorous, with rail customers constantly searching for ways to increase it, using connections to competing carriers (sometimes through a switching carrier) or establishing (or credibly threatening to establish) new connections through "build outs" of rail track.

For example, the Burlington Northern and Santa Fe Railway (BNSF) and a group of chemical shippers are moving forward with plans to build a new 13-mile line which would connect numerous major plastics and chemical-producing facilities in Houston with BNSF's network. The facilities, which ship thousands of rail carloads per year, are now served solely by the Union Pacific Railroad (UP). And according to recent press reports, United Parcel Service (UPS), which may be the single largest customer of the U.S. freight railroad industry, recently reportedly transferred significant traffic that had been moving on BNSF to UP instead. These examples are not anomalies. Rather, they are indicative of the way that railroads compete against each other all over the country.

Proponents of more extensive regulation of railroads also object to the railroads' use of "differential pricing," Indeed, some wrongly believe that the ability to price differentially is itself indicative of excessive market power. Like businesses throughout the economy, railroads price their services on the basis of demand: shippers with the greatest demand for rail service pay higher margins than shippers with lower demand. At first blush, differential pricing may seem unfair or harsh. In fact, though, it is the fairest, most-pro-efficiency, and most pro-competitive pricing system consistent with the continued functioning of the rail industry. All shippers, *including* those who pay a higher markup, benefit from differential pricing because it maximizes the number of shippers using the rail network and, therefore, maximizes the number of shippers who make contributions to railroads' huge fixed and common costs.

What Would H.R. 2924 Actually Do?

Railroads do not fear competition, including rail-to-rail competition, as long as it is the product of free-market forces. Unfortunately, H.R. 2924 would artificially manufacture rail-to-rail competition through increased railroad regulation.

Through a variety of provisions, H.R. 2924 would use the power of government to force down rail rates for certain shippers at the expense of other shippers, rail labor, rail stockholders, and the public at large. In doing so, it would transfer billions of dollars per year from the rail industry to favored shippers. If this happened, our nation's freight railroads — who already offer the world's lowest rates and lag most other U.S. industries in terms of profitability — would be doomed to inadequate earnings, unable to make the massive investments required year after year to meet our nation's rail transportation needs. Over time, unless taxpayers stepped in with a bailout, freight service over many rail lines would simply disappear. Highways would become more overcrowded and costly to build and maintain, environmental degradation would rise, safety would deteriorate, and shipping costs would rise. Policymakers should not let this happen.

Five major provisions of H.R. 2924 are discussed below. *Each* of them would involve a substantial increase in government regulatory control over the rail industry. Together, they threaten the very existence of freight railroading as we know it in this country. For this reason, the legislation and all its provisions should be rejected.

A. "Bottleneck" Policy

A central element of H.R. 2924 is a provision that would overturn the STB's "bottleneck" policy. Bottleneck cases are those in which only one railroad (the "bottle-neck" carrier) serves either an origin or a destination, but multiple railroads serve the remaining route. Proponents of H.R. 2924 present the false image that most rail shippers enjoy full two-railroad competition from origin to destination. In truth, a very large proportion of rail shippers are served by just one railroad. Therefore, bottleneck policy has enormous significance for railroads.

Existing bottleneck policy is the result of court decisions going back to the 1920s and regulatory precedent going back even further:

1. As common carriers, railroads must provide rates and routes to move traffic from an origin to an ultimate destination.

2. Railroads cannot refuse to use multiple-railroad routes that are reasonably more efficient than their own single-line routes.
3. Absent a significant disparity in efficiency, however, a railroad does not have to "short haul" itself by moving traffic just to a junction with another railroad if it can move the traffic all the way to the ultimate destination.
4. A railroad is not required to provide a shipper with a separate rate for a segment of a through movement.
5. The rate for a through movement can be challenged for reasonableness under existing maximum rate regulation, and the reasonableness test is based on the cost for the entire through movement.

H.R. 2924 would overturn existing bottleneck policy in every major respect. Upon shipper request, a bottleneck carrier would be required to short-haul itself — *i.e.*, provide a rate for a movement to, and interchange traffic at, any junction with another railroad the shipper so designates. The rate for the short-haul segment would be subject to maximum rate regulation based on the stand-alone cost of just that segment, while the rate of the non-bottleneck segment would be driven down toward variable cost.

By effectively capping rates on segments of a through movement, the new bottleneck policy would ordain that railroads would not be able to cover their full costs or replace their assets over time. The shipper would pay a lower rate, but it is a fallacy to claim, as proponents of H.R. 2924 do, that the rate reduction is the product of more competition. Rather, it is the product of more regulation, and it is not sustainable.

Extended over the entire U.S. rail network, this provision could be expected to lead to a revenue loss to railroads of more than $4 billion per year.[4] No one has convincingly explained how such an enormous revenue shortfall could be recouped, or how, in the face

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[4] Based on the 2001 STB Costed Waybill Sample. If in 2001 the rates for all traffic affected by regulation had been held to a revenue-variable cost ratio of 180 percent, the railroads would have received $9.2 billion in revenue instead of $13.4 billion, a revenue loss of $4.2 billion (with no associated reduction in expenses).

of such a huge revenue loss, the rail industry could continue to make the massive investments required year after year to meet our nation's current and future freight transportation needs. H.R. 2924 dooms the rail industry to a *non-competitive* outcome that is clearly at odds with the needs of our nation.

The bottleneck provision of H.R. 2924 would have other serious negative effects:

- It would lead to an explosion in regulatory proceedings and in costly behavior oriented toward regulatory ends.
- It would compel railroads to splinter traffic over hundreds of interchanges at the direction of shippers, since shippers would be able to dictate to railroads the location of interchanges. This would constitute a return to the "open routing" that characterized the pre-Staggers era and would reverse the substantial progress railroads have made since then in creating a streamlined, efficient nationwide network.

B. Terminal Trackage Rights and Reciprocal Switching

Existing law provides that the STB "may require terminal facilities ... owned by a rail carrier ... to be used by another rail carrier" and "may require rail carriers to enter into reciprocal switching agreements" if the STB finds either measure "to be practicable and in the public interest."

In a series of decisions, the STB — and the Interstate Commerce Commission (ICC) before it — have consistently required that the owning carrier first be found to have engaged in anti-competitive conduct before granting terminal trackage and reciprocal switching rights. This ensures that in STB access cases, like comparable court antitrust cases, relief is predicated on actual competitive conditions and marketplace demand, rather than simply on regulatory intervention on request designed to promote artificial competition. The mere fact that the incumbent is the sole railroad serving a shipper, or that the incumbent chooses not to grant another carrier access, or prices differentially, has never been considered a competitive abuse in this context.

H.R. 2924, though, would upset this structure. It would force the STB, upon request by a shipper, to order railroads to enter into reciprocal switching agreements and provide terminal trackage rights. If, as is likely the case, the railroads involved cannot agree on access terms, government regulators would set them, including the access fee. The proposed legislation explicitly eliminates the requirement that a railroad must have engaged in anti-competitive conduct before such action could be mandated.

This provision could be interpreted as mandating terminal trackage rights and reciprocal switching whenever it was operationally feasible — thereby essentially creating forced access on demand in terminal areas. As in the bottleneck provision discussed above, the purpose of this provision is to obtain lower-than-market rates by artificially manufacturing rail-to-rail competition in ways beyond what a competitive market could justify.

Meanwhile, regulators would be inundated with unwarranted requests from shippers to grant terminal access. Moreover, regulators would need to step in to resolve myriad disputes covering priorities for use of track, operating conditions, and a host of other issues. Complex, lengthy, and costly disputes over terms of use would be inevitable as government interference replaced direct negotiation among railroads and shippers and between railroads. In addition, the complexities involved in coordination between track owners and operators could have significant safety ramifications.

C. Final Offer Arbitration

Under H.R. 2924, railroad rate and service disputes could be subject (at the shipper's sole discretion — the railroad would have no choice in the matter) to binding "final-offer arbitration" (FOA).

The FOA process would be completely outside the STB's jurisdiction. An arbitrator's decision could be completely divorced from regulatory precedent and sound economic principles — an unacceptable condition in any case, but especially in the rail context in which "final offers" could differ by millions of dollars. Moreover, there would be no requirement that an arbitrator take into account the existing statutory requirement that regulators recognize that "rail carriers shall earn adequate revenues."[5]

Railroads know of no other case in which private-sector suppliers of a good or service are forced by the federal government to use binding arbitration to set a price just because the purchaser desires a lower price. It is no more valid for the government to force binding arbitration on railroads than it is to force it on chemical companies, plumbers, supermarkets, or any other business.

This provision too is a frontal assault on railroads' use of differential pricing because it directs arbitrators to base rate decisions in many cases on rates paid by rail customers in the most intensely competitive markets. By definition, these markets have the lowest rates. But a railroad must have a sufficient mix of low-demand, low-margin and high-demand, high-margin shippers to cover its huge common and fixed costs. By using regulatory strictures to eliminate railroads' high-margin traffic and effectively cap rail rates, this provision of H.R. 2924 also dooms railroads to a perpetual inability to cover costs.

Today, railroads and shippers can (and sometimes do) voluntarily agree to use binding arbitration if both parties deem it desirable. There is a huge difference, however,

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[5] 49 U.S.C. 10701 (d)(2)

between the voluntary use of binding arbitration and a mandate forced on private businesses by the power of government. In addition, the rail industry has suggested ways to make rate cases quicker and less costly to resolve, while retaining the use of sound, well-established economic principles as a basis for decisions.

D. "Areas of Inadequate Rail Competition"

In a provision of striking scope, H.R. 2924 proposes that the STB designate a state or any part of a state to be an "area of inadequate rail competition" if any of a variety of criteria are met. The criteria used to define these areas are so broad and vague that all or most of the country would qualify — an absurdity on its face, given the intensity of competition railroads face for the vast majority of their traffic. In "areas of inadequate rail competition," government regulators could assume control of huge areas of rail operations. For example, regulators could:

- Control current and future rail rates;
- Force an owning railroad to allow another railroad access to its tracks where it could "cherry-pick" traffic;
- Force an owning railroad to carry freight to a junction with another carrier at a rate set by a regulator.

Regulators would be expressly prohibited from considering whether railroads engaged in any sort of anti-competitive conduct before ordering these actions.

Railroads are open to ways to improve the existing regulatory regime. However, a return to heavy-handed government regulation — as dramatically exemplified by the concept of "areas of inadequate rail competition" — is anything but an improvement.

E. Interchange Agreements ("Paper Barriers")

Since passage of the Staggers Act, Class I railroads have spun off tens of thousands of miles to local or regional railroad operators whose lower costs and closer ties to their customers and communities enable them to operate at a profit where Class I railroads could not. These new carriers have preserved rail jobs and rail service — often in rural areas — that otherwise would be lost.

At the time of some line sales, the parties involved voluntarily agreed to a lower sales price in exchange for an agreement by the new railroad to interchange future traffic solely or largely with the selling railroad. In effect, the purchase price included a cash component and a future carload component. H.R. 2924 would prohibit future line sales from including these types of agreements (sometimes called "interchange agreements" or "paper barriers"), thereby prohibiting interested parties from voluntarily using a legitimate tool that has helped preserve rail service on a significant number of rail lines. It would become more difficult for buyers to purchase and keep marginal lines in operation, since their up-front costs would increase. As a result, an increasing portion of the rail network would likely lose rail service entirely through abandonment, rather than have it transferred to short line carriers.

Moreover, H.R. 2924 would allow the STB to declare interchange agreements more than ten years old to be null and void. This would constitute blatant government interference in the sanctity of private contracts — akin to the government deciding that the price someone sold his house for ten years ago was too high and ordering him to rebate some of the sales price to the buyers. It is another example of a provision in the legislation that proponents would never support if applied to their own firms, but are willing to subject railroads to.

Does H.R. 2924 Reregulate Railroads?

For all the reasons discussed above, it is beyond serious dispute that H.R. 2924 would substantially increase government control over freight rail operations in numerous ways — as good a definition of reregulation as any. The ways that government control would be increased are not just minor intrusions into rail affairs. If enacted, they could be expected to lead to the transfer of billions of dollars of rail revenue each year to favored shippers.

Proponents of H.R. 2924 do not even try to explain how railroads would be able to recoup this revenue, or how railroads could possibly make the huge ongoing investments they need in the face of the capital starvation they would confront. Instead, proponents of the legislation simply claim "there must be a way"[6] for railroads to remain financially healthy under the legislation. Given how critical freight railroads are, claiming "there must be a way" is not good enough.

In our economy, firms and industries must produce sufficient earnings or capital will not be attracted to them. The electric utility industry understands this. In the wake of the huge blackout that struck the Northeast, the Midwest, and Canada last August, the electric industry's major trade association suggested that "FERC and the states should utilize innovative transmission pricing incentives, including higher rates of return, to attract capital to fund needed investments in transmission...[T]he amount of money that FERC [currently] allows investors to earn on transmission facilities still is not in line with

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[6] "Draft Reply to Railroad Letters," June 20, 2003, prepared by supporters of S. 919/H.R. 2924.

what they can earn on other investments."[7] Utilities recognize that "the rate of return that regulators allow for investments in new and augmented transmission facilities must be high enough to be competitive with investors' other options for using their money or sufficient investment funds will not be forthcoming."[8]

The chemical industry understands this too. For example, Dow Chemical's basic long-term financial goals include earning a 20 percent return on equity, earning 3 percent above its cost of capital across the business cycle, and earning the cost of capital at the trough of the business cycle.[9] Degussa, a major global chemical firm with substantial U.S. operations, states that "our aim is to generate a return on capital employed (ROCE) two percentage points above our cost of capital as derived from the capital market."[10] BASF, the world's largest chemical company, notes, "Only profitable growth will give us an edge in the international competition for capital.... In all areas we want to earn our cost of capital — and a premium on it too." [11]

Railroads agree with this sentiment. Without the ability to cover total costs and earn an adequate return, railroads — like electric utilities, chemical companies, or any other firm — would be unable to maintain (much less increase investment in) their

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[7] Edison Electric Institute, "Five Steps That Would Help Assure That We Have the Reliability Standards and the Transmission Capacity We Need Going Forward," August 19, 2003.

[8] Stanford L. Levin, "Electricity Competition and the Need for Expanded Transmission Facilities to Benefit Consumers," prepared for the Edison Electric Institute (September 2001), p. 15.

[9] Presentation by J. Pedro Reinhard, Dow Executive Vice President and Chief Financial Officer, to the Lehman Brothers Global Chemical Industry Leaders Conference, April 3, 2003.

[10] Heinz-Joachim Wagner, Member of the Management Board of Degussa AG, Statement at the Financial Press Conference on March 9, 2004.

[11] BASF Strategy and Value-based Management, BASF Financial Report 2003, p. 17.

infrastructure and equipment, resulting in deterioration and/or shrinkage of the national rail system. That is exactly what H.R. 2924 would do. The legislation ignores the fundamental point that rail competition is enhanced only when the railroads are healthy, not when their earnings, which are already substandard, are severely and artificially restricted. If H.R. 2924 were enacted, the already large gap between the rail industry's cost of capital and its return on investment would only widen — taking railroads farther away from the financial performance that proponents of the bill, including some of the firms in the electric utility and chemical sectors, expect from their own businesses.

Does H.R. 2924 Cap Railroad Rates?

H.R. 2924 does not have a provision that *directly* caps rail prices at a certain level — *e.g.*, so many cents per ton-mile — but the legislation caps rates, just the same. After all, the whole purpose of H.R. 2924 is to use the power of government to force railroads to charge lower rates, and it does so in a variety of ways. For example:

- The provision overturning existing rail "bottleneck" policy would have the effect of capping the rate for a typically small part of a through movement at stand-alone cost and the rate for the rest of the movement at a much lower level. The net effect would be a revenue loss to railroads of up to several billion dollars per year.
- Like the bottleneck provision, the provision ordering the STB to grant terminal trackage rights to another carrier upon shipper request would artificially manufacture rail-to-rail competition is ways beyond what a competitive market could justify. The purpose is to obtain lower than market rail rates.
- The final offer arbitration provision mandates that arbitrators base rate decisions in many cases on rates paid by rail customers in highly competitive markets. By definition, these markets have the lowest rates. Therefore, for all intents and purposes, this directive to arbitrators functions as a cap on rates.
- Similarly, rates paid by rail shippers in "areas of inadequate competition" would be based on rates paid by customers in highly competitive markets, further effectively capping rail rates.

These limitations on rail rates would doom railroads to woefully inadequate earnings. Rail disinvestment would be sure to follow, since railroads and their capital providers would not be interested in committing funds to investments if they could not have a reasonable chance to capture the economic benefits of those investments.

Rail Labor Opposes Railroad Reregulation

Since railroad reregulation would prevent railroads from earning sufficient revenues to maintain their systems, and the inevitable consequence would be a shrinking rail network, disinvestment, and lower rail employment and wages, rail labor opposes legislative proposals to reregulate the rail industry. In fact, representatives of unions accounting for more than 70 percent of unionized rail labor have written to Congress in opposition to H.R. 2924. They write that "Any further shifting of the regulatory balance toward shippers would result in greater job losses and wage and benefit suppression. Large corporations who ship by rail may receive financial benefits from these bills but it would come at the expense of many hard working American families in the form of financial loss, the loss of health care and retirement benefits."

The Financial Community Opposes Railroad Reregulation

The financial community, on whom railroads depend for access to the capital they need to operate, has consistently supported the view that, under reregulation, an era of capital starvation and disinvestment would return. For example:

- In a submission to the STB in October 1996, a group of nine investment bankers and securities analysts wrote, "A move toward re-regulation that would cause a substantial reduction in rail revenues would sharply curtail the railroads' access to capital on reasonable terms, and would be a most unwise and short-sighted decision...If rail rates are more heavily regulated...the ultimate result will be that shippers and the public will suffer."
- In April 1998, Stephan C. Month of Credit Suisse First Boston, a global investment bank, testified to a House Subcommittee that "the greater the limitations on the [rail] industry's ability to grow revenues and cut costs, the costlier Wall Street funding will become and...the more difficult it will be for the railroads to earn their cost of capital and remain economically viable."

- In September 1999, Anthony Hatch, a prominent independent Wall Street analyst, noted that "Capital flows to the areas of highest return. If ... new [rail] regulations change the rules of the game and ensure poor returns, then the Street will disinvest ... causing managements to begin to reallocate cash and begin "harvesting" the business. They will have no choice."
- In testimony to the Senate in May 2001, Morgan Stanley's James Valentine, another prominent analyst, cautioned that rail customers "need to be careful what they wish for, as their efforts to drive rates lower will likely only cause more capital to leave the industry and service to deteriorate."
- In January 2004, John Barnes of Deutsche Bank warned, "In the beginning, there would be short-term benefit [from reregulation] for captive shippers through lower rates. However, instant gratification usually comes with a headache the next morning, and there would be no Advil strong enough for the long-term damage associated with railroad re-regulation...[O]ver the long-term, everyone would share in the hangover: shareholders, customers, railroads, the entire transportation system, the U.S. and global economies. In the worst case scenario, ... a repeat downward spiral of the railroad industry, similar to the 1970s, could occur, with multiple bankruptcies that could cripple the transportation system."

If rail access to capital is reduced or eliminated, the only alternative is for the government to step in and provide subsidies to railroads to make up for the billions of dollars of lost revenue caused by reregulation.

Rail Customers Oppose Reregulation

I firmly believe that the overwhelming majority of railroad customers believe that railroads are meeting their freight transportation needs efficiently, cost-effectively, and fairly. I also believe that most rail customers do not support reregulation, and that many of those who have expressed support for H.R. 2924 would rethink that support if they paused to consider all the implications of the legislation.

We have concrete evidence of the fact that many shippers oppose reregulation. We asked shippers opposed to reregulation to write to Congress to express their opposition. Hundreds of shippers, large and small, have done just that. They cover the gamut of rail shippers — auto manufacturers, chemical companies, steel companies, grain companies, coal companies. Some are "singly served" and some are not.

I'd like to share a few excerpts from those letters with you:

- The Alliance of Automobile Manufacturers, a trade association whose members account for more than 90 percent of U.S. vehicle sales, wrote: "Alliance members — as major users of the rail system — view [S. 919/H.R. 2924] as an attempt to re-regulate the rail industry and undo the progress made since the Staggers Act deregulated it in 1980. We strongly urge the Committee to reject this legislation and maintain the free market system that has been beneficial for shippers and the railroads alike."
- The Port of Los Angeles, one of the largest and busiest ports in the world, wrote, "Increased efficiency and improved service ...has enabled the rail industry to divert significant amounts of business from highway to the intermodal option. ...None of this would have been possible without the billions of dollars that the railroads have invested in new technology and to improve locomotive and car fleets. To maintain these high standards, railroads will need to continue that level of investment in the future. However, their ability to do so may be negatively impacted by the re-regulation legislation currently being proposed....Our railroads have recovered from the serious financial troubles, including numerous bankruptcies, of the 1970s. We cannot run the risk of that happening again."
- Martco, a Louisiana lumber and forestry firm, wrote, "Senate Bill 919 is an attempt to reregulate the railroad industry... Initially the bulk shippers and bulk industries would perhaps benefit by the establishment of some noncompensatory rate structures. The reduced returns would have to be addressed and they would, through the passing of increased rates to the non-bulk and smaller shippers. Thus the pre-Staggers Act cycle would return: reduced rate for shipper A, must be met by increased rates or reduced service for other shippers who then will divert traffic onto our overcrowded highway system...thereby increasing logistics costs to all parties while further reducing the rail industry route structure. Soon rail rates for the few large bulk shippers would have to be increased given the absence of other traffic to spread cost and hopefully provide a return."
- The president of Schneider National — the nation's largest truckload motor carrier — wrote that if H.R. 2924 were passed, "Schneider National and its thousands of shipper-customers would suffer significantly from the loss of a cost effective and efficient intermodal rail system and would be forced to divert much of our volume onto the already crowded highway system. ...We believe that additional regulation of the rail system would have a detrimental effect on the progress achieved through a free market."
- The CEO of Kokomo Grain in Indiana wrote to express "strong opposition" to S. 919/H.R. 2924, writing "[E]ven those shippers that are only served by one railroad and have limited shipping alternatives are better served by a business environment that is not hindered by re-regulation. On the whole, the deregulation of the railroad

industry in 1980…has been a positive experience for American business. I do not want to see those gains and benefits thrown aside with a move towards blanket re-regulation to fix certain competitive concerns of some shippers that would be best addressed in other fashions."

- The general manager of the Port of Montana wrote that H.R. 2924 "would significantly reduce railroad revenues by forcing upon them governmentally mandated price "competition" which the free market would not otherwise sustain. …I urge you to continue your support of the current rail regulatory structure. I believe this is the best way our company can guarantee continued access to a healthy railroad network, a network which is critical to our company's competitive success in the domestic and global marketplace."
- Chemical company Dyno Nobel wrote: "Clearly all shippers would like to reduce the rates that they pay for transportation services, but calling for re-regulation of the rail industry is remarkably short sighted and is a move that we do not support. In the long run, all rail users will be the losers because the inevitable result will be to devastate the ability of the railroads to continue providing their present level of service, much less to make vitally needed investments for the future."
- Oregon Steel Mills, one of the most diversified minimills in the United States, wrote: "[D]ue to the influence of the unregulated marketplace, rail service is safer, more reliable, more efficient, and less costly. The situation has been good, not only for the industry itself, but also for customers like Oregon Steel Mills, who use rail service extensively. We urge you to continue your support of the current rail regulatory structure."

The point is this: for every shipper who supports reregulation, there are many others who oppose it. And they oppose it because they rely on rail service and do not want to return to the failed policies of the past.

Railroad Customer Service

It is a fact of life in the rail industry that in addition to facing unrelenting competition, the service requirements of rail customers are continually becoming more stringent. Railroads recognize that service shortcomings have been a major factor behind shipper dissatisfaction in recent years, including shipper dissatisfaction that has sometimes manifested itself in calls for railroad reregulation.

I am happy to say, though, that railroads have made tremendous progress in the customer service area. This is not to deny that from time to time railroads experience service problems — as one would expect on a rail network with enough trackage to circle the globe nearly six times. When these problems occurs, railroads work diligently to resolve them, as they should. Overall, though, the U.S. freight rail system today is operating smoothly. Moreover, it is foolhardy to believe that reregulating railroads, and thereby limiting even more the amount of funds railroads have to devote to service improvements, could possibly improve rail service. Indeed, the opposite is true.

Shippers and others recognize railroad service improvements:

- In an article in the August 18, 2003 issue of Traffic World, UPS spokesman Norman Black says, "The most important thing we see from all of our rail partners is a huge commitment to customer service. They're doing a much better job. Trains are running when they say they're going to run, and arriving when they say they're going to arrive. From a UPS standpoint, that's all we want."
- In a July 25, 2003 article in The Wall Street Journal, Bill Zollars, the CEO of Yellow Corporation, one of the nation's largest trucking companies, says railroads "are more focused on the customer and growing their business than I've ever seen."
- A February 6, 2003 article in Purchasing magazine notes that "[R]ail shippers continue to report consistent efforts and improvements in the level of service they receive from carriers..."
- In a Traffic World article on rail service improvements on January 27, 2003, the rail operations manager at a major U.S. petrochemical company credits railroads with doing "an admirable job of identifying areas of concern and then addressing the problem."
- In October 2003, Burlington Northern and Santa Fe (BNSF) was named Carrier of the Year by FedEx Supply Chain Services for the second year in a row. Criteria for the award included on-time service, safety, claims/damages, communication and freight bill accuracy. In addition, in September 2003, American Honda Motor Company awarded BNSF the "Premier Partner Awar" for excellence in quality, value and customer service. BNSF was one of 15 suppliers selected out of the 74 nominated companies that service American Honda nationwide. "We are extremely pleased to honor Burlington Northern Santa Fe Railway and the other American Honda suppliers who continually provide us with invaluable services that consistently meet and exceed our expectations," said a Honda official.

- Canadian National (CN) received on-time service awards from Toyota Canada in 2003 and 2002 and was named the "Canadian Carrier of the Year" for 2002 by Quaker-Tropicana-Gatorade. In addition, CN's Wisconsin Central subsidiary was the recipient of a 2003 Quest for Quality Award, having been selected by the readers of Logistics Management as one of the Quality Carriers in the Railroads (Standard Rail Service) category.
- In April 2003, Toyota Logistics Services recognized Norfolk Southern Railway (NS) with two awards for service excellence. Toyota awarded NS a "Logistics Excellence Award" for superior quality performance among rail carriers and an on-time performance award for transportation service. NS was also named Coors Brewing Company's 2002 "Transportation Supplier of the Year," the first time NS received the award.
- In June 2003, CSX Transportation was awarded the Gold Carrier Award by Shell Chemicals for the quality of the rail carrier's overall performance in moving Shell chemicals. The award marks only the third time in the award's 10-year history that a rail carrier was so honored. A Shell official remarked that "CSXT has worked hard at becoming one of the few Gold Carrier recipients. We at Shell would like to give CSXT and its employees a well-deserved congratulation."
- In April 2003, Union Pacific Railroad (UP) was also named a recipient of Toyota's "Logistics Excellence Award." UP also earned a General Motors "Supplier of the Year" Award for 2002. A GM official remarked that UP's "performance and contributions have been critical in helping GM become the industry's low cost producer of high quality vehicles. They serve as a role model for other suppliers."
- In a recent communication, a manager at a Louisiana agribusiness firm wrote: "I have been the complex manager of Terral Farm Service in Delhi, Louisiana for ten years. Over that period of time, we have shipped thousands of rail cars with Kansas City Southern and before that with Mid South. This year, the individuals at KCS performed as well as I could ask for. The service was almost perfect."
- Canadian Pacific Railway's (CP) won the prestigious 2003 Franz Edelman Award for Achievement in Operations Research and the Management Sciences. The award, recognized as the "Tech World Series" and sought after by operations researchers and planners around the world, is presented by the Institute for Operations Research and the Management Sciences. CP won the award for its work on improved scheduling that yields significant, direct benefits to the company's customers.

Railroads and Plant Shutdowns

Proponents of H.R. 2924 have claimed that excessive rail rates will cause U.S. manufacturers to shut down their U.S. operations, either in favor of locations overseas or simply in totality. In testimony to the Senate in October 2003, for example, a representative of Consumers United for Rail Equity (a pro-reregulation group) stated that some "captive" rail shippers "will shift their manufacturing to foreign countries, exporting American jobs overseas. Some companies might be forced to close a U.S. plant or to forego an expansion without even having an offshore alternative."

The implication of this kind of statement is that a railroad would prefer to lose a (presumably profitable) customer's business entirely rather than do whatever it reasonably can to keep that customer competitive. This is, frankly, ridiculous. A railroad's management — and its shareholders, to whom the management is responsible — know full well that pricing rail movements or limiting service offerings in such a way as to make the products produced at a customer's facilities uncompetitive in the marketplace, and thereby losing that customer's traffic, is hardly in the best interest of the railroad, and it will do whatever it reasonably can to avoid it.

More broadly, in recent weeks and months there has been an even greater than usual amount of discussion in the press, in the halls of Congress, and elsewhere regarding the issue of plant shutdowns and relocations, especially overseas.

This topic is certainly complicated and controversial. Many observers point to substantially lower labor costs in foreign countries as perhaps the primary reason for the movement of plants and jobs from here to abroad. Health care costs, a component of labor costs, are themselves often cited. A March 6th, 2004 article in The Washington Post, for example, noted that "the rapidly rising cost of health care in the United States means that even developed countries have an edge when it comes to keeping jobs."[12]

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[12] Kirstin Downey, "A Heftier Dose to Swallow," The Washington Post, March 6, 2004.

Energy costs also certainly play a role. An article in The Washington Post two weeks ago notes that Dow Chemical Company has closed four major chemical factories in North America in the past two years and replaced them with production from factories elsewhere in the world. The article quotes a Dow executive as saying, "These jobs...left the U.S. because of uncompetitive energy costs."[13] It is no secret that the U.S. chemical sector especially has been hit extremely hard by the sharp increase in natural gas prices in recent years — so much so that the industry is waging a huge campaign to make the public and policymakers aware of the damage high natural gas prices are causing.

A recent study sponsored by the National Association of Manufacturers points to excessive corporate tax rates, employee benefits, tort litigation, regulatory compliance, and energy as primarily responsible for the competitive challenges facing U.S. manufacturers and their workers relative to major foreign competitors.[14]

No doubt all of these factors come into play to some degree. But there is also no doubt that U.S. freight railroads — with their remarkable efficiency and cost-effectiveness — are a source of extraordinary competitive advantage for U.S. companies and industries, not a competitive disadvantage as some would have you believe.

Indeed, the U.S. freight rail system is the envy of the world. Lou Thompson, until recently the World Bank's Railways Adviser and one of the world's foremost authorities on global railways, has stated, "Because of a market-based approach involving minimal

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[13] Greg Schneider, "Chemical Industry in Crisis," The Washington Post, March 17, 2004.

[14] Jeremy Leonard, How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness, paper prepared for The Manufacturing Institute of the National Association of Manufacturers, December 2003.

government intervention, today's U.S. freight railroads add up to a network that, comparing the total cost to shippers and taxpayers, gives the world's most cost-effective rail freight service." Moreover, due to efficiency gains made by freight railroads and other transportation providers relative to other sectors of the economy, logistics costs as a percentage of GDP have been driven down substantially in recent years.

Conclusion

The partial deregulation of U.S. freight railroads brought about by the Staggers Act has worked. Railroads have been able to upgrade their systems, reinvest hundreds of billions of dollars in productive rail infrastructure and equipment, provide higher levels of service, raise traffic volumes, dramatically increase productivity, improve profitability, and improve safety — while at the same time sharply lowering rates for shippers.

Proposals to reregulate railroads threaten all of these gains and are contrary to economic logic and sound policy. They would severely harm rail service, the shippers that rely on that service, and the national economy. They represent the legacy of failure and should be rejected.

RESPONSE TO QUESTIONS FROM REP. CORRINE BROWN

1. In your testimony you state that Staggers replaced economic regulation with competition and market forces, but there is a significant portion of rail traffic where there is no alternative carrier – rail or otherwise. These shippers have not benefited from lower rates and improved services – quite the opposite. If competition has been so beneficial to other parts of the market for railroad services, shouldn't we extend it to the captive shippers?

With all due respect, the premise of this question — i.e., the only competitive force that matters is rail-to-rail competition, and service to a shipper by a single railroad is equivalent to monopoly power by the railroad over the shipper — is not correct.

Railroads almost always face a variety of competitive constraints that rail customers can use to their advantage. Consequently, most shippers, including most of those served by only one railroad, can negotiate competitive rates and service with railroads.

As I noted in my testimony, the competitive forces railroads face extend well beyond competition from another railroad, or even from trucks and barges. These forces include geographic and product competition, and countervailing shipper power. My testimony includes examples of each of these competitive forces. Shippers can also generate competition between railroads before a plant is built by considering transportation options and negotiating favorable contracts when evaluating potential plant locations. Over the long term, shippers can locate or relocate plants on the lines of different railroads, and changes in the technology, regulation, and/or structure of a shipper's industry over time also provide leverage over railroads.

The bottom line is that, because of these very real competitive forces, the universe of shippers that are truly "captive" to railroads is far smaller than proponents of H.R. 2924 would have you believe. For these shippers, the Surface Transportation Board (STB) has the authority to set maximum rates or take certain other actions if a railroad is found to have market dominance or to have engaged in anti-competitive behavior. The rail industry has suggested ways to make STB cases involving both large and small shippers quicker and less costly to resolve, while retaining the use of sound, well-established economic principles as a basis for decisions.

Finally, all rail shippers — including those allegedly "captive" to railroads" — have benefited immensely from rail deregulation. U.S. freight railroads form an integrated national system. When deregulation-induced productivity gains have been achieved (through, say, a reduction in crew sizes) those gains are applied throughout the system, including to shippers that are singly-served. Likewise, fuel efficiency gains, technological and operational advances, and so on are spread throughout the rail system. In other words, market competition has already had a huge effect on rail productivity, and that productivity has not been withheld from the railroads' higher-margin markets.

Specifically regarding rail rates, railroads do practice differential pricing — as they must if the industry is to survive. All shippers, including "captive" shippers, benefit from differential pricing because it maximizes the number of shippers using the rail network and, therefore, maximizes the number of shippers who make contributions to railroads' huge fixed and common costs. In part because of differential pricing, not all rail shippers have shared equally in the profound rail rate reductions that have occurred since the Staggers Rail Act of 1980 partially deregulated the rail industry, but it is wrong to claim that "captive" shippers have not generally shared in rail efficiencies. In a December 2000 report, the STB found that "inflation-adjusted rail rates have fallen 45.3 percent" from 1984 to 1999. The STB also observed, "It is important to note that all types of rail customers, and not just those with competitive transportation alternatives, must have received some portion of the rate reductions we have measured here."

2. Do you not agree that there is some traffic for which rail is the only option and that a large percentage of that traffic is captive to a single railroad? You say that there are constraints on how far a railroad can go in exploiting its monopoly power, but that is always the case with monopolists. The question is should we allow the railroads to severely limit the earning potential of other firms and industries?

As discussed above, railroads believe that because of the multitude of competitive forces they face in the transportation marketplace, the universe of shippers for which "rail is the only option" is, in reality, very limited.

Railroads can only be financially healthy if their customers are financially healthy. As rail management (and shareholders) are fully aware, it makes absolutely no sense, and there is no incentive, for railroads to price their services or restrict their service offerings in a way that jeopardizes the financial viability of their customers. Instead of severely limiting the earnings power of its customers, railroads most often are one of the more important factors which enable a company to exist and prosper.

Of course, shippers are not always "happy" with the prices they are able to negotiate with the railroads. Virtually every purchaser of goods or services, including railroads, would like to get a better deal than what they have from their suppliers. But there is no question that the vast majority of railroad rates are market-based and driven by competition. The alternative — a return to excessive government regulation — cannot reasonably be viewed as in the best interest of our nation as a whole. Moreover, no amount of rhetoric about "competition" can change the fact that if a railroad cannot cover its costs, it cannot maintain its infrastructure and provide the services upon which its customers and our nation depend. Pleas to reregulate railroads must be considered within this context.

3. You say that the railroads do not fear rail-to-rail competition as long as it is the result of free market forces. Isn't it a little disingenuous considering that the current system is hardly the result of "free market" forces?

As noted above, the vast majority of railroad rates and service offerings are market-based and driven by competition. Where there is an absence of effective competition, the STB enforces maximum rate regulations to protect shippers from an abuse of market power.

Moreover, the level of rail-to-rail competition in the United States today reflects real world decisions as to which markets have sufficient demand to sustain multiple railroads and which do not. In other words, the U.S. rail system very much is the result of free market forces. It is not economically feasible for there to be two railroads serving every shipper, because many markets do not have sufficient traffic to sustain that level of competition. Claiming that every market can sustain two railroads just because some markets can is like saying that every city can support two major league baseball teams just because New York can.

In testimony to the Senate Subcommittee on Surface Transportation and Merchant Marine in May 2001, a prominent railroad financial analyst stated, "When customers complain that they are being unduly charged by the carriers I think it's completely missed that there is no law in the U.S. that says a new rail line can't be built. If the railroads were charging rates that were truly excessive, we would see entrepreneurs pouring capital into new build-outs to get these customers competitive access to another carrier, similar to what we see in the long-distance telephone market — and yet, we can find less than 20 such rail build-outs in the past decade. Customers need to be careful about what they wish for, as their efforts to drive rates lower will likely only cause more capital to leave the industry and service to deteriorate..."

4. You claim that railroads have an enormous infrastructure maintenance burden, and that differential pricing is necessary if railroads are going to earn profits sufficient to finance infrastructure investment needs. Unlike railroads, water carriers and truckers do not pay their full cost of infrastructure use. Because it is unlikely that we can significantly raise water and highway user charges, doesn't it make sense to allow public investment in the rail infrastructure?

First, the U.S. freight railroad industry has long maintained that all transportation modes should be treated equitably. Equitable treatment means, among other things, that motor carriers and commercial waterway users should not rely on other users to subsidize the costs of their use of their rights-of-way. Sound public policy requires that other freight transportation modes be made to "pay their own way," just as freight railroads do.

Second, as you imply, freight railroads have no shortage of potential infrastructure investment projects, but financial markets provide stern discipline to ensure that investments are made only where they will provide a reasonable promise of a direct economic benefit to the investing railroad. This discipline is necessary and appropriate in a market economy, but it discourages investments that would yield significant public benefits (*e.g.*, congestion mitigation, emissions relief, enhanced safety) but only limited financial benefits to the railroad.

Freight railroads agree that this major problem can be partially mitigated through a more pronounced reliance on voluntary public-private financing partnerships for railroad infrastructure improvement projects, especially in cases where the fundamental purpose of the project is to provide public benefits or meet public needs. Such partnerships are a mechanism by which private entities pay for private benefits and public entities pay for public benefits (with the public share coming from resources available through existing government programs and future initiatives, not directly or indirectly from railroads).

To that end, major freight railroads are prepared to contribute private capital to fund their share of such partnerships. To help ensure success, the partnerships should be executed in a manner that preserves the rail industry's regulatory regime, ownership rights, and market environment.

It should be emphasized that these partnerships do not constitute "subsidies" to railroads. Consequently, there is no legitimate rationale for "offsetting" alleged subsidies to rail through the imposition of regulatory strictures that re-inject government control over freight rail operations.

An emphasis on enhanced public-private partnerships extends to short line railroads. Short lines perform a variety of critical tasks, including connecting rural areas to the national rail network. However, the infrastructure of many of these smaller, lower density railroads cannot support the operation of the rapidly increasing number of heavier rail cars that railroads require to offer competitive, economical service to their customers. Absent outside assistance, many of these short line carriers will be unable to upgrade their lines — which may eventually face abandonment. If this happened, countless communities would be cut off from the national rail network, resulting in severe economic displacement and a sharp increase in truck traffic on local roads. Consequently, we believe that H.R. 876 (the "Local Railroad Rehabilitation and Investment Act"), which authorizes a federal tax credit of up to $10,000 against maintenance for track owned by non-Class I railroads, deserves support.

5. Couldn't public capital support be used to offset any revenue shortfall that might result from enacting legislation that increased rail-to-rail competition?

Conceivably, yes. In fact, in the event of passage of H.R. 2924 or similar legislation, a taxpayer bail-out would be the only way to make up for the billions of dollars of lost rail revenue caused by reregulation and the only way to prevent widespread disinvestment in our nation's rail network.

Ultimately, the question of whether it is wise public policy to rely on taxpayer funding to support rail revenue losses caused by reregulation is a matter for Congress to address. For their part, railroads believe that the phenomenal performance of the U.S. freight rail industry since Staggers proves that rail deregulation works. Fueled by massive productivity gains passed along to rail customers, inflation-adjusted rail rates have plunged, saving shippers billions of dollars per year and greatly enhancing U.S. global competitiveness. Once-anemic railroad returns on investment have risen to moderate levels. Thanks to the more than $320 billion generated in the private sector financial markets and spent on their privately-owned network since 1980, Class I railroad infrastructure is in better overall condition than ever before. Railroad accident and employee injury rates are both down substantially. Since Staggers, rail market share has trended slowly upward after decades of steady decline. Today, the U.S. freight railroad system is the envy of the world.

As the World Bank's railways adviser explained, "Because of a market-based approach involving minimal government intervention, today's U.S. freight railroads add up to a network that, comparing the total cost to shippers and taxpayers, gives the world's most cost-effective rail freight service."

6. You point out that rail rates have been falling over the years since Staggers. But isn't it also true that rail services are being reduced as well? For example, haven't the railroads reduced the number of cars they supply and now require that shippers supply their own cars?

Railroads do not require shippers to supply their own cars or make other investments. As common carriers, railroads are required to provide reasonable service upon reasonable request, even if that requires railroads to supply the freight cars. That does not mean, however, that railroads cannot offer incentives to shippers that make efficiency improvements themselves or make it possible for railroads to engage in practices that improve efficiency.

A shipper will make an investment in, say, a loading facility, or some freight cars, only if it makes economic sense for the shipper to do so. But, a railroad cannot simply appropriate the value of that shipper's investment. All else being equal, a shipper will pay lower rates for movements for which railroad costs are lower than movements for which railroad costs are higher. Take coal, for example. Average revenue per ton-mile (RPTM - a surrogate for rail rates) for movements using shipper-owned coal cars are demonstrably and significantly lower than shipments using railroad-owned cars. This example illustrates the fact that to the extent shippers bear some of the costs associated with rail transportation, they pay lower rates — just as one would expect.[1]

It should also be noted that the STB has investigated the claim that rail rate declines are the result of shifting costs unto shippers. In the December 2000 study noted earlier, the STB found that "While some portion of the decline in rail rates that we have measured results from costs that have been shifted away from railroads and onto shippers, this portion is dwarfed by the most important factor responsible for the rail rate reductions – the productivity gains achieved by railroads since the Staggers Act." The STB states, "For example, certain rail car ownership costs, by our assessment amounting to no more than $2.5 billion per year, have been transferred to shippers. While this is a large number by itself, it is far smaller than the $31.7 billion in annual savings enjoyed by shippers in 1999 from post-1984 rate reductions."

[1]This is analogous to a vacationer whose vacations cost more when he rents a car than when he drives his own car.

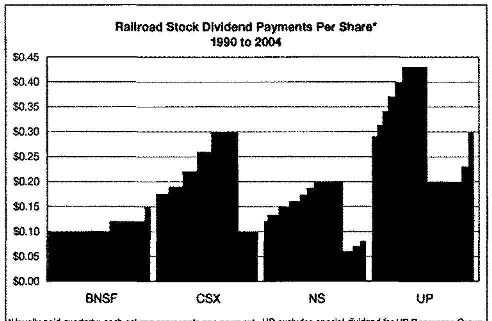
"[T]he STB has never found or almost never found railroads to be revenue adequate, making enough money. Yet railroads pay dividends to their shareholders. How can you have revenue inadequacy and still be making payments to shareholders? ... If you're not revenue adequate, don't the shareholders have to share in that inadequacy?"

A railroad is "revenue adequate" when its rate of return on net investment (ROI) equals or exceeds the rail industry's current cost of capital (COC), as determined by the Surface Transportation Board (STB). As such, revenue adequacy is an indicator of a railroad's ability to attract and retain capital in amounts and at rates necessary to achieve financial health and *sustain its economic viability over the long term.* Revenue *in*adequacy does not mean that a railroad is not making any money; it just means it is not making *enough* money to cover its replacement costs over time.

There are a number of indicators other than the STB's annual revenue adequacy determination (which shows a reduced, though still significant gap between ROI and COC over time) that suggest that railroads have not been delivering a competitive return to shareholders, and that shareholders, in an important sense, *have* therefore "shared" in railroads' revenue inadequacy. For example:

- Return on equity (ROE) is commonly used as an indicator of short-term profitability. Based on Fortune 500 data, in each of the 19 years from 1985 to 2003, the median ROE for Class I railroads was less than the median for all Fortune 500 companies. In 14 of the 19 years, the median railroad ROE was in the lowest quartile among Fortune 500 industries. Similar analyses using earnings data from *Business Week* and *Value Line* yield similar results: Class I railroads typically register returns substantially inferior to those of other industries.
- Rail stocks have typically significantly underperformed the broader market over the recent and mid-term past.
- Measured by total return to shareholders, the most recent Fortune 500 (dated April 5, 2004) ranks the railroad industry as 33rd out of 46 industries in 2003, 34th out of 45 industries in the five years from 1998-2003, and 33rd out of 37 industries in the 10 years from 1993-2003.
- The April 5, 2004 issue of *Business Week* grades individual members of the S&P 500 based on various financial criteria, including one- and three-year total returns, with "A" going to the top 20 percent, "B" to the next 20 percent, and so on down to "F" for the bottom 20 percent. The four largest freight railroads that are part of the S&P 500 averaged an "F" for total one-year returns, a "C" for total three-year returns, and a "D" for return on equity relative to the rest of the S&P 500.
- U.S.-owned Class I railroads have traditionally paid dividends to their shareholders, and in the early 1990s most were regularly increasing their dividends. In recent years, though, they have been forced to make major dividend reductions to conserve cash.[1] Although two carriers have restored a small portion of the

[1] Kansas City Southern, not shown on the chart, has not paid a dividend since 2000, when it spun off the non-rail portions of its business.



*Usually paid quarterly; each column represents one payment. UP excludes special dividend for UP Resources Group Inc. spin-off paid Oct. 1996. Source: CSI

dividend cuts in the past three quarters, their payments are still far below previous levels.

These examples show that rail shareholders have suffered as a result of the inadequacy of railroad earnings in terms of lower stock appreciation and suppressed dividends.

As noted above, railroads (and other firms) can be revenue inadequate yet still make money. Generally speaking, when a publicly-owned firm makes money, it can do one of two things with it: It can reinvest the earnings in itself (say, by investing in plant or equipment, hiring more workers, acquiring other companies, or paying down debt) or it can distribute all or part of the earnings to shareholders in the form of dividends.[2] Dividend payouts plus stock appreciation constitute the total return to shareholders for ownership in the company. The payment of dividends is a means for railroads to provide a return to shareholders, and it is in no way incompatible with their revenue inadequacy.

In our market economy, any public firm, including railroads, must offer a total return to shareholders comparable to what the shareholders can expect to obtain from alternative investments with similar risk. If shareholders do not expect railroads to provide a competitive return, they will take their money out of railroads and invest instead in firms and industries they expect will yield a higher return. One result will be higher financing costs for railroads.[3]

Although a host of factors influence a company's dividend policy and a thorough discussion of dividends is beyond the scope of this response, generally speaking if investors are convinced that a corporation has high-return investment opportunities, they are likely to be much more willing to leave the money in the firm (rather than have it returned to them as dividends) in the hope that higher stock appreciation will lead to greater shareholder returns. (This is why "growth" companies often do not pay dividends.) On the other hand, firms in mature industries — like railroads, banks, and utilities — are more likely to pay dividends, because investors do not generally see the same potential for significant relative stock appreciation and therefore demand more returns in the form of dividends.

The important point is that shareholders must be able to expect competitive returns one way or another, or they will put their money in investments they think will

[2] A company could also buy back its stock as a way to distribute earnings back to shareholders.

[3] On the debt side, over the past 10 years railroads have experienced the detrimental effects of lower bond ratings. The bond ratings of the four largest U.S. railroads have fallen to the bottom of the so-called "investment grade" level — a position which hampers capital investment programs and increases financing costs.

offer such returns. Management is aware of this, and thus will try to keep total returns to shareholders (including dividend payments) as high as possible.

Notwithstanding the pressures on stock prices and dividends, railroads have been better able to attract capital because deregulation has enabled them to improve earnings gradually, and investors have come to believe that the rail industry can continue to improve profitability if allowed to operate in a predictable, deregulated environment. In this regard, it is important to remember that progress toward adequate revenues is not attainment of adequate revenues, and expectations of improved earnings are not realizations. Regulatory restrictions that impede a railroad's opportunity to generate competitive returns would halt or reverse that progress and crush those expectations

Some observers seem to believe that railroads should reduce or eliminate their dividends in the face of their revenue inadequacy. One of the principal objectives of railroad deregulation was to ensure that the rail industry had improved access to capital. Reducing or eliminating dividends, especially in a mature industry like railroads, would work strongly against this goal. As one observer writes, "The negative implication of a dividend reduction sends shock waves throughout the investment community. It casts a pall of doubt about the quality of the company in the minds of potential investors and damages the stock's future investment appeal."[4] Such a move may conserve cash in the short-run, but at a probable cost of a reduced ability to attract reasonably-priced capital in the future. Railroads that reduced their dividends in recent years certainly understood this, though they ultimately decided that the conditions they faced required such an action.

The STB's responsibility is to determine whether a railroad's long-term profitability is such that the long-term sustainability of that rail network and service to the shipping public is being encouraged. Short-term improvements in profitability, accumulations of cash reserves, dividend pay-outs, and other similar measures do not necessarily signal the long-term profitability necessary for rail operations.

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[4] Weiss, Geralding and Weiss, Gregory, *The Dividend Connection: How Dividends Create Value in the $tock Market*, Dearborn Financial Publishing, Inc., 1995, p. 208.

TESTIMONY BEFORE THE

RAILROAD SUBCOMMITTEE

OF THE

HOUSE TRANSPORTATION AND INFRASTRUCTURE COMMITTEE

STATUS OF THE SURFACE TRANSPORTATION BOARD
AND
RAILROAD ECONOMIC REGULATION

MARCH 31, 2004

SUBMITTED BY

TERRY HUVAL
DIRECTOR, LAFAYETTE UTILITIES SYSTEM

ON BEHALF OF

CONSUMERS UNITED FOR RAIL EQUITY
LOUISIANA ENERGY AND POWER AUTHORITY
AMERICAN PUBLIC POWER ASSOCIATION

Mr. Chairman and members of the Subcommittee, thank you for the opportunity and the invitation to appear before you today to discuss captive rail shipper concerns.

My name is Terry Huval, Director of Lafayette Utilities System in Lafayette, Louisiana. I am appearing today on behalf of Lafayette Utilities System, Louisiana Energy and Power Authority (LEPA), American Public Power Association (APPA) and Consumers United for Rail Equity (C.U.R.E.).

Our customers are paying unnecessarily high electricity prices because our coal-fired generating facility is served by a single railroad. That railroad is denying us access to existing railroad competition that is located only 19 miles away. Astoundingly, the Surface Transportation Board policy is that the railroad is within its right to deny us access to railroad competition. Mr. Chairman, this is a senseless national rail policy and must be corrected by this Congress.

LAFAYETTE UTILITIES SYSTEM (LUS)

LUS was established in 1896 and provides electric, water, and wastewater services to the citizens of Lafayette, Louisiana. Today we provide electricity to households and businesses in a community of over 110,000 people. As a customer-owned and operated utility, subject to the jurisdiction of our City Council and, ultimately, the people, we establish our rates, control our standards of service and, of course, retain all of the proceeds of our sales to provide substantial financial support to the remainder of our local government functions. LUS is committed to providing electricity to our customers at the lowest possible cost and the highest reliability of service.

OUR COAL FIRED GENERATING FACILITIES

The LUS system generates approximately 588.5 Megawatts of electricity, 327 Megawatts through three gas fired units and 261.5 Megawatts through its 50 percent ownership share of the coal-fired Rodemacher Power Station Unit No. 2 located in Boyce, Louisiana.

Rodemacher Unit No. 2 is a 523 Megawatt unit that also provides 104.5 Megawatts of power to LEPA. LEPA is a joint action agency that collectively represents 18 Louisiana municipalities that also own and operate their own electric distribution systems. The third co-owner of the remainder of the plant's capacity is responsible for plant operations and for obtaining coal transportation.

The Rodemacher co-owners collectively purchase coal from mines in the Wyoming Powder River Basin. The only practical way to transport this coal from Wyoming to Rodemacher (a distance of over 1500 miles) is by rail. To facilitate our rail deliveries, the Rodemacher co-owners have obtained and maintain, at our own expense, four train sets of coal cars (over 500 cars).

OUR RAIL CAPTIVITY PROBLEM

Now, Mr. Chairman, let me share with you our experience as a captive rail customer – one served by a single railroad at our plant.

A.) LUS is a Bottleneck Captive Shipper

I have appended a schematic to my testimony to help illustrate our situation. Two different railroad companies serve our Powder River Basin mine origin. Thus, we enjoy a choice of railroads at our coal origin. Alternative rail providers can transport our Powder River Basin coal deliveries to Alexandria, Louisiana, a distance of approximately 1506 miles. (The Official Railroad Station List shows railroad interchange traffic between our existing rail provider and an alternative rail provider in Alexandria, Shreveport, and other points in Louisiana. Alexandria is the nearest listed interchange point to Rodemacher). So, as you can see, there are competitive options for rail transportation for the entire length of the movement to Alexandria.

Beyond that point, our current rail provider owns the only rail line between Alexandria and our Rodemacher plant -- a distance of approximately 19 miles. As a consequence, the Rodemacher owners are "captive" to our current provider since it is the only rail carrier serving this plant. Under the Surface Transportation Board's current interpretation of the law, the current rail provider's control of the last 19 miles allows it to push its pricing monopoly all the way back to the Powder River Basin -- turning a 19 mile monopoly into a 1500+ mile monopoly.

Obviously, our current rail provider has no interest in allowing us to escape its monopoly power and maintains that power by simply quoting us rates only from the Powder River Basin-to-Rodemacher. It has no incentive to allow us access to existing rail competition by quoting a rate to the exchange point in Alexandria, then quoting us a rate from there to our plant. If it quoted us such rates, our carrier would face competition from the Power River Basin to Alexandria and would be forced to provide much lower rates for this portion of our coal movement. The carrier would still maintain its monopoly power over the last 19 miles and could extract maximum reasonable rates across that segment, but overall, the total transportation costs for the entire length of our transportation likely would be reduced. Thus, the Rodemacher co-owners face a transportation monopoly from our existing rail provider.

I might say, Mr. Chairman, that we understand why our rail carrier would not wish to allow us access to existing rail competition. Frankly, however, we don't understand why the Surface Transportation Board, would allow our carrier to block our access to rail competition.

B. Our Customers Are Paying Higher Electricity Rates Because of our Railroad Captivity

Due to this monopoly, LUS pays substantially higher coal transportation prices than other western coal transportation customers that enjoy effective origin-to-destination rail competition. In common with most rail contracts, the Rodemacher co-owner's current transportation contract with its rail carrier precludes us from disclosing our actual transportation prices, or getting into the details concerning our freight rate levels. However, publicly available information suggests our current transportation prices are at least 50% higher, on a mileage-adjusted basis, than rates where there is rail-to-rail competition for long-haul western coal train deliveries.

For the Rodemacher owners, and their customers, this lack of competition translates into millions of dollars per year in "captivity payments" – the difference between what we pay our existing rail carrier compared to what we would pay if we enjoyed railroad competition. Specifically, for the case of Lafayette, Louisiana, the annual cost of these captivity payments is about $5 to $6 million. These higher payments are included in monthly electric bills of LUS customers and cause higher utility bills both for individuals and for the businesses in Lafayette. Please note in this regard, that the cost of coal transportation is one of the single largest cost items included in our electric generation costs.

C. Our Limited Options

What can we do to obtain transportation competition? Our options under current STB interpretations of the law are limited.

- Quote a Rate to the Interchange in Alexandria. One option would be to ask the alternative rail providers to contract with us for a competitive market price for service between the Powder River Basin and Alexandria. Under the Surface Transportation Board's 1996 "Bottleneck Decision," if LUS were to secure such a contract, our existing provider would be required to provide us with a reasonable price to transport this alternatively transported coal traffic the 19 miles from Alexandria to Rodemacher.

However, experience has shown that getting a transportation contract from a competitive provider under such a scenario does not occur. As we understand it, the large western rail carriers generally refuse to provide such bids. Their collective concern appears to us to be if Carrier A "poaches" Carrier B's captive customers by providing such contracts, Carrier B will then retaliate by "poaching" Carrier A's captive shippers. So unless either the Surface Transportation Board changes its interpretation of the law, or Congress changes the law to require railroads to quote rates across railroad "bottlenecks" to points of competition, this option simply is not available.

- Build-Out Relief. A second option is to look at rail construction. Several utilities in the west and south have broken their captivity to a single rail-delivery carrier by constructing new access lines to obtain service from a second rail carrier. Mr. Platz is testifying before you today about an $80 million build-out that four chemical companies are attempting near Houston to obtain access to rail competition. When access can be obtained to a second rail carrier, shippers usually report that they can obtain origin-to-destination competitive rail service and competitive rail prices.

In general, these "build-outs" are quite expensive, when they can be accomplished at all, and they result in the unnecessary duplication of existing rail facilities. In the past, LUS and its Rodemacher co-owners have explored constructing facilities that would allow direct alternative rail providers access to Rodemacher. In our case, any such access would most likely entail construction of a rail bridge or conveyor system across the Red River and Interstate 49. It seems absurd that current federal transportation policy would require small municipal entities like LUS to even study such projects when other alternatives make much more sense, such as, for example, requiring our existing carrier to transport our coal from Alexandria to Rodemacher at a fair price. With such a legal requirement, there would be no need for us to consider construction of costly, duplicative second carrier access facilities at a cost that would be passed on to our electric customers. While we would remain captive over that final 19 mile segment, we would enjoy the benefits of competition for the next 1500 miles of our coal movement. Under such a scenario, our overall transportation costs likely would be reduced.

- Origin-to-Destination Rate Case Relief. A third option is to obtain origin-to-destination common carrier rates from our existing rail provider to apply after our transportation contract expires. Obtaining these rates would allow us to initiate a maximum rate complaint with the Surface Transportation Board. Such a complaint could result in a maximum rate prescription order from the Surface Transportation Board for our Powder River Basin-to-Rodemacher transportation. This option cannot, however, produce competitive pricing under current law.

By law, the Surface Transportation Board cannot set maximum rates at less than 180 percent of a railroad's variable costs (including capital costs). However, I am advised that in competitive coal transportation markets, the transportation rates should be substantially less than 180 percent of the railroads' costs (while still ensuring the railroads earn a healthy profit margin). As a result, the Surface Transportation Board relief simply cannot give us a competitive market rate for the competitive segment of our rail transportation (Powder River Basin-to-Alexandria).

I am also advised that the STB in its recent round of maximum coal rate decisions has approved carrier rates, or prescribed rates, in origin-to-destination cases that are substantially in excess of 180% of the carrier's service costs.

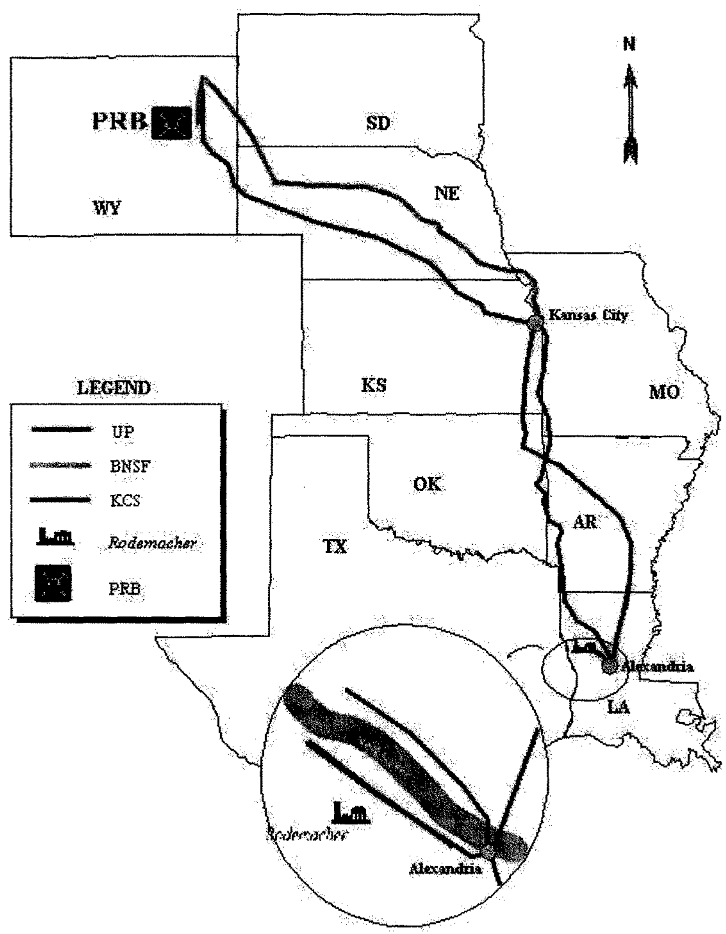
WHAT CAN CONGRESS DO TO HELP US?

Mr. Chairman, we have one simple request of Congress: require the railroads to provide rates to their customers to interchanges where the customer can gain access to existing rail competition. This leaves the railroad with monopoly power to or from the point of interchange, but prevents the railroad from extending that monopoly power to the entire length of our movement. This seems fair to the railroads and to the captive rail customer.

Two bills are pending in Congress that would require the railroads to provide rates to points where rail customers can gain access to competition: H.R. 2924, the Railroad Competition Act of 2003, whose principal cosponsor is Congressman Richard Baker (R-LA) and H.R. 2192, the Surface Transportation Board Reform Act of 2003, whose principal cosponsor is Congressman Jim Oberstar (D-MN), Ranking Democrat on this committee. Both bills require carriers to quote reasonable rates to or from the point of access to existing rail competition. Again, Mr. Chairman, this seems fair to both the railroads and to us, their customers.

Mr. Chairman, thank you for your attention to this important matter. Our electric ratepayers are suffering a daily injustice. This Congress can and should correct that injustice this year!

Selected Routes For PRB Coal Moving to Rodemacher



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LAFAYETTE CONSOLIDATED GOVERNMENT

LAFAYETTE UTILITIES SYSTEM

LUS

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May 3, 2004

The Honorable Corrine Brown
Ranking Member
House Subcommittee on Railroads
2251 Rayburn House Office Building
Independence Ave. & S. Capitol Street, SW
Washington, D.C. 20515

RE: Responses to "The Status of Economic Railroad Regulation" Questions
March 31, 2004

Dear Honorable Brown:

Please find responses to the questions the committee posed to me as per your letter dated April 8, 2004.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Terry J. Huval, P.E.
Director, Lafayette Utilities System
(337) 291-5804

TJH:agc

Attachment

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RESPONSES TO
CONGRESSWOMAN BROWN'S QUESTIONS OF TERRY HUVAL
May 3, 2004

QUESTION #1

Assuming that your estimate of the added cost of rail service is correct, it works out to $50 annually per customer – at least some of which are large commercial users. Bottleneck relief could adversely affect the railroads' ability to meet shipper and consumer needs. Are you sure it is worth it?

ANSWER

I think you misinterpreted my testimony. On page 1 of my testimony, I stated that "we provide electricity to households and businesses in a community of over 110,000 people". On page 3 of my testimony I stated that the annual cost of our captivity payments "is about $5 to $6 million."

While our electricity is used by over 110,000 *people*, we do not have 110,000 *customers*. However, you make an interesting point. For a household of four people using our electricity, the rail captivity payment could approach $200 annually. Of course, our commercial customers often pay higher electricity rates, meaning that they are feeling even more greatly the impact of the rail captivity payments. Rest assured, all of these impacts are significant to us and our customers. This issue is especially important now in light of the fact that our existing carrier has been public about its desire to increase its coal haulage rates across the board.

As Dr. Grimm persuasively testified to the subcommittee, bottleneck relief will not adversely affect the railroads' ability to meet shipper and consumer needs. In fact, bottleneck relief will help meet our consumer needs. It will also benefit the railroads by helping to improve railroad industry performance.

QUESTION #2

If railroads can't earn above 180% of variable costs, how can they cover their fixed costs?

ANSWER

There is nothing in H.R. 2924 or H.R. 2192 or in bottleneck relief itself that prevents a railroad from charging a rate above 180% of variable costs across its bottleneck segment. Remember, across that bottleneck segment the railroad will still possess market dominance. As you are probably aware, the rate relief process at the STB does not establish 180% as a maximum, but rather establishes 180% of variable costs as the minimum that a captive rail customer must pay. In fact, the STB does not have jurisdiction to reduce a captive rate below 180% of variable cost.

Captive rail customers are not seeking an end to railroad differential pricing or an across-the-board cap on rates. Rather, captive customers are seeking to prevent railroads from denying them access to a competing railroad that might provide competitive rates across the competitive portion of a movement. We believe strongly that railroads should not have the power to make us captive where there is a competing railroad present – which is what is allowed under current policy. I was pleased to hear Dr. Grimm at the hearing strongly endorse our position on this issue.

Of course, you heard STB Chair Nober's response to this issue at the hearing: let the captives build their own railroads. The City of Lafayette is not interested in pursuing building its own, redundant railroad – that's why we have railroad companies in this country. We also thought one of the responsibilities of the STB is to protect us from the abuse of railroad monopoly power.

Testimony of Roger Nober
Chairman of the Surface Transportation Board
House Committee Transportation and Infrastructure Subcommittee on Railroads
Hearing on the Status of Railroad Economic Regulation
Wednesday, March 31, 2004
2167 Rayburn House Office Building 10:00 a.m.

Good morning, Chairman Quinn, Ranking Member Brown, and Members of the Subcommittee.

My name is Roger Nober, and I am Chairman of the Surface Transportation Board. I appreciate the opportunity to appear before this Subcommittee today to discuss the status of railroad economic regulation.

I appreciate the longstanding and deep interest that the Members have shown in the economic issues facing the freight railroad industry, which are vital to the financial health of the railroads, to the railroads' customers and employees and to the nation's freight transportation system as a whole. I want to particularly commend the Subcommittee for holding this hearing on matters which are among the most important and difficult matters now facing the Board.

In my written testimony, I first will provide the Subcommittee with an overview of the Board and its responsibilities. Next, I will focus on the most important economic regulatory issues now facing the Board, namely the rate and service issues faced by railroad shippers in general and singly-served (otherwise known as "captive") rail shippers in particular, and the need for railroads to earn adequate revenues. Finally, I will address legislation designed to address the concerns raised by captive shippers, including the bills introduced by members of this Committee -- H.R. 2192, the Surface Transportation Board Reform Act of 2003, and H.R. 2924, the Railroad Competition Act of 2003.

Overview of the STB

As all of you know, the Surface Transportation Board was created eight years ago by this Committee in the ICC Termination Act of 1995. The Board is an economic regulatory agency that Congress charged with the fundamental missions of resolving railroad rate and service disputes and reviewing railroad mergers, line sales, abandonments and new construction. Structurally, Congress determined that the Board should be decisionally independent but administratively affiliated with the Department of Transportation.

The Board serves as both an adjudicatory and a regulatory body. The Board has jurisdiction over railroad rate and service issues and rail restructuring transactions (mergers, line sales, line construction, and line abandonments); certain trucking company, moving van, and non-contiguous ocean shipping company rate matters; certain intercity passenger bus company structure, financial, and operational matters; and matters related to certain pipelines not regulated by the Federal Energy Regulatory Commission.

One of the main reasons the Board exists is to provide a regulatory backstop to assess the reasonableness of rates charged to captive shippers when those customers and their railroads are unable to successfully negotiate a contract for the transportation and to redress unreasonable rates. Another main reason is to assess the adequacy of service received by shippers, as well as to provide redress if railroad service is inadequate. These issues may be addressed in formal proceedings before the Board. In addition to our formal adjudication processes, the Board also created a number of informal mechanisms to help railroads and their customers resolve disputes before needing to avail themselves of the Board's formal processes.

When it was created at the beginning of 1996, the Board had to accomplish its statutory missions with one-third fewer employees than had been performing those same functions at the

ICC. Since 1996, the Board has met its statutory deadlines while functioning with nearly the same level of resources during that time. But as I will outline in my testimony, the Board will face new challenges in the coming year as it works to address the issues raised today and will need some modest additional resources to continue its important work.

In carrying out its duties, the Congress directed the Board to balance the needs of carriers to earn adequate revenues with the needs of shippers to have reasonable rates and adequate service. It is no secret that many captive shippers believe that the Interstate Commerce Act as interpreted by the Board is an ineffective regulatory backstop, and therefore the transportation market for freight rail services does not properly function. By the same token, many railroads feel that twenty five years after the passage of the Staggers Act, they are still not earning adequate revenues. I will next turn to the fundamental concerns raised by captive shippers and railroads and the steps the Board is taking to address them.

Issues Faced by Captive Shippers

1. Unreasonable Rates

Under the Interstate Commerce Act, the Board has exclusive jurisdiction to resolve rate disputes in those instances when railroads have market dominance – in other words, when the railroad is charging a rate higher than the regulatory floor and the shipper has no effective transportation alternative. Under the Interstate Commerce Act, the Board must balance the often conflicting objectives of assisting railroads in attaining revenue adequacy, on the one hand, and ensuring that the rates that individual shippers pay are reasonable and fair, on the other. The balance, as we all know, is not an easy one. Rates that are too high can harm rail-dependent businesses, while rates that are held down too low will deprive railroads of revenues to pay for the infrastructure investments needed to provide shippers the level and quality of service that they require and permit economic growth. The Board is the forum of last resort if a captive shipper feels its rate is unreasonable, and the agency must do its best to carry out the law in a way that is fair to all when deciding railroad rate cases.

For determining whether rates are unreasonable, the Board has one set of procedures for handling "large" rate cases and another for "small" cases. In recent years, the Board has experienced a significant increase in the number of large rail rate complaints filed with it. Whereas in past years the Board had two or three of these cases pending at any one time, today it has 10 large rail rate disputes pending (as well as two pipeline rate disputes and two water carrier rate disputes pending). The Board has not had a single small rate case filed since it adopted its small case guidelines in 1996, but as I will discuss further, my top priority going forward is to establish a more meaningful process for deciding small rate cases.

a. Large Rate Cases.

Determining the reasonableness of a rate in a large rate case is a complicated inquiry. The Board's governing statute requires it first to determine whether the railroad has market dominance over its customer – in other words, whether the railroad has monopoly power over it. Only if the railroad is market dominant does the Board have jurisdiction to review the rate. This is so because under the Interstate Commerce Act, there is no rail rate regulation where there is effective competition. Once it has determined that it has jurisdiction to review the rate, the Board applies a court-approved methodology known as "constrained market pricing" (CMP) to determine whether the rate is reasonable.

i. Market Dominance.

There are two components to the inquiry as to whether the railroad has "market dominance" over the transportation to which the rate applies. The first part is to determine the "variable costs" of providing the service. The statute establishes a conclusive presumption that a railroad does not have market dominance over transportation if the rate that it charges produces revenues below 180% of the variable costs of providing the service, which means that this 180% revenue-to-variable cost (r/vc) percentage is the floor for regulatory scrutiny.

The second part of the inquiry is to perform a qualitative assessment to determine whether there are any feasible transportation alternatives that could be used for the traffic involved. The Board considers whether there is actual or potential direct competition – that is either competition from other railroads (intramodal competition) or from other modes of transportation such as trucks, pipelines, or barges (intermodal competition) for transporting the same traffic moving between the same points. If there are effective competitive alternatives for the transportation, then the Board does not have jurisdiction to regulate the rate, even if the rate charged yields an r/vc ratio greater than 180%.

ii. Rate Reasonableness Standards.

If the shipper can show that the railroad is market dominant, then the Board applies its CMP principles to assess whether the rate being charged that shipper is in fact unreasonable. CMP provides a framework for the Board to regulate rates while affording railroads the opportunity to cover their costs. It is premised on differential pricing, that is, pricing based on the demand for the service provided. CMP principles recognize that, for railroads to earn adequate revenues, they need the flexibility to charge different customers different prices based on each customer's demand for rail service. But CMP principles also impose constraints on a railroad's ability to differentially price. Despite the complexity of CMP, the courts have held that it is the most desirable available approach to railroad rate review and that the Board must use it whenever it is feasible.

Although complaining shippers can choose from three CMP approaches, the most commonly used is the "stand-alone cost" (SAC) test. Under SAC, a railroad may not charge a shipper more than what a hypothetical new, optimally-efficient carrier would need to charge the complaining shipper if such a carrier were to design, build, and operate – with no legal or financial barriers to entry into or exit from the industry – a system to serve only that shipper and whatever group of traffic that shipper selects to be included in the traffic base. The ultimate objective of the SAC test is to ensure that the complaining shipper is not charged for carrier inefficiencies or for facilities or services from which the shipper derives no benefit. As with CMP in general, this assures the complaining shipper that it is not required to pay for inefficiencies or to subsidize unfairly other customers of the railroad.

iii. The Board Is Working to Reform the Large Rate Case Process.

Deciding large rate cases is time consuming and costly for both the parties involved and for the Board. Although the Board by statute has nine months after all evidence is filed to decide a large rate case, it can take more than twice that long after the shipper files its complaint for the parties to file all their evidence with the Board. Preparing that evidence and presenting it to the Board are very expensive – parties have testified that a SAC case can cost as much as $3 million to prosecute, $5 million to defend, and generate more than 700,000 pages of material.

When I became Chairman, the Board intensified its search for ways to simplify and speed up this process, and as a result of this effort the Board adopted a number of changes to its rules that are having an effect on the conduct of these cases. In early 2003, the Board held a hearing in the rulemaking proceeding entitled *Procedures to Expedite Resolution of Rail Rate Challenges To Be Considered Under the Stand-Alone Cost Methodology*, STB Ex Parte No. 638, which was exceptionally productive.

Based on the extensive testimony received from shippers and railroads, in April 2003 the Board revised its rules in ways that ought to both shorten the decisional process and limit the expense of bringing a case. The new rules' most significant provisions include: (1) mandatory, non-binding mediation at the beginning of the case, under the Board's auspices, between the complaining shipper and the defendant railroad; (2) expedited procedures to resolve disputes, using Board staff, over what information the parties can be required to give to each other during "discovery"; (3) technical conferences to resolve, before the actual evidence is filed, certain factual disputes between the parties using the expertise of Board staff; and (4) requiring parties to submit versions of all filings with the Board that can be read by the opposing party and the public.

A significant component of the new rules is to increase the involvement of Board staff in the process through technical conferences and regular meetings with the parties. The Board established technical conferences because the parties were spending time and attorney and consultant fees fighting about – and the Board was expending resources to resolve – technical matters over which there should be no dispute, such as the number of miles between a coal mine and a power plant. In the first technical conference (held in the "*Otter Tail v. The Burlington Northern and Santa Fe Railway*" case), disputes over 200 pieces of data were settled in just over an hour. In the past, these disputes would have led to protracted litigation that would have cost the parties thousands of dollars in fees and could have substantially slowed resolution of the case. We have since held several additional technical conferences in pending cases, including one earlier this week, and found these to be very helpful in all instances.

Another major component of the new rules was the institution of a 60-day period of mediation at the start of any new case. All parties – railroads and shippers alike – who testified at our hearing on *Ex Parte No. 638* thought mediation would be a useful tool to help them to resolve their rate disputes privately. The first case since the Board adopted these new rules, "*AEP Texas North v. The Burlington Northern and Santa Fe Railway*", was filed in August 2003, and I selected former Congressman John Thune to serve as the mediator in that case. Although this mediation did not result a settlement, I believe that mediation in rate matters will help some parties resolve their disputes.

An important objective is to instill greater transparency into our rate case procedure. It is important that the process for resolving major rail rate disputes be open and fair, and every party must have an opportunity to make its case so that the Board will have a full grasp of the implications of any actions it takes. In that regard, on September 10, 2003, for the first time, the agency held an oral argument in an individual large rate case ("*Duke Energy v. CSXT Transportation*"). Since that initial argument, the Board has held oral arguments in three other rate cases. These sessions were productive both for the Board and for the parties, and the Board will continue to hold arguments, as appropriate, in future cases.

One significant outgrowth of holding oral arguments on rate cases is that the Board realized that it needed to ask the parties to supplement the records in three cases in which the records were incomplete in at least one critical respect. The parties submitted that additional evidence to the Board in all three cases. Over an 18 week period, the Board issued a decision in each of those cases.

Many observers have tried to draw conclusions from the results of those three cases, which arose in the Eastern United States. In two of those cases, the Board found the rate charged by the railroad was reasonable and in one case the Board found the rate charged was unreasonable. I think the lesson clearly is that each rate case stands on its own and depends on the particular stand-alone railroad designed by the complainant and the particular evidence submitted by the parties. However, the parties have asked us to reconsider each of these decisions, and those are pending before the agency now.

In sum, while major litigation such as large rate cases is expensive and slow, the Board has made progress in helping to ensure that the rate cases before it proceed faster, cheaper and better. I will make it a priority to continue to make more improvements in this area, and more progress is possible.

b. Small Rate Case Procedures

Since I became Chairman, my top priority has been to provide shippers who have smaller rate disputes an effective forum for resolving such disputes where none now exists. It is a difficult issue, one where the Board must be mindful of maintaining the delicate balance between the legitimate concerns of shippers to have a forum to challenge rates that they believe are unreasonable on the one hand, and the need for railroads to earn adequate revenues on the other. It is a difficult balance, but as I will explain below, one I believe the Board can be successful in striking.

I have spent much of the past 16 months learning why no shippers have brought any small rate cases. Their procedural and substantive concerns can be summarized as follows.

First, shippers contend that the ambiguity of who would qualify to use the small rate case procedures is an insurmountable hurdle that has chilled them from bringing any cases before the Board. Shippers believe that the railroads would fight any shipper's claim that it is entitled to use the expedited procedures, thus tying up the shipper in extensive, expensive threshold litigation. This uncertainty appears to be a major reason why no cases have been brought using the small-case process.

Second, shippers want the Board to ensure that the consideration of small rate cases is expedited and to constrain the discovery process. These shippers argued that protracted litigation of small rate case disputes under the current rules would do them no good because the transportation marketplace for such shipments is so fluid. Many shippers have suggested arbitration as a way of resolving such disputes because of its speed and simplicity. Railroads oppose arbitration, because those proceedings are outside of the strictures of the Interstate Commerce Act and could produce inconsistent results. While mandating binding arbitration is beyond the Board's statutory authority, I also believe it is unnecessary because the small rate case process being developed should be able to accommodate each side's concerns.

I believe that the Board can address these two procedural concerns through procedural reform. Some level of certainty can be brought to the issue of who qualifies for the small rate case procedures, so that if a shipper met that new test, the shipper automatically would be eligible to use the small case process. The Board can streamline the discovery and resolution phases by creating an administrative process that combines the speed and simplicity of arbitration while ensuring that such cases are decided under the framework of the Interstate Commerce Act.

One way for the Board to accomplish these goals is to hire an Administrative Law Judge (ALJ) to hear and decide small rate cases in the first instance. The ALJ would have a prescribed time period for overseeing discovery and for issuing a decision. The ALJ's decision could then be appealed to the full Board. This would allow cases to proceed with the speed and low cost of arbitration, but also ensure that these matters are decided under the principles of the Interstate Commerce Act.

Beyond procedural concerns, shippers and railroads alike have urged the Board to adopt a rate standard for small cases that is clear, unambiguous, fair, and of course, able to withstand legal challenge. The Board promulgated a standard in 1996, but that standard has been widely criticized and – despite having never been applied – was challenged in court (although the court declined to hear the challenge before the standard is actually applied in a case).

There is no doubt that identifying an appropriate standard for the resolution of these cases is the Board's greatest challenge. It is also the area where it will be hardest to find any consensus. Last year at our hearing on this subject, while I asked the parties to provide suggestions to the Board on revising the small-case standard, none has yet done so.

In the Board's efforts to revise our small rate case procedures, we are pursuing every alternative. For example, last year I assembled a team from within the agency to meet with other economic regulatory agencies to gather information on how they handle smaller disputes. The team talked with other agencies, including the Federal Energy Regulatory Commission, the Federal Communications Commission, the Postal Rate Commission, and the Maryland Public Utilities Commission, in a "best practices" survey to gather information that might inform the Board's ideas.

And the Board's efforts are not focused solely on procedural changes to formal proceedings. I am also exploring whether the Board can institute enhanced informal processes to allow the Board to be more responsive to shipper concerns. While the Board does currently have a Rail Consumer Assistance Program in place, I do believe more could be done in terms of staff assistance and outreach to make this program an effective enhancement to the rail economic regulatory environment.

Despite the importance of this effort and the priority I place on it, unfortunately the Board has not been able to move forward on a small rate case rulemaking initiative. I have made a judgment that a rulemaking to finalize a new process for resolving small rate cases is significant enough that I should not take such action as a single Board member, even though I have the power to act alone. Although it is uncertain exactly how the Board's final proposal will look, I have outlined several key elements of the process and believe that these will form the core of meaningful reform.

2. Bringing Competition to Singly-Served Customers

A common desire of singly-served rail customers is to gain service from a second, competing railroad. Singly-served rail customers who want to be served by a second railroad may work with that railroad to finance and to apply for authority to construct a new rail line to the singly-served facility to gain rail competition. The Board's experience over the past decade has shown that, despite some recent court setbacks, new line construction can bring competition while maintaining the private-sector characteristics of our rail system.

As the Subcommittee is aware, the Board must approve certain new rail line construction projects. I testified earlier this month before the Subcommittee on the Board's processes for reviewing new rail line construction projects and will not repeat those standards here. But I can assure you that the Board has worked hard to expedite consideration of requests to construct rail lines and to approve them when appropriate. I would like to highlight two such proposals that I believe will, if constructed, provide significant competitive benefits to rail shippers.

First, the Board approved the construction by the Dakota, Minnesota and Eastern Railroad (DM&E) of a line into the Powder River Basin in Wyoming, which, if constructed, will provide enhanced rail transportation options for coal shippers, particularly in the Midwest.

Second, the Board recently approved the construction of a line to provide the Burlington Northern Santa Fe Railway (BNSF), in partnership with a consortium of singly-served chemical shippers in the region, access into the Bayport industrial area near Houston, Texas, which would provide competition to the members of the consortium located there.

While build-ins can increase competition and provide many benefits, the Board has seen recently that the construction of new rail lines can be controversial in local areas. Indeed, both the DM&E and Bayport Loop projects have generated extensive local opposition and spawned court challenges to the Board's decisions in those cases by various citizen and other groups.

In DM&E, the United States Court of Appeals for the Eighth Circuit reviewed the Board's decision, and while the court found the Board had done "a highly commendable and professional job," it nonetheless remanded the matter to the agency for limited additional consideration of a few environmental issues. Although the Board asked the court to reconsider its finding that the Board should look at the environmental impacts of increased consumption of the commodity that would be carried by the transportation project, the court declined. Thus, the Board recently reopened its proceeding on the DM&E project and will work as expeditiously as possible to address those issues remanded to it by the court.

The Bayport Loop case has produced litigation both in Federal court (where the Board's environmental review process was challenged but subsequently withdrawn) and in state court (where the City of Houston is resisting the railroad's attempts to use state condemnation procedures to acquire property needed for the new line). A state court in Texas delayed construction on the grounds that the project's proponents could not use state eminent domain laws to acquire property needed to construct the line. I believe this court's interpretation of state law is preempted by the federal statute that gives the Board authority to determine which proposed rail construction projects should be built.

Despite these two recent court decisions, the Board is confident that it will prevail in both of these cases. But notwithstanding the litigation that they can generate, construction projects represent the best way to balance the need for greater competition with the importance of preserving the private rail network.

Capital Needs of Freight Railroads

As the Board considers the concerns of captive shippers, it must also keep in mind the concerns of freight railroads, particularly the need for railroads to earn sufficient revenues to invest in capital. While the Board is an economic regulatory agency, the state of railroad infrastructure is inextricably intertwined with every rate and service matter it addresses. Upkeep of rail infrastructure is a key part of the conundrum that has faced the rail industry for several generations – how to provide a level of service that will allow railroads to grow their businesses and provide the level of service expected by shippers while maintaining our freight railroads as viable private entities.

The problem is as follows. The service railroads provide and the rates they charge customers are directly limited by the capacity and reliability of their network. To increase their business or to charge premium prices, railroads must improve service. But, they can only improve service if they increase their capital investments. Railroads cannot increase infrastructure spending because they are not earning their cost of capital. To earn their cost of capital and be revenue adequate, railroads must increase their revenues, which are limited due to the condition of their networks. And thus the problem comes full circle.

As publicly-traded companies, freight railroads must listen to their investors, who are seriously concerned about the returns on railroad capital investments. Since I have become Chairman, I have met with most major figures in the railroad investment community. They all agree that the railroads are not meeting their cost of capital, but they disagree on the solution. Some urge increased capital spending, some say current levels are about right, and others believe railroads should cut back. Many urge railroads to increase revenue by raising prices to existing customers, rather than by investing to grow their traffic. Railroads face a difficult decision, rooted in the conundrum I referred to earlier.

When the Board considers the rate and service issues raised by shippers, we must balance their concerns against those of the railroads. Our rate standards allow railroads to price their services in a way that will permit them to earn a reasonable return on the facilities needed to serve captive traffic. That is a fundamental principle of railroad economics. As freight and passenger rail traffic grows, there will be infrastructure improvements that should not be deferred if our nation is to maintain a healthy rail industry that can meet the growing demand of the economy for rail transportation, which ultimately works to the benefit of all shippers.

Legislation to Address Shipper Concerns

Finally, I would like to address the legislation that has been introduced in the House and Senate that would address many of the issues raised here today. In the House, two bills address these issues: H.R. 2924, the Railroad Competition Act of 2003 and H.R. 2192, the Surface Transportation Board Reauthorization Act of 2003. Pending in the Senate is S. 919, which is the companion bill to H.R. 2924.

Taken as a whole, legislation such as H.R. 2924, H.R. 2192, and S. 919 would fundamentally change the economic model of the railroad industry and is unwise. Not a single one of our major railroads is revenue adequate, and if enacted these bills would call into question the continued economic viability of our freight railroad system. While some shippers may realize a short-term gain from lower rates, in the long run this legislation of this type, if passed, could significantly degrade our nation's freight rail network, to the detriment of all of its users. Although the nation's privately funded railroad system may have some problems, it is the best freight railroad system in the world, and the United States is the only country with a national freight rail network that does not need taxpayer subsidy.

Most of the provisions of these bills reflect unhappiness with the Board and certain of its regulatory doctrines. I have met with most of the supporters of these bills, and they almost all agree that they would not be calling for legislation if the Board had interpreted certain provisions of the Interstate Commerce Act differently. But to me, the individual provisions in any bill are less significant than the underlying concerns that gave rise to seeking legislative changes in the first place. Since I have become Chairman I have worked hard to understand the core concerns of captive shippers and the railroads that serve them.

First, many shippers do not have full confidence in the Board as a fair and impartial regulatory body. My most important initiative as Chairman has been to win that confidence through openness and dialogue. During my nomination and confirmation process, there was a great deal of concern expressed about the lack of transparency at the STB. Since I have become Chairman I have taken several steps to change this perception, including restoring regular voting conferences on cases; holding hearings on significant matters such as large and small rate case procedures, and on individual cases and merger proposals; and holding oral arguments on large rate cases. In fact, on Friday, the Board will hold a field hearing in Trenton, New Jersey, related to its five-year oversight of the CSXT and Norfolk Southern acquisition of Conrail, which is due to expire in July of this year. I am pleased that 20 witnesses have asked to testify at that hearing.

Last summer, the Board also held an open house for practitioners to introduce our staff to them and explain how the agency processes cases. I have an open door policy for meetings and have met with many shippers and railroads. I have traveled extensively in the past year to better understand rail transportation. The Board has also redesigned its web-site to provide practitioners, stakeholders, and interested persons easier and more extensive access to Board information, including streaming audio broadcasts of the Board's public meetings. While these may seem like small steps, I believe they have gone a long way to help the agency's stakeholders understand how and why the Board makes its decisions.

Second, many disputes between shippers and railroads often take on a life of their own because of the way shippers feel they are treated by the railroads. Rail customers often conclude that while rates are high, the railroads' service and attitude are bigger problems.

Rail customers are primarily wholesale enterprises who are themselves industrial and manufacturing companies or producers of goods. Like railroads, these shippers are capital intensive and work on thin profit margins. They have customers who demand top-notch service and low prices, and they have suppliers from whom they demand the same. All operate in a brutally competitive global marketplace. These companies understand the financial pressures railroads are under, but they feel that they are not treated by the railroads the way they would treat their own customers. This has led some shippers to assume that railroads act this way because they are monopolies and to believe that legislation like H.R. 2924, H.R. 2192, or S. 919 would introduce more competition into the rail network and force railroads to be more responsive to them.

Railroads should work harder to operate in a more customer-friendly fashion, and I am working with all of our major rail carriers to impress upon them the importance of doing so. Railroads must be nimble competitors in the transportation marketplace to increase their business and grow their revenues. While the leadership of each of the major railroads understands this, that attitude does not always translate throughout their entire organizations. The good news is that in many circumstances railroads have worked with their customers to improve efficiency and take costs out of the supply chain to the benefit of both parties. But these examples are not common enough, and they must become the norm, not the exception.

Helping railroads improve their operations to provide better service is one goal that carriers, shippers and policy makers all share. The Board has been instrumental in bringing the railroads, the city and the state together to improve operations and devise a capital plan for improving operations in the Chicago terminal area. Approximately one-third of all rail shipments go through Chicago at some point in their journey. Improving Chicago and other rail gateways will allow for faster, more reliable shipments, to the benefit of all.

But these efforts to improve service through operational focus can only go so far. As we have seen in recent months, the growing economy has sharply increased the demand for rail shipments, and the railroads are short of the crew and equipment necessary to meet this increased demand. Without sufficient capital funds, the railroads' efforts to improve service will not be fully successful.

Third, a fundamental underpinning of these bills is that very few rail shippers feel the Board provides an effective regulatory forum in those instances when carriers and shippers cannot privately resolve their differences and the shipper has no effective recourse.

The agency tries to help parties informally resolve their differences and improve relations between railroads and their customers. The Board's Rail Consumer Assistance Program is a model for informally addressing a wide variety of concerns between shippers and railroads. The Board's Office of Compliance and Enforcement generally acts on inquiries made through this program within four hours and has had some significant successes assisting railroads and shippers to resolve their disputes.

I believe the Board can do more to be an informal facilitator when shippers and carriers have difficulties. Just a few months ago, the Board successfully facilitated discussions to address delays in moving agricultural freight from the upper Midwest that occurred last fall. A confluence of events that affected that region occurred last fall, including a great harvest, an increased demand for grain to export (which meant grain was being transported further distances than normal), an improving economy that meant more traffic of all kinds on the rails, and shortages in railroad crews. As a result of this "perfect storm," the railroad was very late in getting rail cars to some North Dakota shippers. The Governor of North Dakota and some shippers in that state contacted me for assistance, and I hosted meetings and facilitated discussions among the Governor, grain shippers from North Dakota, and the senior management of the railroad that serves the area. As a result, they agreed to a number of measures to address the problem and work off the backlog. I consider this behind-the-scenes approach a model for resolving similar problems in the future. Of course, the Board can only try to solve the problems, like this one, that it knows about with specificity.

Even with the success of informal Board activities, the Board has to remain an effective regulatory backstop when a dispute over rates and services is formally brought before the Board. No cases have ever been brought under our small rate guidelines, and we must work to change that. But in doing so, the Board must recognize that the economic relationship between shippers and carriers is complex. In many cases, shippers have many facilities – both captive and competitively served – and ship to numerous destinations on several railroads. While the legislation seeks to simplify the shipper-carrier relationship, in reality the relationships between shippers and carriers are enormously complicated and not easily understood. Many shippers do have economic leverage with railroads when the totality of their relationship is considered, and the legislation takes no account of this reality.

Finally, certain areas of the country are disproportionately dependent on rail service in general, and on a single rail carrier in particular, for their economic health. Many who are from the upper Midwest feel that, because of the importance to their states' economies of producing bulk, commodity-based products, their region's economies are particularly dependent upon the business practices of a single railroad.

The Board must pay close attention to the unique set of concerns of rail shippers in that part of the country. I traveled to North Dakota and met with a number of government officials, shippers and producers. I have spoken numerous times with the railroad that primarily serves that area about the issues raised there and, as I indicated earlier, worked to mediate a service dispute there. The issues faced in that part of the country are complex, and not easily resolved. However, attention – and not legislation – is the best way to resolve the issues faced there, and while attention may not solve every problem, significant progress is possible if there is communication and focus.

Conclusion

One of my goals as Chairman of the STB has been to ensure that the agency's processes work as well as they possibly can. The first step was to open up the Board. The Board has taken steps to streamline the process for large rate cases, steps which are already working. The Board will continue to reevaluate and refine how the parties and Board staff work through the large rate cases. The next step is to improve the agency's small rate case process.

I believe that the Board can and will do a better job to address the concerns raised by captive shippers. The reforms outlined today – and not substantive changes to the statutory scheme– are the best way to address the concerns raised by captive shippers while maintaining a healthy private freight rail network. It is a difficult balance, but one that can be achieved.

I appreciate the opportunity to discuss these issues today, and look forward to any questions you might have.

Post-Hearing Questions from
Ranking Democratic Member Corrine Brown
To Chairman Roger Nober
Surface Transportation Board
For the March 31, 2004 Hearing before the
House Subcommittee on Railroads on
Status of Railroad Economic Regulation

1) In your statement, you note that some shippers believe that railroads treat their customers badly because they are monopolists and that more competition would help. Don't you agree? Doesn't competition provide the incentive to innovate and to force firms to satisfy their customers?

Customers have a valid concern that they are sometimes not treated by the railroads as they should be. I have made it a high priority to work to improve how the railroads work with their customers. Although I believe many in railroad management understand that they need to work more cooperatively with their customers, they must continue to get their entire organizational cultures to adapt such that each employee asks, "What can I do today to better serve our customers?"

An example of how the Board is working with the railroads is the shipper forum held this week by the Union Pacific Railroad and the National Industrial Transportation League. The Board has facilitated that forum so that the railroad can convey directly to all interested shippers, not just the very largest of the railroad's customers, the difficulties the railroad is facing in parts of its system, how it is addressing those problems, and what the customers can expect in the coming months.

Although there is more work to be done to improve the railroads communication with an attitude toward their customers, I do not think it would be wise to fundamentally change the economic regulatory system in which the railroads operate.

In the nearly twenty-five years since the Staggers Rail Act of 1980 freed our nation's railroads and their customers from the restrictions of a cumbersome and outmoded regulatory scheme, there has been competition in our nation's freight rail industry. This competition has been sufficient for the railroads to innovate and achieve productivity enhancements that are, in turn, passed along to their customers in the form of lower rates and better service.

The Board seeks to foster effective competition among rail carriers. Towards that goal, the Board promotes the consideration and construction of build-outs – new rail lines that provide shippers access to competing rail carriers. Significantly, the process of seeking approval for a build-out often achieves the benefits of competition even if, ultimately, the new line is not built because the railroad originally serving the shipper often responds to the proposed build-out by offering the shipper better rates, service or both. In the merger context, the Board has preserved competition by granting trackage rights to competitors when the merger would reduce a shipper's rail options from two carriers to one carrier.

Competition, however, is but one prong of fifteen often conflicting elements of our nation's Rail Transportation Policy. There can be limits beyond which increasing competition ceases to represent sound public policy. I note, for example, that the Rail Transportation Policy also requires that the Board promote the revenue adequacy of rail carriers. Despite having the world's best privately-funded national freight rail network, the Board must remain mindful that not a single one of our major railroads is revenue adequate.

2) Short line railroads are potential competitors for the Class I's but many are constrained by agreements they signed with large railroads when they were spun off. Aren't these agreements contrary to the public interest? Don't you agree that phasing out these "paper barriers," as provided for in H.R. 2942 would promote competition and solve many of the problems that shippers face today?

The emergence of a growing list of shortlines has been, on the whole, a positive force in the railroad industry. Shortline spin-offs from the major rail carriers have enabled many shippers with facilities located alongside light-density rail lines to continue to receive rail service.

To create these shortlines, Class I railroads entered into agreements with the shortline companies. These agreements sometimes included clauses, known as paper barriers, which restrict the shortline railroad's ability to interchange traffic with railroads other than that Class I railroad. Although these paper barriers are a concern to me, I do not believe that government action to retroactively alter the agreements is appropriate. These agreements were privately negotiated between the parties with the expectation that the government would not later change or eliminate them. To phase out the agreements retroactively would alter fundamental premises upon which the bargains were struck. In addition, these agreements did not alter the rail options available to the shippers before the lines were spun off. Thus, they did not reduce competition from the level that existed before the shortline railroad was created.

3) I understand that you have said that build outs are THE solution to the captive shippers competitive problem. Isn't building such duplicative facilities wasteful? And isn't it often very difficult to actually construct the build out?

I have said that build outs are one solution in a menu of solutions to the problems that captive shippers face. There are certainly other solutions, including reform of the small rate case process at the Board and informal dispute resolution. Although I have been reluctant to start a process to reform the small rate case because I am currently the only Board member, the Board has been very effective at informally addressing issues. In my testimony, I mentioned the success the Board had last fall in working with The Burlington Northern and Santa Fe Railway and grain interests in North Dakota, but the Board also has addressed about 200 issues raised over the last few years through its Rail Consumer Assistance Program.

The Board's experience over the past decade has shown that, despite some recent court setbacks, new line construction can bring competition while maintaining the private-sector characteristics of our nation's rail system. But it is not always necessary for a shipper to actually construct a build-out before enjoying the benefits of competition brought about by the build-out process. Even the threat of a build-out will often constrain railroad rates.

In some cases, shippers and railroads may have different expectations about the credibility and economic efficiency of a build-out option. But, if a shipper seeks to exercise its build-out option by coming to the Board for approval of its build-out plans, the Board is obliged to approve the construction application unless the construction is inconsistent with the public convenience and necessity. In practice, the Board routinely approves such applications subject to appropriate environmental mitigating conditions, because of its belief that the competition provided by the build-out process is in the public interest.

Even when the Board approves a construction application, the parties still have an opportunity to strike a mutually beneficial arrangement that obviates the need to build out. In fact, the Board has had several construction applications withdrawn after the parties agreed on either a trackage rights arrangement or a new contract. Thus, it is not always necessary for a shipper to actually construct a build-out before enjoying the benefits of competition brought about by the build-out process.

TESTIMONY BEFORE THE

RAILROAD SUBCOMMITTEE

OF THE

HOUSE TRANSPORTATION AND INFRASTRUCTURE COMMITTEE

STATUS OF THE SURFACE TRANSPORTATION BOARD
AND
RAILROAD ECONOMIC REGULATION

MARCH 31, 2004

SUBMITTED BY

CHARLES E. PLATZ
PRESIDENT, BASELL NORTH AMERICA INC.

ON BEHALF OF

CONSUMERS UNITED FOR RAIL EQUITY
AMERICAN CHEMISTRY COUNCIL

Mr. Chairman and Members of the subcommittee, my name is Charles E. Platz, President of Basell North America Inc. Thank you for the opportunity to testify here today. I appear on behalf of the employees and shareholders of my company, the American Chemistry Council and Consumers United for Rail Equity, of which I serve as co-chair.

In the next few minutes, I want to discuss with you a problem with our current national rail policy that is having a devastating effect on the ability of many chemical companies in this nation to remain competitive and is, I believe, contributing to the export of United States manufacturing jobs. In fact, during both 2002 and 2003, for the first times in the history of our industry, the United States spent more money importing chemicals than we earned by exporting chemicals. If not yet, then soon, we will export U.S. jobs as well as U.S. dollars. The trend lines are not good. The problem: current policy allows railroads to deny their customers use of existing rail competition.

The problem I bring to your attention today cannot be resolved in discussions between the railroads and their customers. We've tried to make that happen and the railroads have made it very clear that they will not entertain discussions about policy changes. And, while we appreciate Mr. Nober's more open-door policy and his public acknowledgement that we have legitimate issues, the Surface Transportation Board has made it clear that it too will not act on its own to address this problem. Therefore, Mr. Chairman, our problem is left squarely in the hands of Congress. We believe that it is imperative that this Congress address this problem immediately.

BASELL NORTH AMERICA, INC.

Basell North America is headquartered in Elkton, Maryland. Basell has manufacturing facilities in Texas, Louisiana and Tennessee, and markets products manufactured at a plant in Linden, New Jersey. We produce raw material plastic resin that our customers use in a variety of applications such as automobile components, textiles, packaging, medical products and numerous household goods. We are heavily rail dependent with 100% of our products at our Louisiana and Texas facilities being loaded directly into hopper cars for transportation. The vast majority of our customers demand delivery by rail. To enable this transportation, we own or lease - and maintain - 4,000 hopper cars with a replacement value of $260 million. Our plants produce about 14,000 hopper carloads of product annually.

BASELL EXPERIENCE AS A "CAPTIVE" TO A SINGLE RAILROAD

Mr. Chairman, I am before you today testifying on an issue that I knew little about when I returned from Europe five years ago to run our operations in the Americas. In the ensuing years, I have had quite an education.

My company operates in a highly competitive global market. The margins of profitability on our products are exceedingly narrow. Customers have many choices of suppliers so it is difficult to pass cost increases on to our customers. To remain in business, we must constantly work at becoming more efficient and reducing the cost of producing and delivering our product.

As I began to review the cost structure of our operations in the U.S., I noticed that our railroad transportation costs at our Texas facility, which is served by a single railroad, were grossly out of proportion. In fact, these costs were meeting or exceeding the fixed costs of producing our product and made them the largest cost component after the cost of our raw material. Rail transportation costs remain among our largest cost components today.

Obviously, as a businessman, I began to focus on how we could bring these costs in line or achieve greater efficiency in rail transportation. I was surprised to be told by my transportation managers that the rates and level of service we received couldn't be changed because our single railroad carrier would not negotiate with us.

Rather, our railroad carrier set the rates and we had no opportunity to drive service requirements. We had no choice but to pay the railroad's rates and endure the existing poor service. Frankly, at first, I didn't believe that this could be true. As a businessman, my experience is that you can and should negotiate everything in a competitive market.

CAPTIVE RAIL CUSTOMERS HAVE NO BARGAINING POWER

When Basell attempted to open negotiations with the railroad carrier that provides single line service at our Texas plant, I quickly found out that my managers were correct. In fact, our position in negotiations was so poor that, for a long time, our railroad carrier used our captivity in Bayport, Texas to force us to use their service at higher than market prices at our Louisiana plant, which is served by several rail carriers. Allowing our rail carrier at Bayport to handle our cars at Lake Charles was the only method we had to even slightly temper the grossly out-of-market rates we pay for rail transportation out of our Bayport, Texas facility.

THE RATE RELIEF PROCESS AT THE STB DOESN'T WORK FOR CHEMICAL COMPANIES

Since our high rail rates are not tolerable in the long run and are jeopardizing the continued operation of our Bayport facility, we began to look at our options for containing and reducing our rail costs. First, we examined whether we had any chance of relief from the Surface Transportation Board (STB). After all, in 1980 Congress anticipated that there would be captive rail customers and directed the Interstate Commerce Commission (now the STB) to protect rail customers from the abuse of railroad monopoly power where competition does not. One potential option was a rate case at the STB that could determine whether our rate was unreasonably high. Unfortunately, we found that, since railroad deregulation, no chemical company has ever won a rate case at the STB and our advisors indicated our success would be highly unlikely. Moreover, as the Chairman of the STB has testified to this committee, a rate case begins with a filing fee of up to $62,100, takes at least two years and would cost us up to $3 million – not a very attractive process to enter with the hope of becoming the first successful chemical company plaintiff in an STB rate case.

THE STB ALLOWS RAILROADS TO BLOCK THEIR CUSTOMERS' USE OF EXISTING RAILROAD INTERCHANGES TO REACH COMPETITION

Our second option at the Surface Transportation Board involved a competing railroad line that runs within approximately five miles of our plant. Our single line rail carrier could deliver our hopper cars to that competing line. Even though we would have to pay a high rate to our single line carrier for the first five miles of our movement, we would then have competition that could reduce our overall costs and greatly improve our efficiency through better service. Of course, our single line carrier could choose to compete and retain our business for the entire length of the movement. Clearly, our single line carrier would have no incentive to allow us to escape captivity by gaining access to the competing railroad. However, it would also seem logical, and consistent with every market approach applied in every other business in this country, that the Surface Transportation Board, in implementing railroad deregulation, would force one railroad to allow us access to another railroad where the two already exchange traffic.

Despite being contrary to the fundamental economic principles of our country and the tenets of deregulation, in 1996 the STB interpreted the deregulation act to allow railroads to deny customer use of existing railroad interchanges to reach competition. So, instead of being captive for five miles, the STB policy makes us captive for movements of up to thousands of miles, most of which is covered by competitive railroad options. We just aren't allowed to use those options.

CAPTIVE RAIL CUSTOMERS CAN BUILD THEIR OWN RAIL LINES TO A COMPETING RAIL CARRIER

Finally, we identified the only option to reach competition that the STB favors. We could build our own railroad out to the competing railroad. With the opportunity to increase their business, the competing railroad will provide a contract for rail movement at rates and service requirements that can, over a period of years, allow the amortization of the new line and still result in reduced transportation costs and greater operating efficiency.

After repeated unsuccessful attempts to negotiate more reasonable rates from the single line carrier, San Jacinto Rail Limited was born in 2001. Basell, along with three other chemical companies (Atofina, Lyondell, Equistar) and the BNSF railroad formed the San Jacinto Rail Limited to fund, build and operate a new rail line to reach competition. A schematic on the proposed San Jacinto Rail line is attached. After two years of review, the STB approved the project, which is expected to cost approximately $80 million. Today, approaching three years after the public announcement of the project, we hope that we can build this new, yet redundant, route. Unfortunately, it is not at all clear that this project will succeed.

Not unsurprisingly, some in the local community are significantly less than thrilled that a new, redundant rail line could be constructed near their neighborhoods. This strong public opposition has forced elected officials in the City of Houston to oppose the construction and, as a consequence, the City has refused to allow the use of, or to convey, needed City property. Condemnation proceedings were undertaken to force access to this property, but the local trial court dismissed the condemnation proceeding. Now, this critical matter is mired in a state appellate court in Texas. So, while we have invested a lot of money, time and effort and have our STB approval, it is not clear that even this option will work for us.

Now, I ask you to examine this federal policy. Instead of preventing the incumbent carrier from blocking use of existing competitive options – which would seem to be a sound, if not fundamental, policy for a deregulated industry – we are forced to build our own railroad out to the point of competition. When the STB approved this project, the Chairman of the STB said that this represents "the right way" to obtain competition. This right way requires four chemical companies that are fighting to be competitive in a difficult global economy to enter the railroad business, invest $80 million that we would do better investing in our own businesses and build a railroad that nobody wants through a location where it is not welcome. I ask you: Is this the best policy for our nation?

And what if we are successful in building this railroad; what will be the result? First, the incumbent carrier will lose all or most of the business from our four companies for at least a number of years. Our new major railroad carrier will grow its business and, since they are willing participants, presumably increase their profits, all while offering us lower rates and better service. And finally, there will be competition for our business between the two railroads. The history of successful build outs whose primary purpose is to gain access to competition is that the redundant infrastructure often is idled when the initial rail carrier provides competitive rates and regains the business. Most Americans would view this entire exercise as disruptive, inefficient and a waste of investment capital.

Mr. Chairman, how can the current policy of allowing railroads to block customer access to competition at existing interchanges be defended? This policy would only make sense in a regulated system where rates are approved in advance by a regulatory agency. It makes no sense in a deregulated railroad industry. Moreover, this is not a benign bad policy that has minor side effects. Quite the contrary, we are trying to build our own rail line out to competition – at very high cost - because the high rail rates and poor service that results from our current captivity is jeopardizing the continued existence of the plants of our four companies in the Bayport, Texas area. Indeed, one company in the Bayport Industrial District has already closed its facility due in large measure to high transportation costs and moved its operations elsewhere. I have attached a verified statement by this company that was filed in the STB proceeding on San Jacinto Rail Limited, as well as a current picture of the plant site, which is for sale.

At the Bayport, Texas site, Basell has an idled production line that could be restarted with some investment. Restarting the line would create new jobs. The products from this line could also provide significant new revenue to the railroad. Without competitive rail rates, however, we cannot afford to restart the line. Basell will stay the course on the San Jacinto Rail Limited line, but will not invest in the Bayport site until we have competitive rates.

CONGRESS MUST REQUIRE RAILROADS TO ALLOW THEIR CUSTOMERS ACCESS TO COMPETITION AT EXISTING INTERCHANGES

Mr. Chairman, if railroad deregulation is to work for this country, railroad customers must be allowed use of existing railroad competition. Two bills are pending in the House that contain a provision that addresses this problem: H.R. 2924, the Railroad Competition Act of 2003, whose primary sponsor is Congressman Richard Baker (R-LA), a senior member of this Committee; and H.R. 2192, the Surface Transportation Board Reform Act of 2003, whose primary sponsor is Congressman Jim Oberstar (D-MN), the Ranking Minority Member of this committee.

The provisions in both bills are identical and require a railroad, when requested by its customer, to provide in writing a rate to a point on the railroad system where the customer can gain access to rail competition. The provision does not dictate the level of the rate or even require that the rate be reasonable, but only that a rate be provided so that the rail customer can gain use of existing rail competition.

We believe that the enactment of this provision will allow railroads and their customers to reach balanced commercial arrangements regarding transportation, will enable captive chemical plants to improve their competitive positions and will avoid the need to waste capital on build outs that are not designed to increase rail capacity and for that very reason often are unwelcome projects in a community. Allowing rail customer access to existing railroad competition makes sense in a deregulated railroad industry.

While I can not candidly appear before you today and blame all of the job flight taking place from our country on rail pricing and service practices, I can confidently state that it is a factor contributing to job flight in the chemical industry. Companies with facilities served by only one rail carrier and no ability to reach existing competitive alternatives are forced to evaluate whether the facility can remain viable as competition from the global market intensifies. Once a company is forced to consider a move, a number of other factors will come into play, causing the company to ask the question: where should I invest? Given today's climate, it is virtually certain that they will decide not to invest at a site that lacks rail competition and may very well decide to invest in a new site overseas.

The railroads will not change their practice and the STB has made it clear that it will not change the substance of its existing policies. This leaves only one solution: change must come from Congress. We urgently request that this Committee ensure that this provision is enacted into law this Congress. Thank you, Mr. Chairman and members of the subcommittee, for the opportunity to bring this vital issue to your attention today.

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BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 34079

San Jacinto Rail Limited – Authority to Construct – and The Burlington Northern and Santa Fe Railway Company – Authority to Operate – Build-Out to the Bayport Loop in Houston, Harris County, TX

RECEIVED
2001

Verified Statement of David Boswell
On Behalf of Velsicol Chemical Corporation
In Support of the Bayport Loop Build-Out

1. My name is David Boswell. I have been employed by Velsicol Chemical Corporation in various capacities since 1975. My current role is a Director of Materials Management. My business address is 10400 W. Higgins Rd, Suite 600, Rosemont, IL 60018.

2. My current responsibilities as Director of Materials Management include managing all transportation activities. In that capacity I am familiar with Velsicol's bulk transportation arrangements and economics.

3. Velsicol is a global corporation focused on producing high performance speciliaty chemicals based on benzoic acid and cyclopentadiene that serve a variety of niche markets.

4. Velsicol's top-selling products include a full line of specialty plasticizers ranging from innovative benzoate esters to high performance polymerics and monomerics. With such a broad line, Velsicol is able to serve the adhesives, caulks, sealants, coatings, and PVC resins markets.

5. Velsicol is the world's largest marketer of refined benzoic acid and derivatives.

6. Velsicol's third line of chemicals is cyclopentadiene, derivatives used in the production of flame retardants and agricultural pesticides.

7. Velsicol's headquarters is located at 10400 W. Higgins Road, Suite 600, Rosemont, IL 60018-3713, in suburban Chicago. It has manufacturing operations in Chestertown, MD; Memphis and Chattanooga, TN; Kohtla - Jarve, Estonia; and Manchester, UK. Additional information about our company can be found on our website at http://www.velsicol.com.

8. Until September of 2001, we produced Benzoflex plasticizers at our Bayport, Texas, facility. Due to recent market conditions we have had the unfortunate task of consolidating our Benzoflex production capacity at our Chattanooga, TN and Chestertown, Maryland plant sites. This resulted in our decision to idle the unit located in Bayport, TX late in 2001. When decisions were made in this regard, the production costs of the Bayport facility were taken into account, including costs of transportation into and out of Bayport. The high transportation costs were a significant factor in our decision to idle this unit. The Bayport facility is served by one rail line .

9. Although we will not directly benefit from the planned build-out proposed by BNSF and San Jacinto Rail, we nevertheless felt it important to voice our support for the project. If this type of competitive build-out had been completed earlier, it could have played an important role in whether we continued production at this plant.

3/3

10. We believe the new rail line will be a significant enhancement to the Bayport Industrial District and could help industries that are currently attempting to navigate in a generally weakened global economy. We support competitive rail access projects such as this and recommend that it be approved.

I hereby affirm on penalty of perjury that the foregoing is true based on my knowledge and information.

Name

Dated: November 12, 2001


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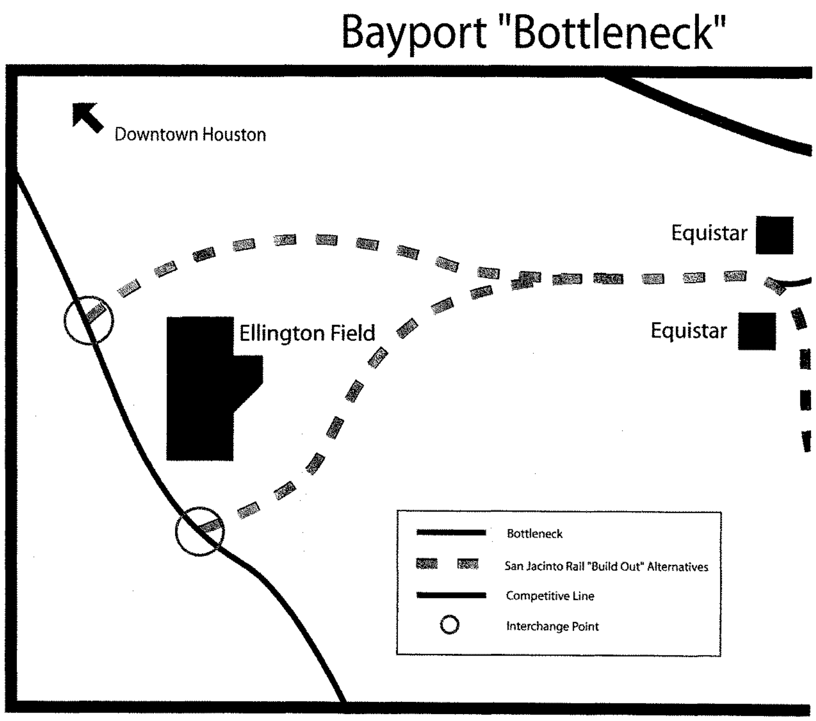
Bayport "Bottleneck"
Downtown Houston
Equistar
Ellington Field
Equistar
Bottleneck
San Jacinto Rail "Build Out" Alternatives
Competitive Line
Interchange Point

• CONSUMERS • UNITED • FOR RAIL • EQUITY •

April 29, 2004

The Honorable Corrine Brown
House Committee on Transportation and Infrastructure
Subcommittee on Railroads
589 Ford House Office Building
Washington, DC 20515

Dear Congresswoman Brown:

Attached please find answers to questions posed to Chuck Platz, President of Basell North America and Co-Chair of Consumers United for Rail Equity, following his testimony on March 31, 2004 before the House Subcommittee on Railroads.

Please do not hesitate to contact me at the number listed below should you have any questions. Thank you for your time and interest.

Sincerely,

Bob Szabo

Robert G. Szabo
Executive Director

1050 Thomas Jefferson Street, NW - Sixth Floor
Washington, D.C. 20007 (202) 298-1844 fax (202) 338-2416

4/29/04

RESPONSES FOR CONG. BROWN
QUESTIONS OF CHUCK PLATZ

QUESTION: Shippers would always want a lower rate, everything else being equal. Why isn't the STB's "stand alone railroad" process an appropriate way to determine the reasonableness of the rate?

ANSWER: Regardless of any economic theory merits of the "stand alone railroad", the "stand alone railroad" and the process for "establishing the stand alone railroad" simply does not work for most captive rail customers.

In his testimony to the Railroad Subcommittee on March 31st, STB Chairman Nober testified regarding the "rate reasonableness" process at the STB. With respect to so-called "large cases", which use the "stand alone railroad" standard, Mr. Nober testified that the process is "time consuming and costly". In fact, he testified that these cases "can cost as much as $3 million to prosecute, $5 million to defend, and generate more than 700,000 pages of material" (page 6 of his written testimony). He testified that these cases can also take up to 3 years and that there are ten large rate cases pending.

Other problems with the "stand alone railroad" process, from the perspective of a captive rail customer, are (1) that most of the information needed to construct the "stand alone railroad" is in the hands of the railroad defendant and the railroad is reluctant to share the information, (2) the captive rail customer has the burden of proof of both "captivity" and that the rate is "unreasonably high", (3) since there is no prior-approval of rates, the railroad defendant exercising monopoly power over the customer escapes all burden of justifying its rate and (4) even if successful, "stand alone cost" means what it would cost the rail customer to provide its own railroad – a very unusual standard to determine where a monopolist is extracting too much from its captive customer. The entire "stand alone railroad" standard and process was not required by Congress, but rather is a choice of the STB and its predecessor, the Interstate Commerce Commission, in its implementation of railroad "deregulation".

QUESTION: You claim that railroad rates are forcing chemical companies to relocate outside the United States, but many factors affect plant location decisions. Can you give any concrete examples where high rail rates were the decisive factor influencing plant relocation?

ANSWER: Yes, you are correct that plant closings, consolidations and relocations are made for a variety of reasons and it is very difficult to identify situations where any one factor is the decisive factor. However, in my testimony I refer to the decision to close down the Velsicol Chemical Plant in Bayport, Texas. Attached to my testimony is a verified statement, filed with the Surface Transportation Board in the San Jacinto Railroad proceeding, by an official of Velsicol that states that high rail rates were the decisive factor in closing down this plant. I cannot provide specific information for other plant closing decisions. I can offer, however, offer the following.

It has been well documented that Toyota recently refused to commit to building an $800 million pick-up truck factory in the San Antonio, Texas area until it gained access to two railroads for transportation. This example underscores the impact of captive customer rail rates on major manufacturing facilities.

One of the leading exports of our nation has been, for many years, chemical products. During the last two years, the U.S. has been a net importer of chemical products. Obviously, U.S. jobs are displaced by the chemicals that are displacing U.S. manufactured chemicals in our country. This trend has a number of causes, including the high domestic price of natural gas. However, with two thirds of the chemical plants in the U.S. captive to a single railroad, it cannot be denied that captive rail rates are a contributing factor.

Finally, I can tell you that captive rail rates are jeopardizing the economic viability of our Bayport, Texas facility. As I stated on page 2 of my testimony to the subcommittee on March 31st, our captive rail costs are the largest component of our production costs at our Bayport facility, after our cost of raw materials. In fact, our rail costs usually meet or exceed the fixed costs of producing our product. If our rail costs cannot be brought down substantially, rail costs could, at some point, be the deciding factor in whether we maintain our operations at Bayport. As I said on page 5 of my testimony to the subcommittee, once captive rail costs have brought into question the economical viability of a plant and the plant owner is forced to consider a move,

> "...a number of other factors will come into play, causing the company to ask the question: where should I invest? Given today's climate, it is virtually certain that they will decide not to invest at a site that lacks rail competition and may very well decide to invest in a new site overseas."

QUESTION: You claim that captive shippers have no bargaining power, but some chemical companies are far bigger than the entire railroad industry. Don't large chemical companies have the power to offset captivity at one location by threatening to retaliate at other where there is rail-to-rail competition?

ANSWER: Your question is based on the notion that a larger economic entity cannot be subject to monopoly power from a smaller economic entity. I don't think this thesis is correct, unless the larger economic entity can do without the services of the monopolist (chemical companies must have rail service), the larger economic entity determines to purchase the monopolist (chemical companies do not wish to be in the railroad business and the STB might not even approve the purchase of a major railroad by a chemical company) or the larger economic entity determines to provide itself the services that are being provided by the monopolist (it would be impossible today to gain the rights of ways and permits to build another major railroad from scratch).

I am the President of a company that is not larger economically than one of the major railroads. Our experience is just the opposite of your question. We are captive at our Bayport facility in Texas but are served by several railroads at our Louisiana facility, including the railroad that has us captive in Texas. The railroad serving us in Texas charged us such a large rate that our ability to maintain operations in Texas was jeopardized. The only way we could obtain a lower rate at our Texas facility was to sign a contract with the same railroad for our Louisiana facility at rates substantially higher than the competitive market rates we could have obtained at our Louisiana facility. Thus, in our situation, the major railroad used its monopoly power to make our Louisiana facility captive as well as our Texas facility. So, our experience is exactly opposite from the thesis of your question.

While I may not know the specifics of every transportation situation in the chemical industry, I do not know of a situation where one of the large chemical companies has been able to use its economic power in the way that you suggest. I assume that such specifics do not exist because Dow Chemical and DuPont Chemical, the two largest U.S. chemical companies, are very active in the effort to enact S.919.

BEFORE THE

HOUSE SUBCOMMITTEE ON RAILROADS

HEARING ON THE STATUS OF THE SURFACE TRANSPORTATION BOARD AND RAILROAD ECONOMIC REGULATION

STATEMENT

OF

WILLIAM J. RENNICKE

MANAGING DIRECTOR OF

MERCER MANAGEMENT CONSULTING, INC.

MERCER
Management Consulting

March 31, 2004

Contents

I. Summary of Statement of William J. Rennicke, Managing Director, Mercer Management Consulting, Inc.

This statement has been prepared by William J. Rennicke, a Managing Director with Mercer Management Consulting, Inc. (Mercer). I have more than 30 years of experience consulting to the transportation industry and to users of transportation on a wide range of management, regulatory, economic, litigation, and asset management issues. I specialize in transportation strategic planning, management, marketing, economics, and operations, and have particular expertise in restructuring, organizational redesign, and transactions to improve financial and operating performance of transport operators around the world. I have previously provided expert testimony on the state of the North American rail industry on several occasions before the Congress and the Canadian Parliament. I have also directed the analysis of the competitive effects of transactions before the Federal Trade Commission and the Department of Justice.

My purpose in preparing this statement is to provide the Committee with Mercer's perspective on the state of the railroad industry, including its current financial conditions and transformation since enactment of the Staggers Rail Act of 1980, issues and challenges facing the industry and long-term capital funding needs. My testimony is based on experience working with many of the largest North American railroads as well as with their suppliers and customers.

I would like to make a number of points before the Committee today. Several of these points are updates of testimony Mercer provided the Senate in 2001 and to the House in 1999. In making these points, I will refer to the supporting visual materials in Section II of the document before you.

1. **Deregulation continues to stimulate an efficient and competitive rail industry and has benefited shippers, consumers, and the economy as a whole.**
   - Since the implementation of the Staggers Act in 1980, U.S. railways have become more competitive, innovative, and efficient.
   - Trends in the operating ratios of the US Class I railroads remain positive; volume has been growing strongly; and rail productivity has improved substantially in the almost two and a half decades following deregulation.
   - Average revenues per ton-mile for major commodities in which railroads have a high market share have been flat or declining through the 1990s and into the current decade.
   - Most of productivity gained through deregulation has been shared with customers in the form of rate reductions.
   - By increasing the efficiency and reliability of railroads, deregulation has driven down the cost to the economy of moving and managing goods.
   - The cost, productivity, and freight rates per ton-mile of the North American railroads are the envy of freight railroads worldwide.

2. **Despite significant productivity and service improvements made during the past two and a half decades, the industry faces many challenges.**

   - Rates of productivity improvement are slowing. Railroads are running out of traditional sources of productivity improvement.
   - Rate declines coupled with unit cost inflation have continued to expand a large "rate-cost" gap for the railroads. Productivity improvements have been key to closing this gap and maintaining the financial viability of the railroad industry.
   - While facing rate pressure on major bulk commodities, railroads are also being challenged by customers to improve service performance. As one might expect, the pressure for improved service comes primarily from shippers of truck-competitive merchandise traffic, but it is also coming increasingly from shippers of bulk traffic as they seek to improve the utilization of their assets and to manage their inventory costs. Continued service improvements will require higher levels of capital investment.
   - Total Class I rail capital expenditures have risen from $3.6 billion in 1990 to $5.7 billion in 2002 – an increase of approximately 56 percent in nominal terms. Even larger capital expenditures will be required, however, for capacity expansion to handle growing volumes and improve service, as well as to realize new efficiencies needed for the railroads to cope with the continuing decline in revenue per ton-mile.
   - However, investors and analysts are skeptical that railroad financial performance will support the additional capital required by the industry. Moreover, the hangover from the financial distress in the airline industry, in which many investors in aircraft lost money, and new international banking regulations are putting pressure even on traditional railroad equipment finance transactions.

3. **Railroads also are under pressure to invest in new capabilities to avoid losing customers.**

   - Railroads are compelled to keep pace with the changing supply chain needs of their customers if they are to remain competitive with other modes of transportation.
   - For example, Radio Frequency Identification, or RFID, is emerging as a major competitive factor in supply chains. RFID tags are similar to electronic barcodes and can be embedded in a shipment to provide tracking and other types of information at a distance.
   - Only a few years ago, RFID tags were virtually unknown. Within two to three years, they will be ubiquitous in supply chains.
   - Supply chain giants, including Wal-Mart and the Department of Defense, are driving the adoption of RFID.

- Wal-Mart is requiring its 100 largest suppliers to include RFID tags in all pallets by January 2005. By January 2006, all 10,000-plus Wal-Mart suppliers will have to add RFID tags at the case level. Researchers at Bear Stearns estimate that Wal-Mart's top 125 suppliers will spend $500M complying with the RFID mandate.
- The Dept. of Defense is requiring its 43,000 suppliers to put RFID tags on pallets, cases, and certain individual items by January 2005.

- In the near future, railroads' customers will demand 100 percent visibility over their goods in transit. The transportation providers that can provide this capability quickly and efficiently through RFID or other technologies will be competitively advantaged.
- Railroads already have invested heavily in RFID to track their own railcars and mobile assets. However, they may have to invest millions of dollars more collectively in the technology – readers, antennae, communications networks, and specialized software – needed to make this location information available to customers in useful form.
- Because of their larger size and the fixed nature of their networks, railroads may be able to mount a stronger response to the RFID challenge than competing trucking carriers. Responses could include an industrywide "pool" to deliver ubiquitous RFID capabilities, potentially with the aid of third-party service providers, integrators, and investors.

4. **Creative commercial alliances between railroads, suppliers and third parties continue to be needed to fuel additional substantive productivity gains for the railroads.**

- With historical drivers of productivity improvement substantially diminished, railroads are likely to turn to extended business partnerships and strategic alliances (short of merger) in order to create new value.
- By "unbundling" the rail value chain, railroads are identifying partner companies that may be more efficient providers of distinct services or more appropriate owners of distinct assets.
- Alliances can and are being formed between a railroad and another railroad; directly between a railroad and a third party (such as a supplier); or between a railroad and an intermediary (such as a financial investor).
- Because direct railroad-to-railroad collaboration can be difficult to execute, indirect collaboration through intermediaries (either traditional or new Internet-based intermediaries) is likely to be easier but may require new and creative transactions with suppliers and financial institutions.
- Railroads are now looking to suppliers for innovative ways to ease capital investment levels and increase productivity. To capture these opportunities,

suppliers along with financial institutions have to take larger stakes in the rail value chain and develop closer working relationships with railroads.

5. **Given the railroads' continuing challenges, a stable regulatory environment is required to ensure the health of the industry and the continued flow of private capital.**

    - In the current skittish capital markets, any substantial shift in regulatory policy will add an expensive level of uncertainty in the investment process.

    - An example of such regulatory uncertainty is the current discussion of providing a different standard for regulatory review of "small shipper" rates, which proponents would extend to cover small shipments made by very large companies.

    - As the exhibits I have provided to the Committee show, while a simplistic analysis of rates would seem to indicate that there are large disparities in rates for similar shipments, most such disparities actually are explained by differences in the characteristics of the specific shipments. An analysis Mercer conducted on a traffic sample several years ago found no pattern of rate discrimination against small shippers.

    - Many of us with experience in the railroad industry began our careers sorting through the wreckage that pervasive regulation of the railroad industry had created. The markets remember why the Staggers Act was necessary, and will be wary of actions – such as the "small shipper" proposal – that could reimpose regulation over large portions of the railroads' marketplace.

6. **New international banking regulations and policy will place railroad investments under an increasing level of credit and risk review and could increase the cost of funds.**

    - New international regulations and policy in the financial sector as well as the high default rate on transportation equipment over the last four years could increase the cost of funds for critical railroad equipment

    - Historically during strong economic periods the valuation process for all types of transportation equipment relied heavily on appraisal and the trailing performance of the asset type. For the last 24 months, however, the high default and writedown rate for aviation assets has created a challenge for the whole range of parties that provide rail rolling stock.

    - The tightening of credit and evaluation comes at a time when the rail equipment sector is trying to pull out of one of the most severe downturns in its history, and the users of rail equipment are scrambling to arrange capacity for areas where car shortages are undercutting the customer's ability to ship and are driving business away from the railroads.

- The international Basel II Accords are establishing new procedures for evaluating the risk on railroad equipment and beginning to impact the ability of parties who are trying to finance rail equipment at attractive cost of funds.
  - In August 2003, to ensure that leading US banks comply with Basel II, the four US bank and thrift regulators jointly issued two consultation documents on the implementation of the new Basel Capital Accord (Basel II).[1]
- Most of the regulatory pressure to improve the way banks approach risk and capital has arisen from concerns over commercial lending risks. Basel II will most affect capital attribution within banks by encouraging banks to attribute capital in a much more risk-sensitive manner than most do at present.
  - The capital attributed to individual business units is insufficiently risk-sensitive at many banks today. Basel II represents a significant improvement in the risk sensitivity of capital regulation and is better aligned with best practice economic capital models. This should provide an incentive for banks to revisit their internal capital attribution assumptions.[2]
- We do not expect Basel II to have a revolutionary impact on the overall banking industry. Most banks operate with capital levels well in excess of regulatory minimums, due to rating agency and market pressures. As banks prepare for implementing Basel II, however, practices and procedures for evaluating the risk associated with all types of investment are being reviewed.
- The requirements to demonstrate the level of risk for railcars has already led in some cases to more complex and less successful funding.
- Mercer believes that many of the issues being raised in the capital markets can be addressed if the focus of credit and risk analyses moves to some of the more rigorous quantitative techniques that have been used for the last 20 or so years by financial institutions that have not accepted appraisals or trailing performance as a factor for future results.
  - Cash flow estimates that project the financial performance of the assets subject to the transaction is one approach that simultaneously addresses the requirements of the Basel II Accords and the credit deficiencies of the last 48 months.
- We believe that the voluntary adoption of the quantitative risk and credit practices will restore the financial sectors understanding of the investment in rail equipment and restore the required capital needed to fund the assets.

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[1] *Advance Notice of Proposed Rulemaking*, joint release from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, 4 August 2003.

[2] *Risk and Basel II: A retail perspective*, Mercer Oliver Wyman, December 2003.

II. Statement Presentation Slides: Today's Hearing on the State of the Rail Industry

In today's hearing, I will address a number of major issues concerning the financial condition, transformation, and long-term capital funding needs of the U.S. rail freight industry:

1. Deregulation continues to stimulate an efficient and competitive rail industry and has benefited shippers, consumers, and the economy as a whole.
2. Despite significant productivity and service improvements made during the past two and a half decades, the industry faces many challenges.
3. Railroads also are under pressure to invest in new capabilities to avoid losing customers.
4. Creative commercial alliances between railroads, suppliers and third parties continue to be needed to fuel additional substantive productivity gains for the railroads.
5. Given the railroads' continuing challenges, a stable regulatory environment is required to ensure the health of the industry and the continued flow of private capital.
6. New international banking regulations and policy will place railroad investments under an increasing level of credit and risk review and could increase the cost of funds.

1. The Rail Industry Since Deregulation: U.S. Freight Railway System Structure

U.S. freight railways are divided into three categories based upon revenue or mileage: Class I railroads, regional railroads, and shortlines.

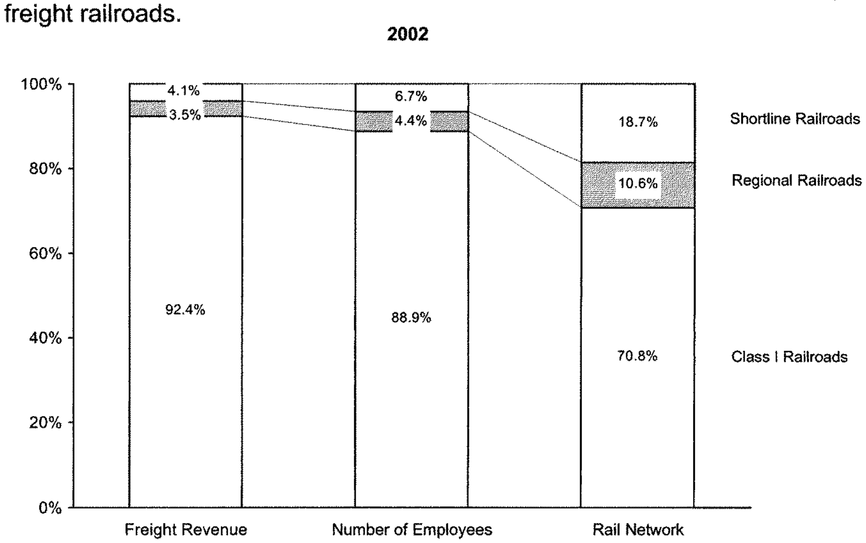
U.S. Class I Railroads	U.S. Regional Railroads[3]	U.S. Shortlines[3]
▪ Seven U.S. railways of Class I size[1] in 2003	▪ 31 companies[2]	▪ 514 companies[2]
▪ Defined as operating revenue >$272 million	▪ Defined as operating revenue $40-$271.9 million and/or operating at least 350 miles of track	▪ Smaller than Regionals in revenue or miles
▪ Large railways with interstate links	▪ Service to selected regions	▪ Cover small geographic areas only
▪ Mainly East-West orientation of lines	▪ Connections mainly between neighboring states/economic centers	▪ Mostly branch lines with only one track; includes switching and terminal railroads
▪ Strong position of unions	▪ Only partially unionized	▪ Little or no union influence

[1]Beginning in 2002, the STB required reporting for Grand Trunk Corporation, comprising Grand Trunk Western and Illinois Central, to be combined with that of the parent company, Canadian Nationall. Similarly, reporting for Soo Line is now combined with that of its parent, Canadian Pacific.
concessions. Only two of the new railroads are of Class I size.
[2]As of 2002.
[3]Class II railroads are railroads with revenues between $21.8 million and $271.9 million; Class III railroads have revenues <$28.8 million.

Source: Mercer analysis; Association of American Railroads Ten Year Trends, 19993-2002; AAR Railroad Facts 2003 Edition.

1. The Rail Industry Since Deregulation: U.S. Freight Railway System Structure

In 2002, the seven U.S. Class I railroads represented 92 percent of U.S. rail freight revenue, 89 percent of all railroad employees, and 71 percent of the network length of U.S. freight railroads.



Source: Association of American Railroads; Railroad Facts 2003 Edition.

1. The Rail Industry Since Deregulation: Financial Performance of Class I Railroads

In 2002, three of the "Big Four" railroads continued to lower their operating ratios, and all four remained positive.

2001/2002 Selected Measures for "Big Four" Class I Railroads

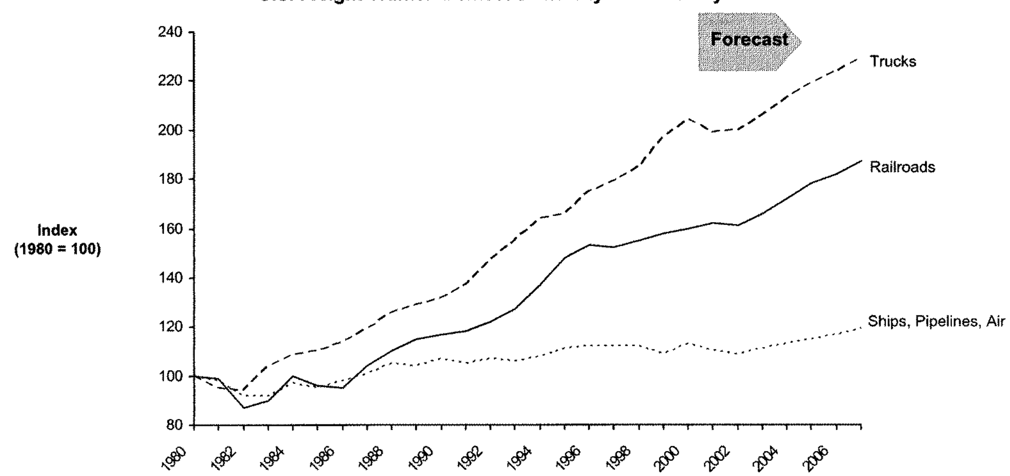
Company	Operating Revenue ($million) 2001	Operating Revenue ($million) 2002	Operating Ratio 2001	Operating Ratio 2002	2001/2002 Operating Ratio Change (% points)	Number of Employees 2002	Revenues per Employee 2002	Freight (millions of tons originated) 2002
UP	$10,614	$11,103	81.3%	79.7%	-0.6	47,219	$235,139	489
BNSF	$9,201	$8,963	81.0%	81.9%	+0.9	37,366	$239,868	438
CSX	$6,454	$6,368	92.9%	90.9%	-2.0	32,425	$196,396	393
NS	$6,170	$6,270	86.4%	84.4%	-2.0	28,751	$218,073	308
Big Four	$32,438	$32,704	N.A.	N.A.	N.A.	145,761	$224,367	1,628
Class I Railroads	$34,576	$35,327	84.3%	83.4%	--	157,372	$224,483	1,767

Source: Association of American Railroads, *Railroad Ten-Year Trends 1992-3002*, *Railroad Facts 2002 Edition* and *2003 Edition;* Mercer analysis.

1. The Rail Industry Since Deregulation: Volume Growth

Although railroad volume declined markedly immediately following deregulation, since the mid-1980s it has been growing strongly.

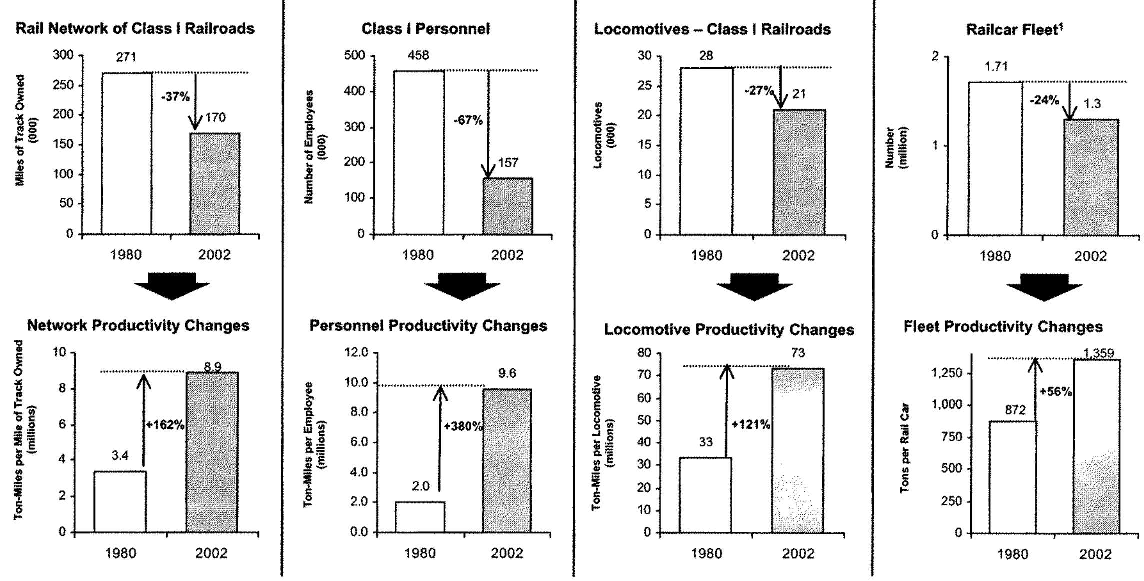
U.S. Freight Traffic: Domestic Intercity Ton-Miles by Mode



Source: Mercer analysis; WEFA; Association of American Railroads.

1. The Rail Industry Since Deregulation: Improved Productivity

Rail productivity improved substantially in the two decades following deregulation.

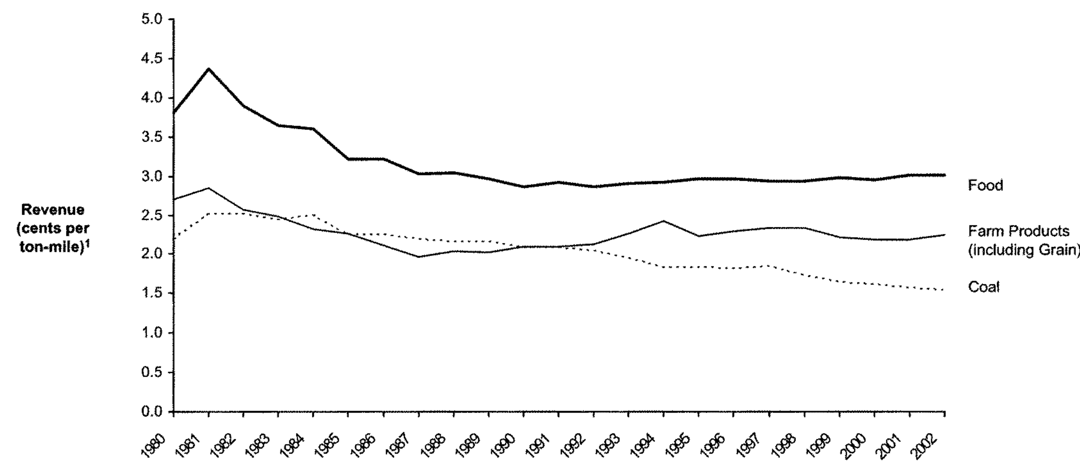


Source: *Railroad Facts, 2003 Edition,* Association of American Railroads; Mercer analysis.
[1]Railcar fleet figures include Class I railroads, other railroads, and other car owners.

1. The Rail Industry Since Deregulation: Flat Revenue Growth

However, average revenues for major commodities in which railroads have a high market share fell during the 1980s before flattening out in the 1990s.

Average Revenues by Major Commodity (1980-2002)

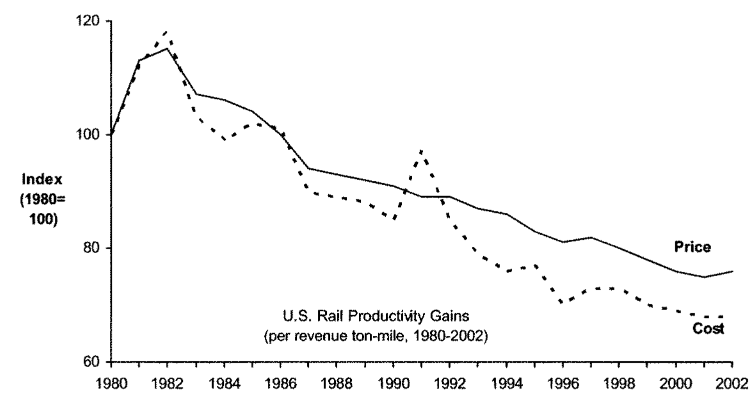


[1]In current dollars
Source: Association of American Railroads; Mercer analysis.

1. The Rail Industry Since Deregulation: Declining Rates

Most of the cost savings from deregulation have been shared with customers in the form of rate decreases.

Rail Industry Cost Savings Have Been Passed on to Customers

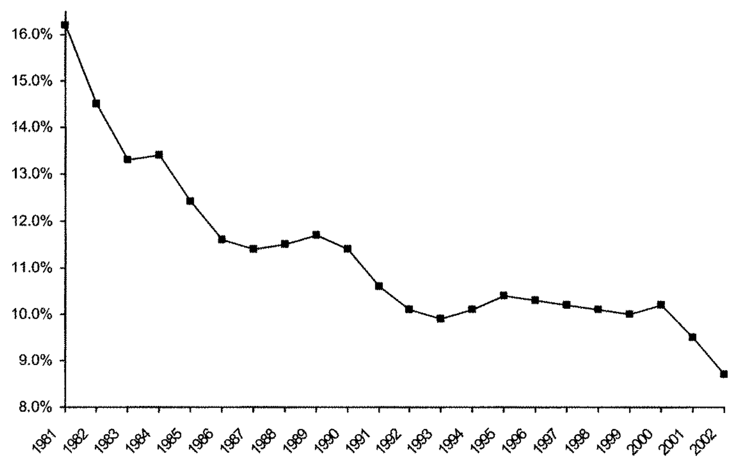


Source: Association of American Railroads; Mercer analysis.
Mercer Management Consulting © 2004

1. The Rail Industry Since Deregulation: Lower Cost of Transporting Goods

The increased efficiency and reliability of railroads since deregulation have helped to drive down the cost to the economy of moving and managing goods.

U.S. Logistics Costs as a Percent of GDP

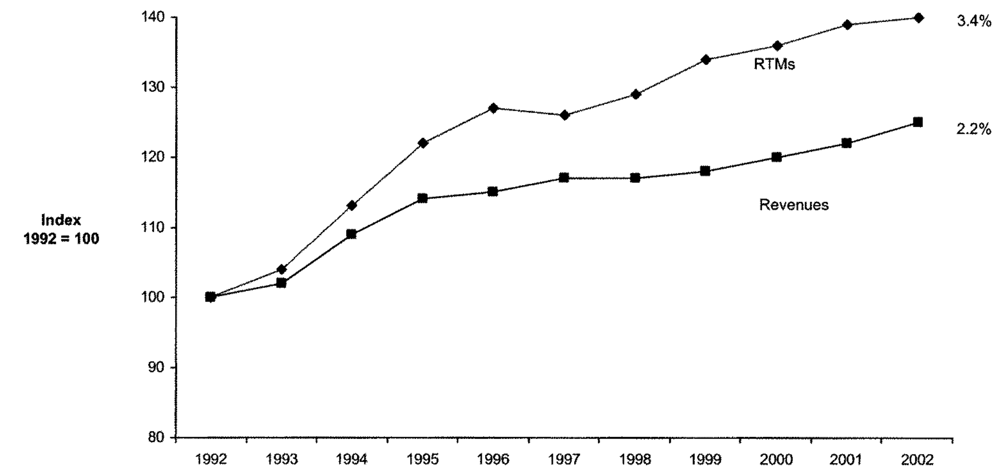


Source: Cass Logistics, 14th Annual State of Logistics Report.
Mercer Management Consulting © 2004

2. The Challenges for Railroads

As noted, revenues are failing to grow at the same pace as volumes (measured in revenue ton-miles).

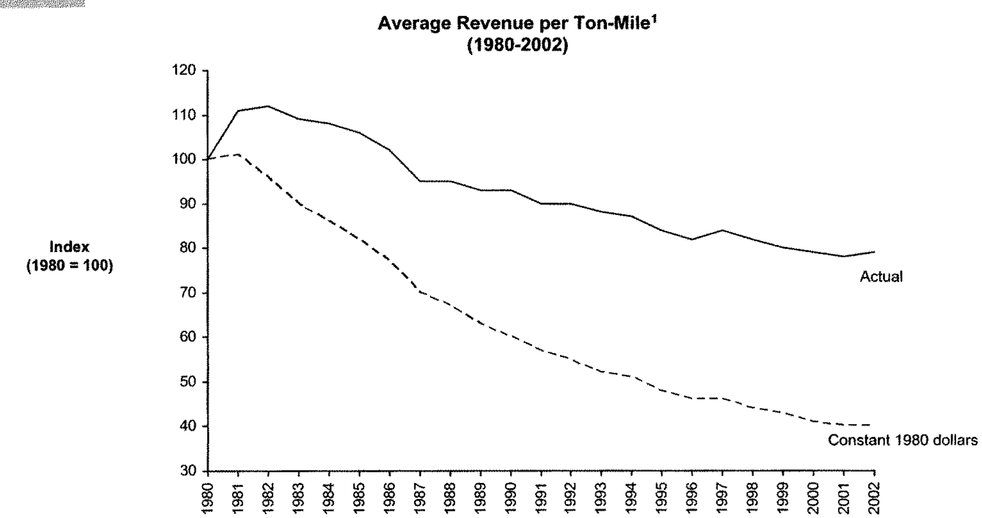
Class I Revenues vs. RTMs
(1992-2002)



Source: *Railroad Facts 2000*; Association of American Railroads; Mercer analysis.

2. The Challenges for Railroads: Declining Yields

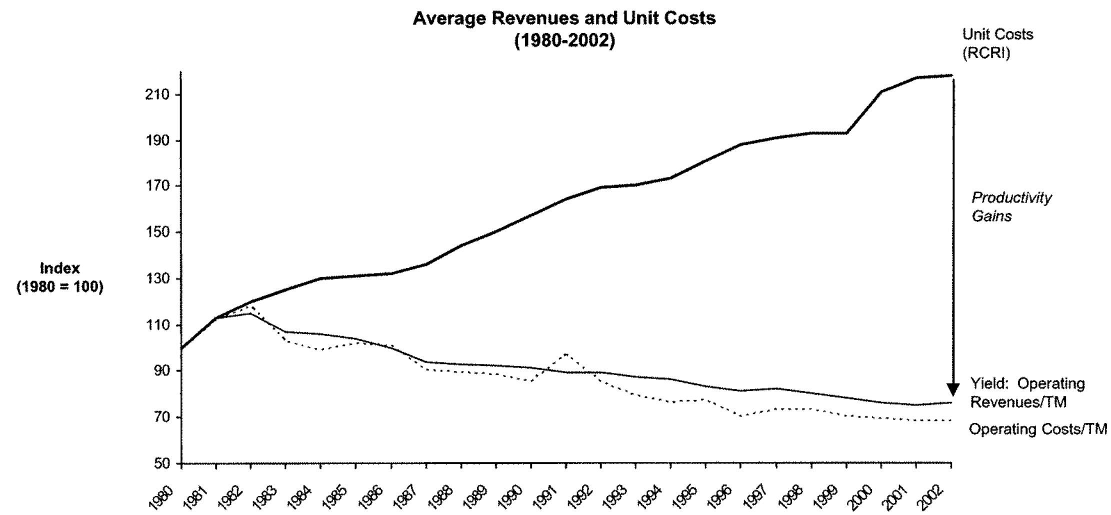
As a result, yields are continuing to decline.



Source: Association of American Railroads; Railroad Facts for 1990, 1995, and 2003
[1]Adjusted for U.S. inflation index using GDP chain-type price indexes.

2. The Challenges for Railroads: The Rate-Cost Gap

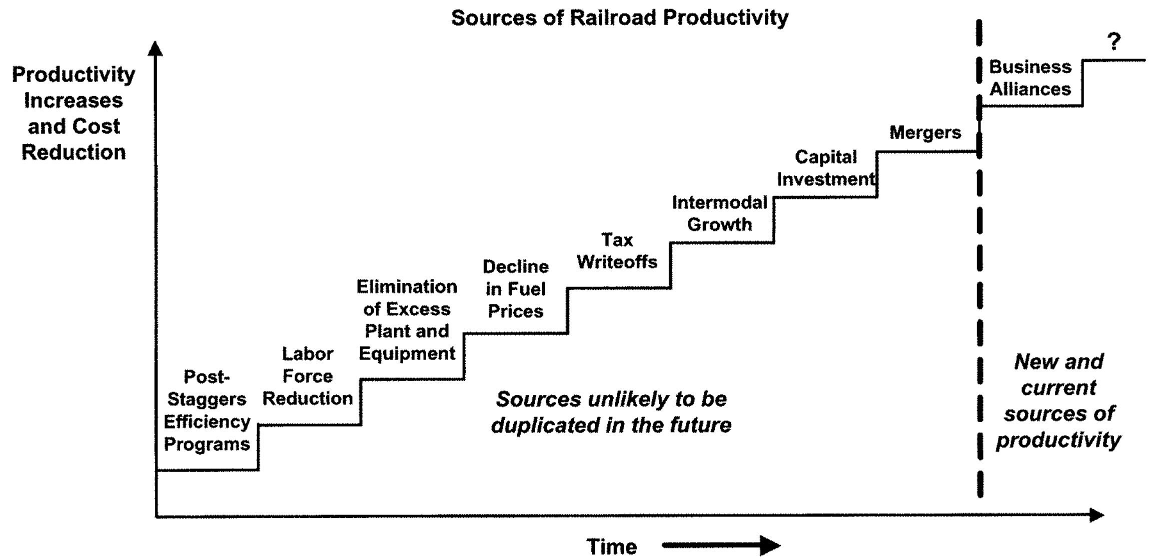
Railroads have managed to maintain profitability only by increasing productivity and cutting costs.



Source: Railroad Facts 2001 Edition; Association of American Railroads; Mercer analysis.

2. The Challenges for Railroads: The Mandate for New Sources of Productivity

However, railroads are running out of traditional sources of productivity improvement.



2. The Challenges for Railroads: Service Improvement Initiatives

Railroads are now turning their attention from the challenges of post-merger integration to focusing on capital investment to improve asset productivity and provide the higher, more reliable service levels that will allow them to improve customer service and their own top line.

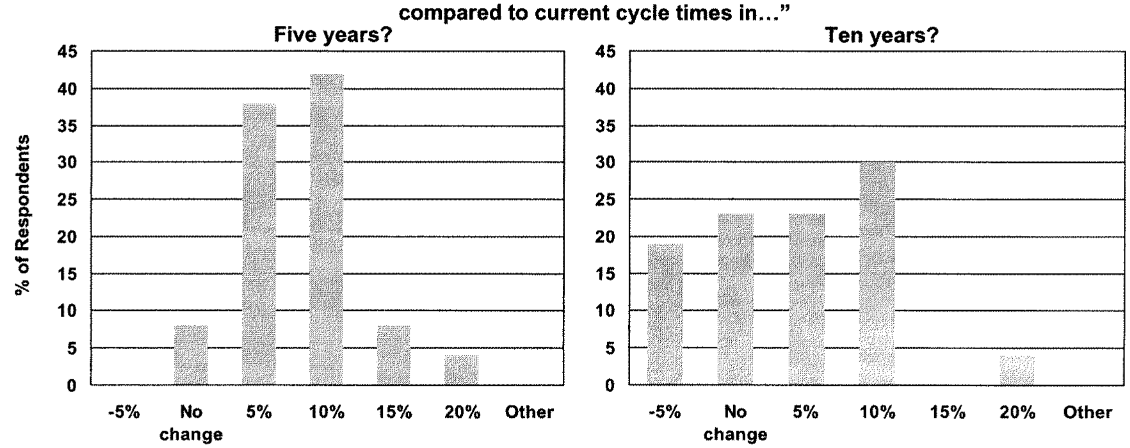
Examples of railroad initiatives

- CN scheduled railroad, measurement of trip plan compliance by car
- CSX and CN collaboration to improve cycle times on selected interline lanes with analysis of performance against plan
- UP and CSX joint Express Lane service to reduce transit time, increase reliability, and measure performance as "one railroad" on selected lanes
- NS Thoroughbred Operating Plan to increase reliability, includes efforts to measure dock-to-dock transit times against trip plan and connection performance at carload level
- BNSF Transportation Service Plan and "disciplined execution" program, includes reporting of trip plan performance by car
- CP scheduled railroad to improve transit times, reliability, and measurement against trip plan

2. The Challenges for Railroads: Capital Requirements for Improved Service

Many of the new initiatives to improve throughput and capacity and to meet increasing service demands require higher levels of capital investment in assets and facilities.

Mercer survey of rail equipment finance executives: "What will car cycle times be compared to current cycle times in..."

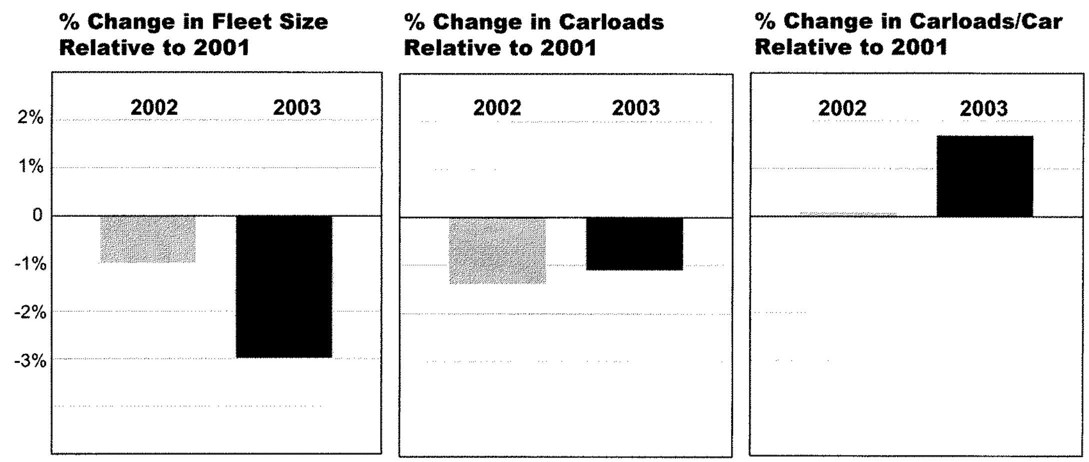


While most respondents anticipated utilization improvements of 5-10% over the next five years. . .

. . .the spread of opinions was much wider when looking at a ten-year horizon.

2. The Challenges for Railroads: Capital Requirements for Improved Service

In 2003, the fleet declined three times as fast as loadings over the past two years, resulting in utilization increasing by nearly 2 percent over the period.

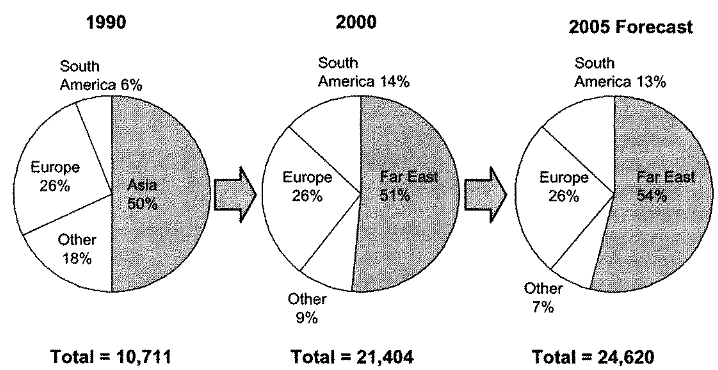


Source: AAR Weekly Railroad Traffic, Annual Summary, 2003 and 2002; AAR Railroad Equipment Report 2003; Mercer analysis.

2. The Challenges for Railroads: Capital Requirements for Improved Service

In addition, large capital outlays will be required to meet growing demand for intermodal service – nearly two-and-a-half times as many units will be handled in 2005 as in 1990.

North American Container Trades
(TEUs in 000's)

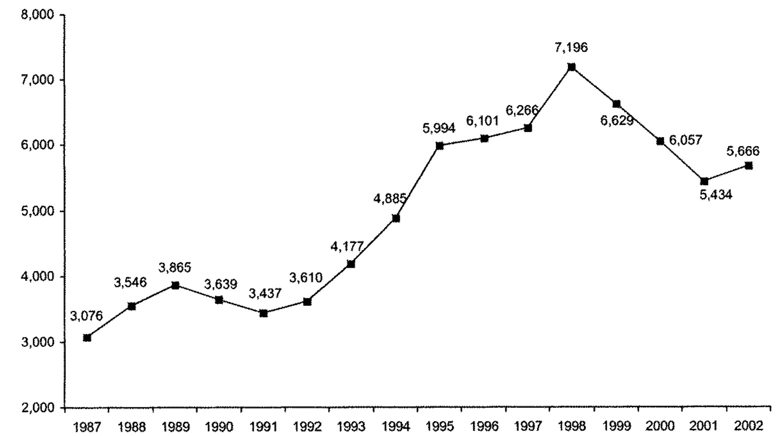


Source: Mercer/DRI World Sea Trade Services September 1997, 4Q 1995 and 2Q 1998 Editions; Global Insight, *Trends in the World Economy*, Fall 2002.

2. The Challenges for Railroads: Rising Capital Investment

Total Class I rail capital expenditures have risen from $3.6 billion in 1990 to $5.7 billion in 2002 – an increase of approximately 56 percent.

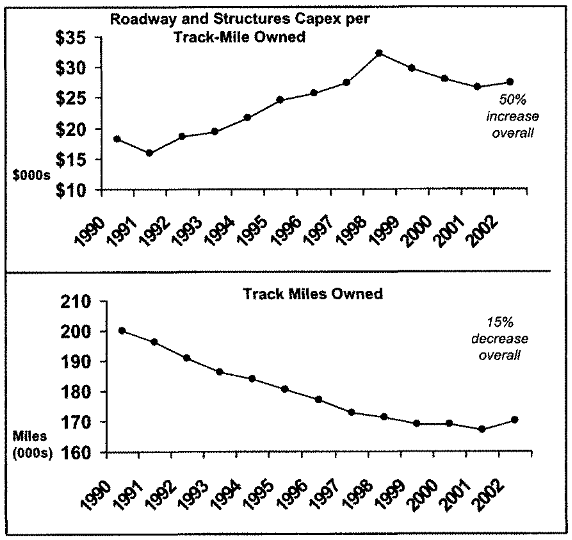
Class I Capital Expenditures
($M)

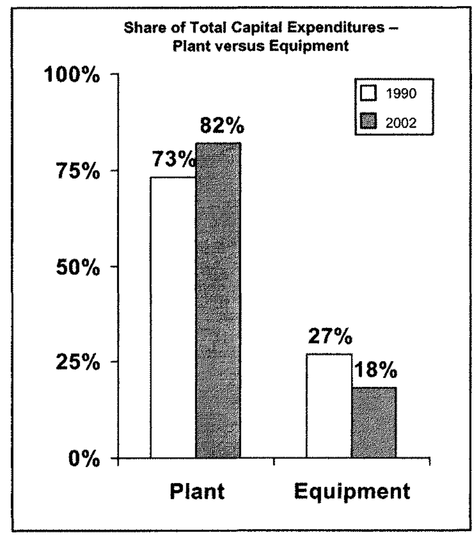


Source: Association of American Railroads, *Ten-Year Trends.*

2. The Challenges for Railroads: Rising Capital Investment

Capital expenditure on roadway and structures[1,2] is increasing even though track networks are shrinking. Railroads are investing more heavily in infrastructure to satisfy customer needs.



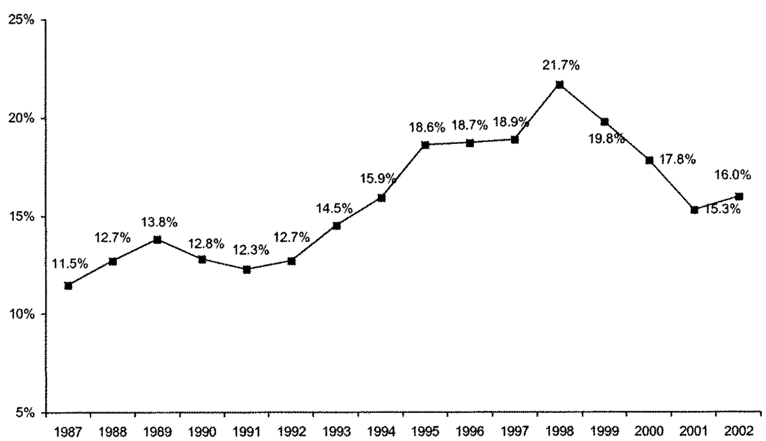


[1] In constant 2002 dollars, deflated using RCRI. [2]Roadway and Structures includes terminals, track, bridges and structures, classification yards and port terminals.
Source: Association of American Railroads, *Ten-Year Trends.*

2. The Challenges for Railroads: Rising Capital Investment

Capital expenditures required for capacity expansion and new efficiencies will enable railroads to cope with the continuing fall in revenue per ton-mile; at the same time, capital expenditures have increased as a percentage of annual operating revenue.

Class I Capital Expenditures as a Percent of Operating Revenue

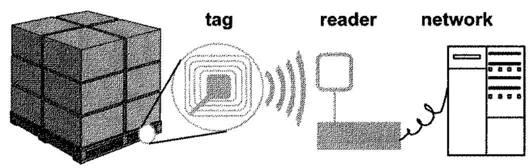


Source: Association of American Railroads.

3. New Investment Requirements for Technology: The RFID Challenge

Railroads will have to commit significant investment to master the emerging demand for Radio Frequency Identification (RFID) technology

Radio Frequency Identification (RFID) is a kind of "wireless barcode" tracking device



- Inexpensive RFID tags can be attached to vehicles, pallets, cases, or individual items
- RFID enables efficient tracking ("supply chain visibility"
- RFID technology does not require line of sight; a tag need only come close to a reader

Source: Mercer Management Consulting; Bear Stearns

The Emergence of RFID

- RFID compliance is emerging as a major supply chain issue, with two global sourcing giants driving the change
- Wal-Mart is requiring its 100 largest suppliers to implement pallet-level RFID by January 2005
- All Wal-Mart suppliers must be RFID compliant at the case level by January 2006
- All Dept. of Defense suppliers will be required to put RFID tags on pallets, cases, and certain individual items by January 2005
- Bear Stearns estimates that Wal-Mart's top 125 suppliers will spend $500M on RFID compliance

3. New Investment Requirements for Technology: The RFID Challenge

Having already embraced RFID technology for internal efficiency, railroads will soon need to invest in "outward-facing" RFID capabilities to meet demand customer demands

Today—inward-facing applications

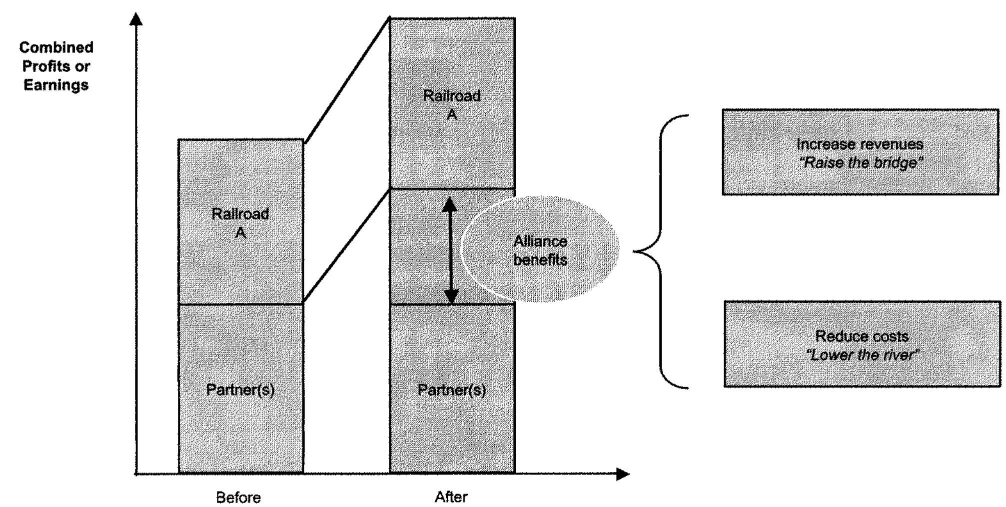
- Railroads have already deployed RFID technology to track their own mobile assets
  - Enables better management of capital

Future—customer-facing applications

- As shippers adopt RFID to meet customer requirements, railroads and other freight carriers will be obliged to support RFID applications
- "Supply Chain Visibility" through RFID will become a valuable point of competitive differentiation for shippers
  - Detailed location information is extremely valuable, as it permits manufacturers and shippers to reduce their inventories
  - Railroads are likely to initially explore individual RFID strategies
  - Longer term, railroads may elect to pursue an industry-wide approach aimed at strengthening the modal competitiveness of rail over road and air

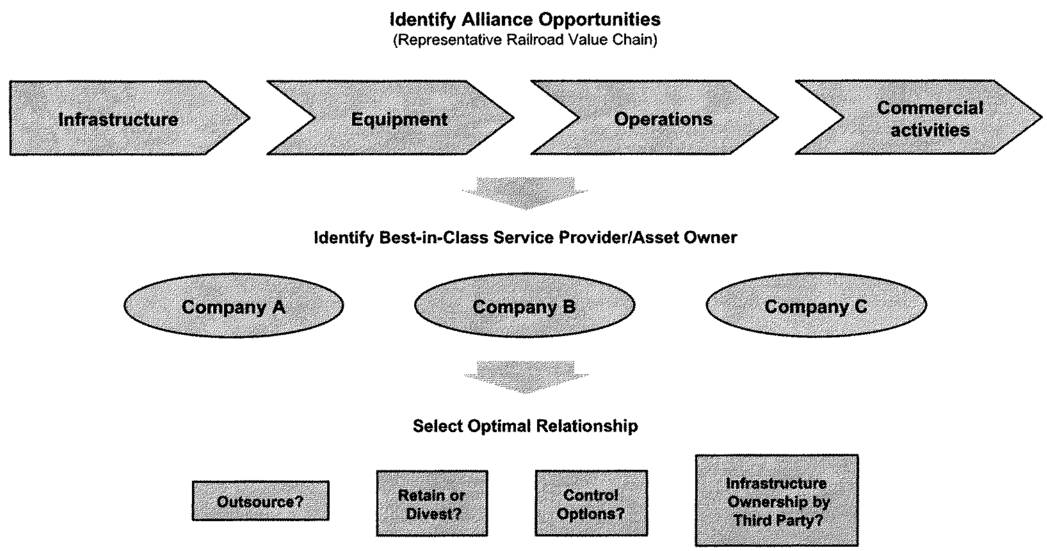
4. Meeting the Challenge with New Business Alliances

The railroad industry is becoming increasingly interested in extended business partnerships and strategic alliances as a way of creating new value.



4. Meeting the Challenge with New Business Alliances: Value Chain Unbundling

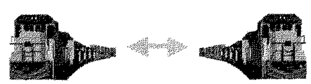
Business alliances involve “unbundling” the rail value chain and identifying the most efficient service providers and the most appropriate asset owners.



4. Meeting the Challenge with New Business Alliances: Options

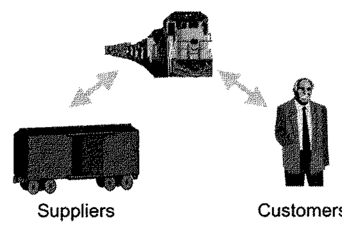
Railroads could realize benefits from accelerating the development of a variety of alliance options.

Railroad-to-Railroad



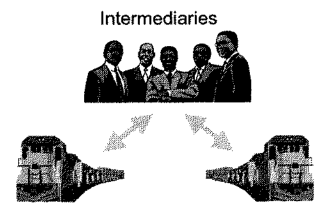
- Direct alliances between competing railroads
- Scope of applicability somewhat limited by legal/regulatory constraints

Railroad-to-Third Party



- Direct alliances between railroads and their suppliers/customers
- Wide scope for collaboration

Railroad-to-Intermediary



- Alliances between value chain participants through neutral intermediary
- No issues with regulatory/legal constraints; ensures neutrality through independent third party

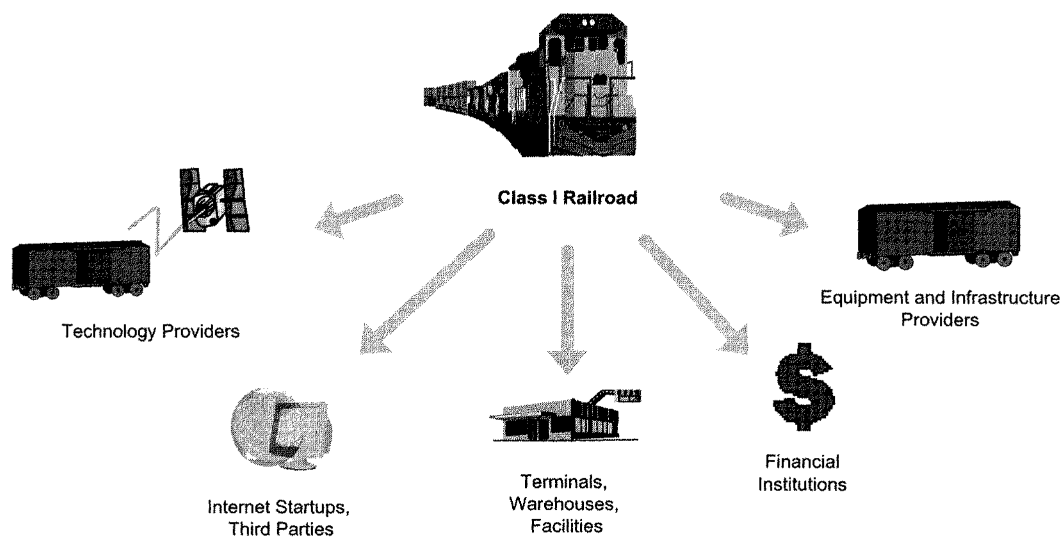
4. Meeting the Challenge with New Business Alliances: Railroad-to-Intermediary

But direct railroad-to-railroad collaboration can be difficult to execute – indirect collaboration through intermediaries is often much easier.

- Expands scope of collaboration
- Removes anti-trust concerns
- Avoids potential conflicts of interest
- Guarantees neutrality

4. Meeting the Challenge with New Business Alliances: Railroad-to-Third Party

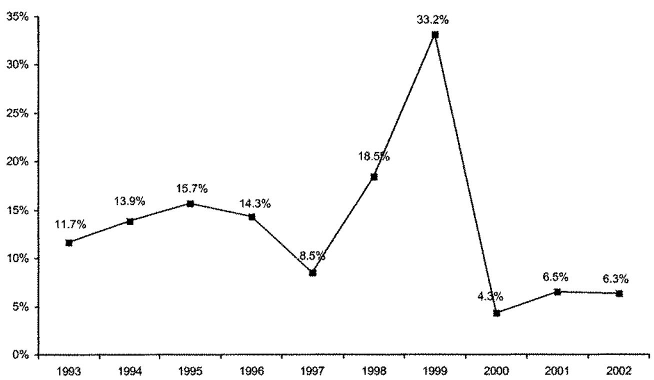
However, the largest potential to create value for railroads will likely come from railroad-to-third party alliances.



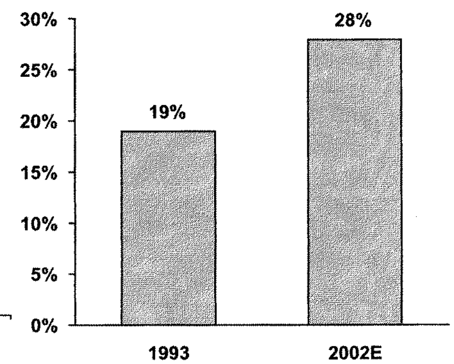
4. Meeting the Challenge with New Business Alliances: Railroad-to-Supplier

Railroads are already looking to suppliers for innovative ways to ease capital investment levels and increase productivity.

% of New Freight Cars Acquired by Railroads



Purchased Services Expense*
(as a % of total operating expenses)



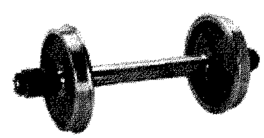
Source: *Progressive Railroading*, May 1999; Railroad Facts 1998; R-1 annual reports; Mercer analysis.
*NS, CSX, UP, BN.

4. Meeting the Challenge with New Business Alliances: Railroad-to-Supplier

To capture these opportunities, suppliers will have to take larger stakes in the value chain and develop closer working relationships with railroads.

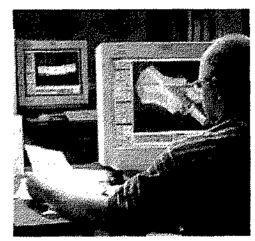
Example: PROGRESS RAIL SERVICES & NS NORFOLK SOUTHERN

From providing a product . . .



Offering: New and reconditioned wheels for railcars

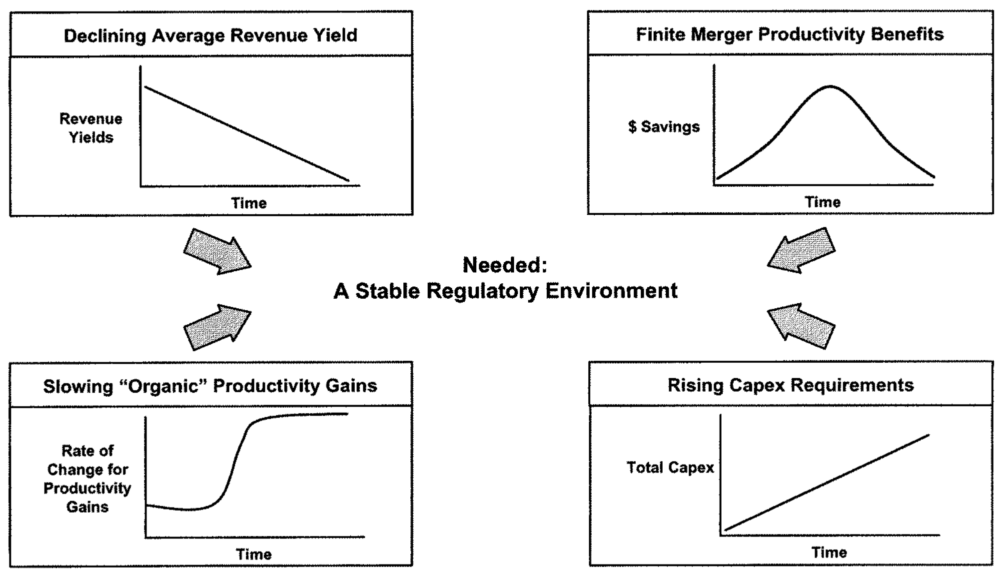
. . . to providing a solution.



Offering: Complete wheel supply, mounting, repair, and maintenance services

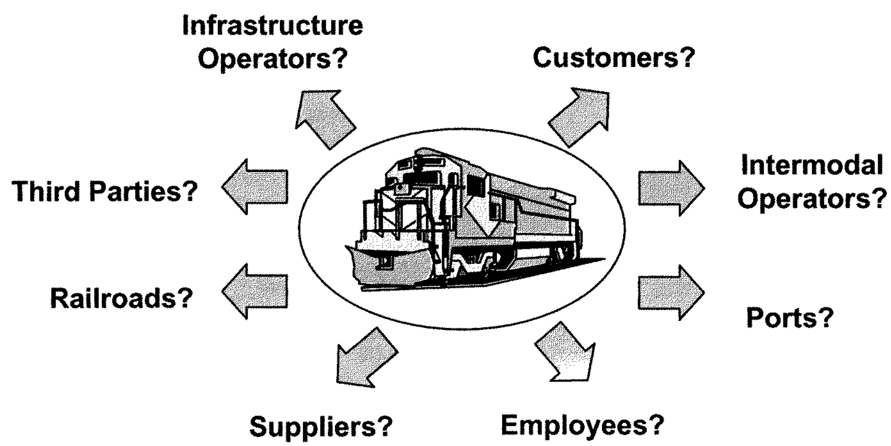
5. Stability of Regulatory Policy

More than ever, the railroad industry requires a stable regulatory environment if it is to raise needed private capital and enhance service to customers.



5. Stability of Regulatory Policy: The Risk of Widespread and Unforeseen Impacts

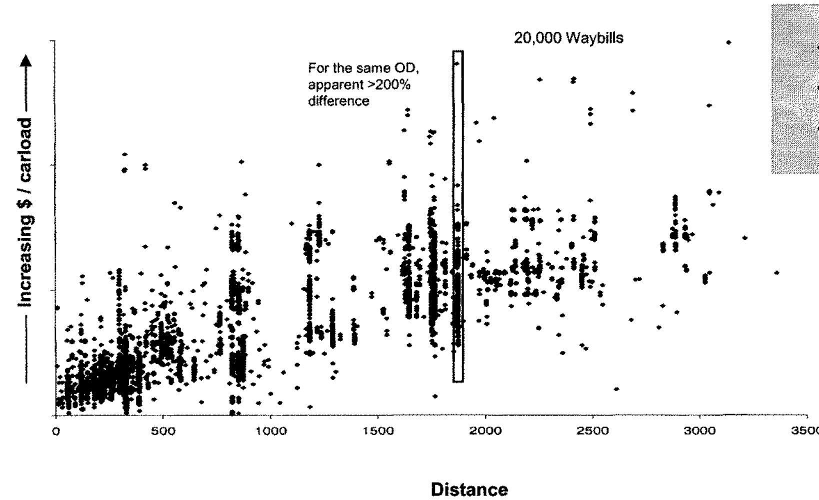
Experimenting with rail's regulatory structure is likely to have unforeseen consequences for multiple rail constituencies.



5. Stability of Regulatory Policy: "Small Shipper" Pricing

In a simplistic rate analysis, railroad prices often appear to vary significantly in terms of both revenue yield and contribution. Such rate analysis often is used to argue for regulation of rates.

Regression on One Set of Equipment, Commodity, and Rail-car Ownership Characteristics

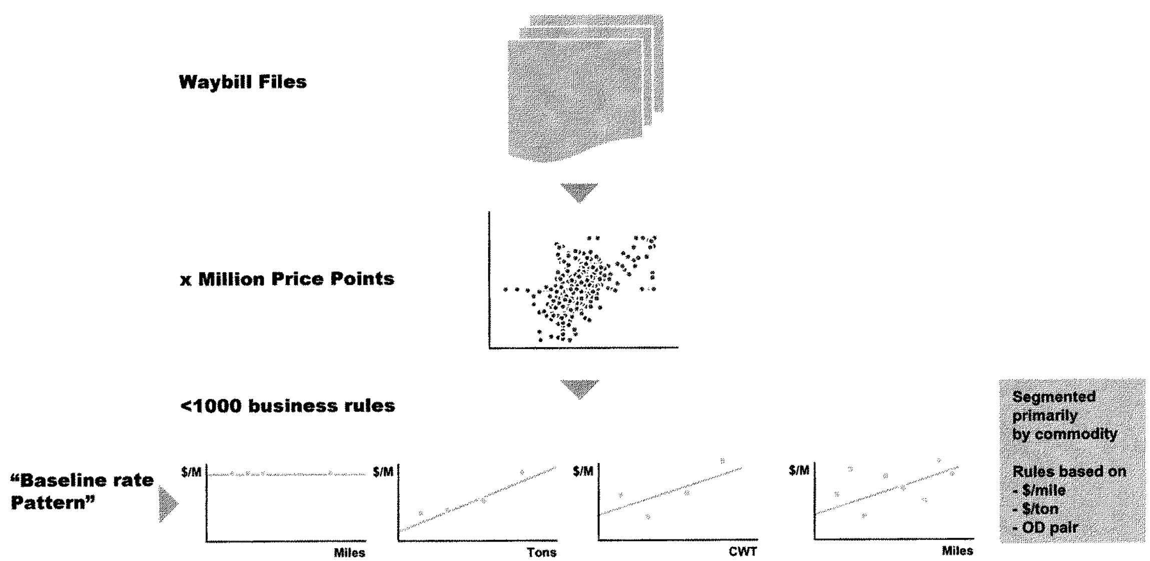


- Commodity: Single 7 Digit STCC
- Car Ownership: Shipper supplied
- A single car type

DISGUISED 2000 WAYBILL SAMPLE

5. Stability of Regulatory Policy: "Small Shipper" Pricing

However, rigorous statistical analysis reveals strong underlying patterns that explain most of the apparent variances.



5. Stability of Regulatory Policy: "Small Shipper" Pricing

Carefully classifying variables (drivers) into three broad categories based on how they are expected to drive price can provide a more appropriate set of insights on pricing.

Variables Impacting Railroad Pricing

	Variable Type: Segmentation	Variable Type: Formulaic	Variable Type: Residual
Description:	▪ Segmentation variables *define market segments* with a unique pricing behavior that should be isolated before analysis	▪ Variables associated with the *physical characteristics* of the move (distance, weight)	▪ Residual variables are all remaining variables that impact price; tend to be rooted in *business reality* rather than the physical characteristics of the move
Implication:	▪ A unique formula is developed for each segmentation variable combination	▪ Tend to be major determinants of price (formulaic relationship). Formulaic variables are included in the baseline rate pattern	▪ Residuals are analyzed and classified to identify counter-intuitive discounts or premiums
Examples:	▪ Commodity STCC, car ownership, region etc.	▪ Length of haul, weight of move, pound-miles etc.	▪ Customer size, seasonality, shipment size etc.

5. Stability of Regulatory Policy: "Small Shipper" Pricing

When the multiple drivers influencing the make-up of rail prices and their related revenue to variable cost ratios are understood, more rational rate patterns appear.

Components/Drivers of Rail Prices

Linehaul

- Distance ranges
- Commodity (type, value, density)
- Customer size
- Car type
- Car ownership (full/zero mileage)
- Traffic at origins and destinations (lows and highs)
- Corridor volume (lows and highs)
- Cross-borders / International shipments
- Directional flow
- Seasonality
- Day of week

+

Add ons (non-linehaul)

- Switching & Shortlines
- Trucking
- Stop-off
- Diversion
- Out -of-linehaul
- Special Train Assignment
- Inspection Services
- Terminal Services Intermodal
- Protective Services
- Demurrage
- Overloads
- Equipment Use / Rental
- Detention
- Terminal Services CargoFlo
- Product Transfer
- Storage
- Late Documentation
- Cleaning Carload, Labour, Loading / Unloading, Weighting

+

Divisions

- Interline forwarded (by carrier)
- Interline received (by carrier)
- Bridge (by carrier)
- Single - line

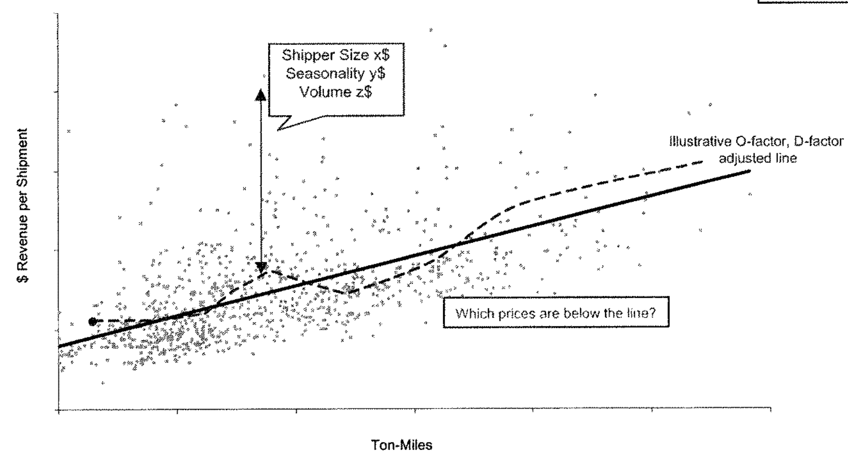
Understanding and de-averaging the impact of each component will provide insights into both individual rates and classes of rates.

5. Stability of Regulatory Policy: "Small Shipper" Pricing

A baseline rate pattern becomes the basis for identifying which prices are "low" or "high" and, more importantly, to explain the deviation off the baseline. The final regression line is adjusted by origin and destination factors to further make the baseline statistically significant.

Price Dispersion

DISGUISED 2000 WAYBILL SAMPLE

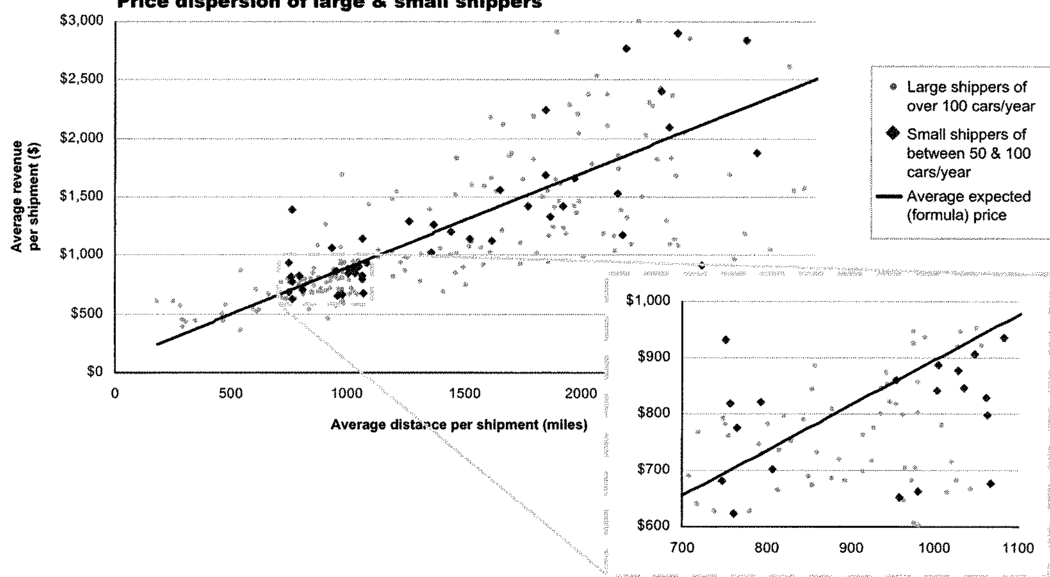


5. Stability of Regulatory Policy: "Small Shipper" Pricing

An illustrative analysis of prices charged to both large and small shippers for the same commodity group indicates that there does not seem to be a pattern of preferential pricing to one group or another.

DISGUISED 2000 WAYBILL SAMPLE

Price dispersion of large & small shippers

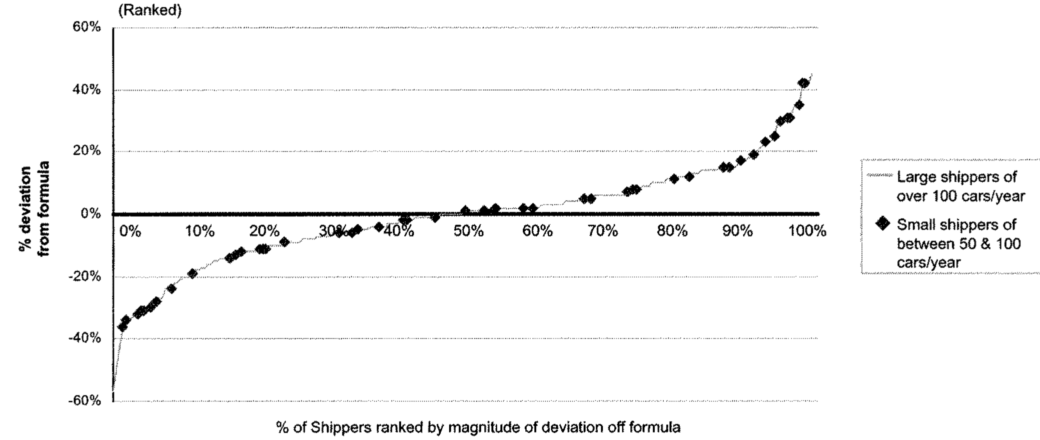


5. Stability of Regulatory Policy: "Small Shipper" Pricing

For the same waybill sample, comparison of actual against expected (formula) prices also indicates that there is no pattern of preferential pricing for any one group. Small shippers are just as likely to receive both discounts and premiums.

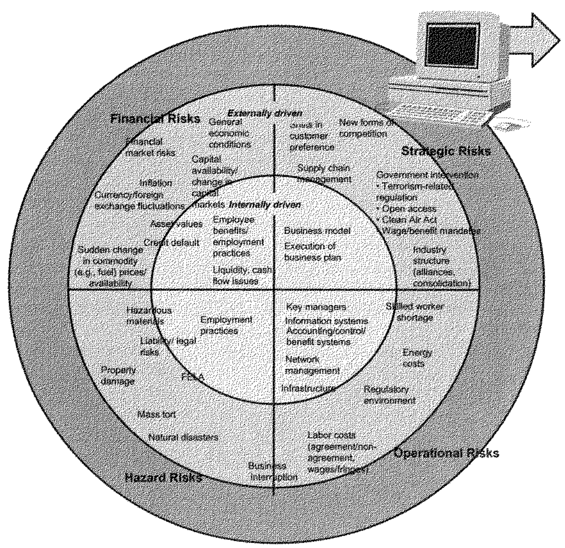
DISGUISED 2000 WAYBILL SAMPLE

Percent deviation of actual shipment price from formula
(Ranked)



6. Changes in International Credit Policy: A New Approach Required

Asset valuation and risk modeling could improve the accuracy of the credit evaluation process and improve borrowing rates. A rigorous analytical approach models the interrelationships among individual value drivers, risk factors, and financial measures in order to quantify lifecycle cash flows.



Integrated Valuation and Risk Analysis/Modeling

- Based on activity and financial data to set up basic financial and operational relationships
- Establishes interrelationships between individual value drivers and risk factors and financial and other measures
- Quantifies the impact of each significant value driver and risk to move financial performance and enterprise value
- Prioritizes drivers of value and elements of risk

6. Changes in International Credit Policy: A New Approach Required

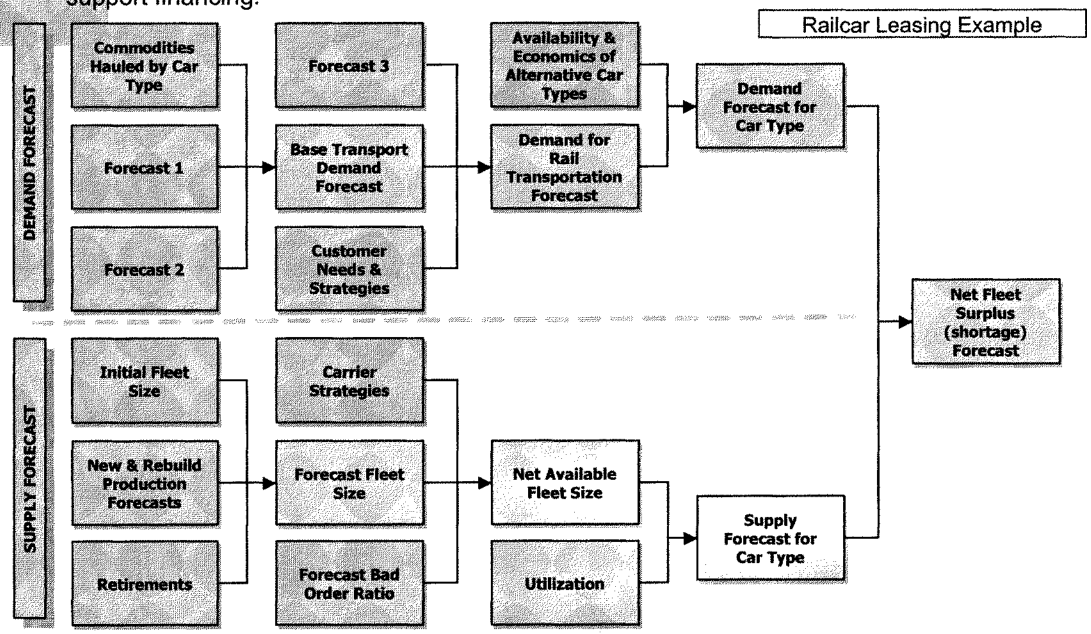
A valuation methodology that can meet the new requirements must be grounded in an in-depth understanding of the key value drivers of asset portfolios.

Railcar Leasing Example

Drivers	High-level examples	Impact
Underlying commodity production and rail market share	→	Rail industry demand by commodity
Customer needs and strategies; desirability of specific car types	→	Demand by car type/characteristics
Utilization	→	Fleet size requirements
Installed base, adds, retirements/obsolescence	→	Supply by car type
Lease rate history, financial factors, external factors	→	Earnings potential

6. Changes in International Credit Policy: A New Approach Required

Mercer has developed one potential structure for the demand/supply analysis needed to support financing.

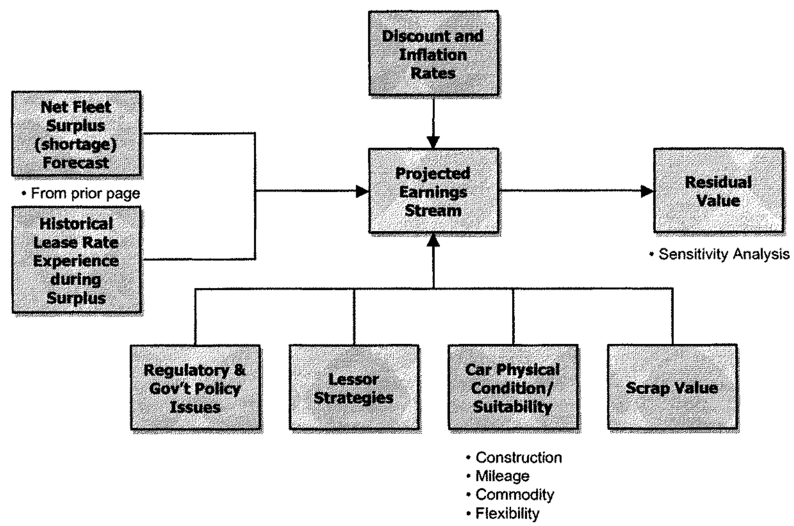


6. Changes in International Credit Policy: A New Approach Required

The demand/supply analysis then becomes the basis for projecting residual value.

Railcar Leasing Example

RESIDUAL VALUE FORECAST

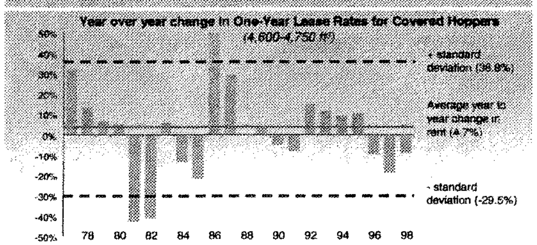


6. Changes in International Credit Policy: A New Approach Required

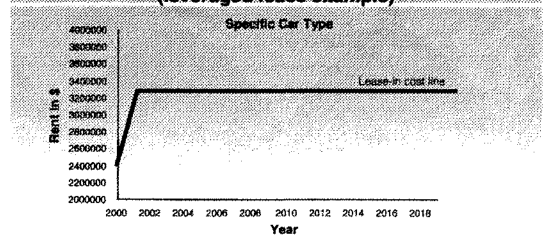
Risk management is at the heart of leasing value capture. A simulation engine can quantify ranges for key value drivers.

Railcar Leasing Example

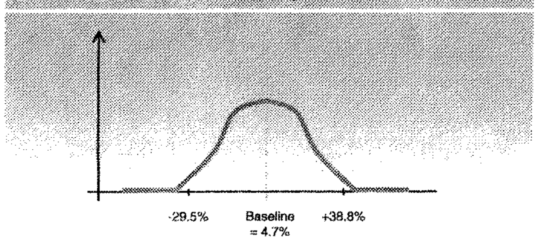
Uncertainty Over Medium to Long-term Revenue Line



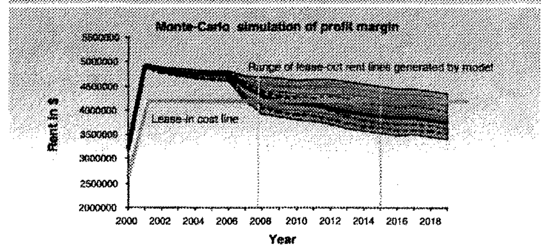
Fixed and Known Long-term Cost Line (leveraged lease example)



Monte-Carlo Input Basis

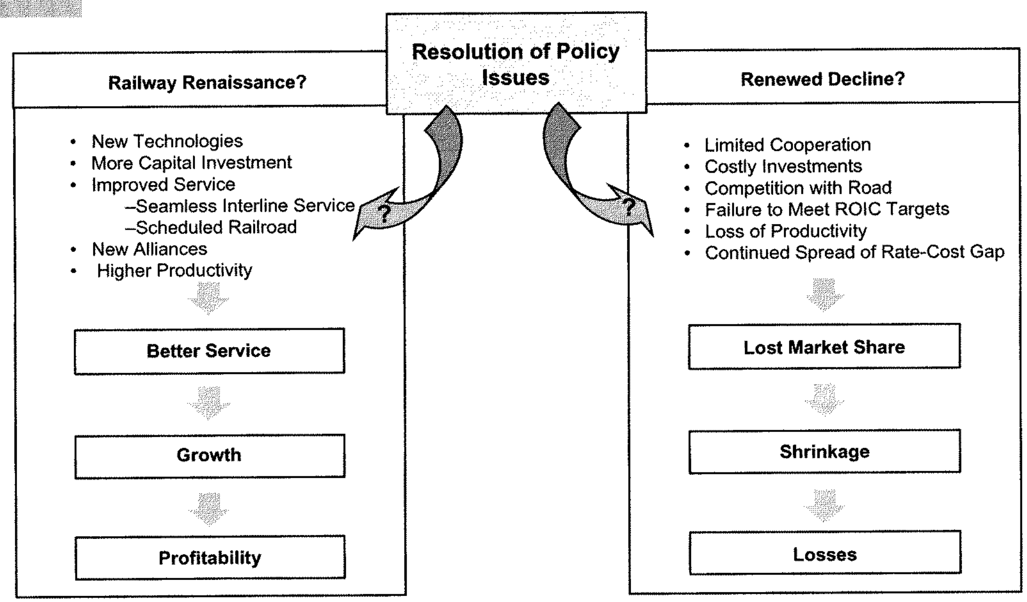


Specific Car Type



Conclusion: A Rail Crossroads

After their successful turnaround over the last two decades, U.S. railroads are again at a crossroads between a railway renaissance and renewed decline.



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April 30, 2004

Rep. Corrine Brown
Ranking Democratic Member
Subcommittee on Railroads
US House of Representatives
Committee on Transportation and Infrastructure
Washington DC 20515

Dear Representative Brown:

Thank you for the thoughtful questions in your letter of April 8th. Let me take an initial pass at responding, and if you require additional information or clarifications I will be pleased to respond. I will take some of your questions out of order.

1. **Why would added competition be bad for Class I railroads when it has proven to be so beneficial for other industries?**

    a. Mercer's comments on reduced opportunities for productivity absolutely do not imply that we believe the North American railroads are not competitive and could not be even more competitive. Since the Staggers Act, the US railroads have become the most competitive in the world. As the attached Exhibit A from a 1998 submission to the Interstate Commerce Commission demonstrates, US and Canadian rail rates are the lowest in the world. Increased competition has been one of the major benefits that has fueled the turnaround of the US rail industry since 1980.

        As Exhibit B (from page II-12 of my testimony) shows, the US railroads have been able to offset a 218% increase in input costs plus a 24% decrease in average rates per ton-mile; most railroads and legislators around the world strive for this type of performance. Over the past 20 years, Mercer has been involved in most of the railroad privatizations and restructurings that have taken place on six continents. In every case, we held out US levels of competition as the standard for the privatizing economy. So I am a big believer in competition and its benefits from productivity, but if there is no practical way to be even more productive then some new strategy needs to be followed.

    b. **You suggest that railroads have captured most of the available productivity gains, and that further improvements are problematic. However, is this**

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consistent with modern management theory? Doesn't modern management theory suggest that industries like the railroad industry are capable of significant productivity gains when confronted with competitive pressures?

First, there are few industries that survive the economic pressures outlined in Exhibits B from my testimony. When we showed these exhibits to the chief executives of some of the European freight railroads, they asked if the companies that were the subject of those charts were still in business. Continuous year over year productivity improvements are the only way the US railroads have stayed in business in the face of flat or declining revenue per ton-mile.

The issue that is capping productivity is that the railroads are bumping up against the physical limits of technology as well as some other constraints, such as labor agreements and mandated safety procedures. For example, in 1980 the average train crew size was four or more (engineer plus conductor and at least two brakemen). That number is down to two, and in yards, remote control locomotives have cut an additional person off the crew. There are only a few railroads in the world that operate freight trains with only one employee (e.g., Quebec North Shore & Labrador, which is a single-purpose iron ore railroad). So there are not too many more ways the railroads can improve train and engine crew productivity.

If you consider the crew size labor issue as only one of hundreds in 2004 that the railroads are up against, it is clear that there are practical limits to shrinking crew sizes further or getting more work out of the available resources. The recent UP service problems also show that, when you get very productive with labor and reduce the work force to levels that maximize efficiency, a single unforeseen event such as rapid retirements can slow the whole railroad down to a crawl.

Track use is the same way. The US railroads already have the most productive freight infrastructure in the world; to get it to the next level, they cannot physically pack any more trains on the vast majority of the network, and so billions of dollars of capital investment are going to be needed for new, higher-capacity signal systems and network expansion.

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Completely in line with modern management theory, when you are approaching the practical limits of any productive asset or system, achieving additional productivity gains is likely to require substantial increases in capital investment. But if you need to raise additional capital to move to the next level of productivity and efficiency, you need to offer the investor some stability and predictability in the playing field. The cost of outside equity and debt goes up as the level of uncertainty or instability increases. The higher the cost of money, the fewer productivity and efficiency projects that get funded and the more money that goes to the financial provider instead of into hard assets.

So I know of no one in the railroad or shipper industry who believes the railroads do not want to be more productive. However, if in some areas the railroads are bumping up against practical productivity limits, then it may not be possible to be much more productive. That is the dilemma – everyone wants the productivity, but reality may dictate that it may be beyond what is reasonably possible.

2. **You advocate a "stable regulatory environment" as necessary for a continued flow of private capital, but wasn't the regulatory environment of the 1950s and 1960s "stable"?**

   a. In the 1950s and 1960s the railroads (and truckers) were regulated, but I would not consider the ever-changing and often contradictory positions of the ICC or state regulators as providing a "stable" regulatory environment. For example, in the late 1960s and early 1970s the ICC determined the US had a grain car shortage. Some grain at that time moved (albeit not efficiently) in 40-foot narrow-door boxcars. In response to the shortage of grain cars, the ICC destabilized the equipment markets by introducing a program called Incentive Per Diem (IPD). The program sought to encourage increased private investment in the industry by increasing the car hire returns of the boxcar investor at the expense of the using railroads. Unfortunately, in reality was there was not a boxcar shortage but a shortage of grain hoppers, which were the newer and more modern way of moving grain. Hundreds of millions of dollars of private money flowed into the industry in search of the spectacular returns promised under the ICC IPD boxcar program. The problem was that the investors purchased 50-foot wide-door boxcars instead of the needed grain hoppers. The 50-foot wide-door

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Representative Corrine Brown

boxcars could not be used for grain, and soon a surplus developed. Car hire rates got so high for many commodities that the railroads paid more in equipment fees than they received in freight revenues for the traffic. As the railroads turned away traffic made unprofitable by IPD, more of the 50-foot wide-door boxcars became surplus.

The whole house of cards came down in September of 1979, along with tens of millions of dollars of defaults and asset writedowns. Traffic that had been priced out of bounds during the IPD period stayed with trucks, and the ICC practice destabilized the equipment markets so badly that even today, 24 years later, some private investors cite the IPD debacle as the reason for not investing in the rail industry.

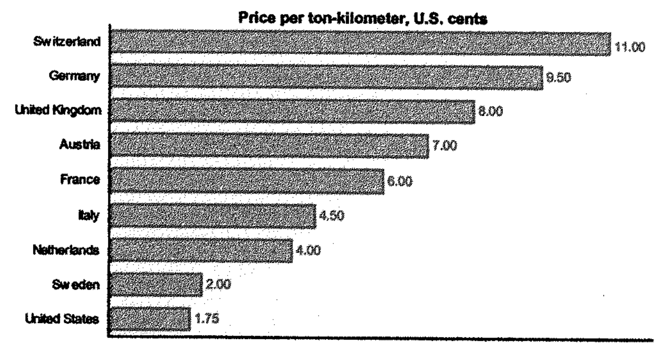
There are hundreds of other examples of how the pre-Staggers regulatory practice destabilized everything from rate setting to trying to save abandoned branch lines. So I take some exception to the notion that regulation equated to stability in the 1950s and 1960s.

Sincerely,

William J. Rennicke
Managing Director

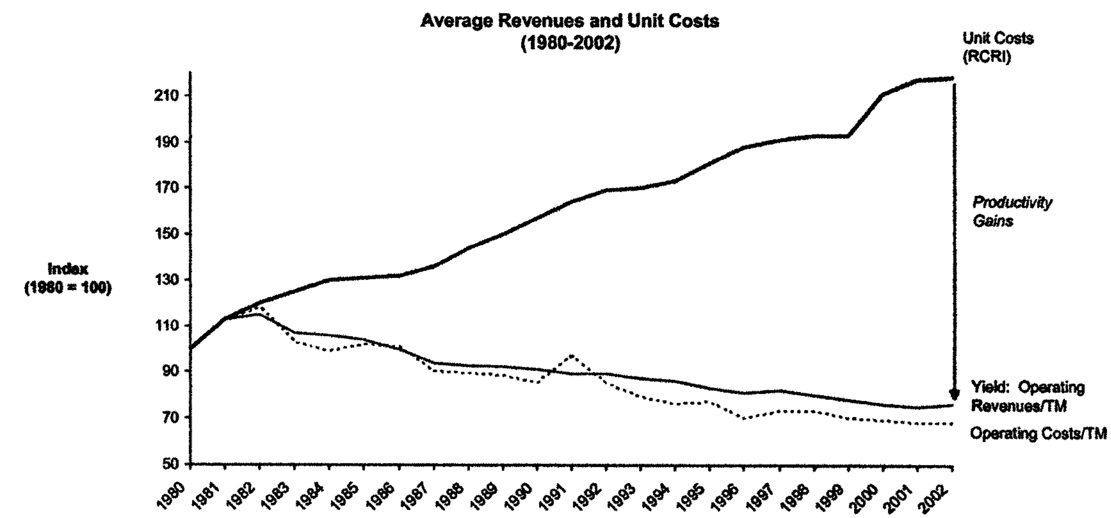
Exhibit A: Comparison of Freight Rates

U.S. versus European Rail Freight Rates



Source: Statens Järnväger Annual Report, referring to UIC statistics.

Exhibit B: The Challenges for Railroads: The Rate-Cost Gap
Railroads have managed to maintain profitability only by increasing productivity and cutting costs.



Source: Railroad Facts 2001 Edition; Association of American Railroads; Mercer analysis.

Testimony of
Steve Strege, Executive Vice President
North Dakota Grain Dealers Association

Presented to
House Transportation and Infrastructure Committee
Subcommittee on Railroads
The Honorable Jack Quinn, Chairman
March 31, 2004

Thank you Mr. Chairman and members of the committee for holding this hearing and for including the North Dakota Grain Dealers Association(NDGDA) as a witness. I'm Steve Strege and for nearly 24 years I have served as Executive Vice President of the North Dakota Grain Dealers Association headquartered in Fargo, North Dakota. This organization is a 93 year-old voluntary membership organization in which over 90% of our state's country grain elevators, large and small, hold membership. My testimony focuses on the transportation issues from the perspective of those country grain elevators. Others in agriculture and other industries face some of the same challenges our captive rail customers have. These elevators are the first point of delivery and sale for farmers' grain. They clean, condition, blend and ship that grain to mills, other food processors, and to export locations.

BACKGROUND:

Most country elevators across the nation are situated on only one railroad and are thus captive to that one railroad for rail services. There are literally thousands of country grain elevators. Some are fairly large companies; but most are relatively small. We have about 400 in our state. They are the funnel through which passes the single largest generator of new wealth in our state and surrounding areas – crop production.

In North Dakota and adjacent areas in Montana, South Dakota and Minnesota there is a more devastating aspect of captivity due to lack of effective competitive transportation modes. We are at the center of the North American continent, far from export ports and with no river barge transportation alternative. Trucking grain a few hundred to fifteen hundred miles to these destinations in the kinds of volumes we produce is both impractical and uneconomical. We are heavily dependent on rail movements. Traditionally 70-75 percent of North Dakota's production moves out of state by rail, and with some commodities and to some destinations it is in the 90- percent range. Any of you who eat high quality breads or pasta products, or who consume a beer now and then, can appreciate the fact that North Dakota is the leading state in the production of hard red spring wheat, durum wheat from which the pasta is made, and malting barley which is the essence of most beer.

In my state we have two Class I carriers, the Burlington Northern Santa Fe (BNSF) and the Canadian Pacific (CP), and three regional/shortlines. The Red River Valley and Western (RRVW) regional railroad is affiliated with the BNSF. CP has two shortline affiliates, the Dakota, Missouri Valley and Western (DMVW) and the Northern Plains Railroad (NPR). These regionals and shortlines usually provide customer-friendly service, but they are dependent on their Class I connections for car supply. When the Class I falls behind, so do its affiliates. These smaller railroads are not competition to the major carriers because their rates and many service practices are determined by the Class I's. These smaller railroads are also at more of a disadvantage when Class I's increase train size and car weight. The lines operated by these smaller railroads are usually the light weight rail segments with lighter traffic density than what the Class I retains.

Agriculture is inherently seasonal. Fall-seed crops in southern areas are harvested the next spring and summer; spring-seeded crops across the land are harvested in summer and fall. Agriculture also can be cyclical. Export market volumes are affected by crop production around the world, currency fluctuations, and the health of economies in importing nations. These things lead to peaks and valleys in demand for rail service. Yes, it would be nice to level this out, and some of that has happened. The railroads say they cannot build the proverbial "church for Easter Sunday". We don't expect them to. Yet many of our grain elevators have had to spend millions of dollars to gear up for sporadic quick loading of railcars.

I hope that what I have said so far establishes our need for rail service and the nation's need for the timely and economic delivery of our food products. We need healthy railroads providing good service. If we were to put our rail grain volume into trucks we'd have about 450,000 truckloads. Placed end-to-end those would extend approximately 5000 miles.

INVOLVEMENT WITH OTHER GROUPS

NDGDA is a member of the Alliance for Rail Competition (ARC), a diverse coalition of shippers that was formed five years ago to address concerns of rail-dependent shippers about railroad market power. These concerns span many rail-dependent shippers and industries. ARC's growing membership reflects the diversity of those interests: agriculture, coal, chemicals, consumer products, glass producers, industrial products, minerals and petrochemicals, and some of the trade associations that represent many of these groups, as well as port and industrial development authorities. ARC has teamed up with 12 other national organizations to combine our work efforts to bring rail competition back to this industry. These other organizations include: Agriculture Ocean Transportation Coalition, American Chemistry Council, American Public Power Association, Consumer United for Rail Equity, Edison Electric Institute, National Association of Wheat Growers, National Barley Growers Associations, National Petroleum Refiners Association, National Rural Electric Cooperative Association, Paper and Forest Industry Transportation Committee, The Fertilizer Institute, and The National Industrial Transportation League.

I have attached some additional comments from other ag-related entities that confirm that these problems are not confined to North Dakota. Many of these rail customers are urging Congress to get involved and support increased rail competition solutions.

CURRENT REGULATORY ENVIRONMENT

Mr. Chairman, your letter of invitation to this hearing said I should address the impact of the current railroad regulatory environment on railroads and shippers. Our view is that there is very little regulatory oversight exercised over the operation of freight railroads. Congress envisioned in the Staggers Act of 1980 that competition would balance interests between railroads and their customers. That Statute says, in part, that the policy of the United States Government is ..." to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail..." and ..."to maintain reasonable rates where there is an absence of effective competition..." Maximum competition, but in the absence of competition – reasonable rates. It appears to us that the regulatory agency has not kept this Congressional intent of balance in mind as much as it should have.

This lack of regulatory oversight on rates and service has allowed the railroads to pretty much do as they please and the captive shippers, their customers, suffer the consequences. As the railroad industry has consolidated from the pre-Staggers era of 40-50 "large" railroads to only a handful of behemoths today, the economic power that those remaining can have over customers, markets, and the nation's economy has been magnified. Meanwhile the shippers are left with less competitive options and having to comply with the railroad's latest product design. Many shippers, and shipper organizations, are reluctant to speak out loudly because they fear retribution.

We think a major problem in this whole scheme of things is that the STB, past and present, seems to believe that the revenue adequacy test for carriers is the most important measure for the railroad system, outweighing even the consequences of poor service or unjust freight car distribution programs. I don't claim to be an expert on railroad finances or this revenue adequacy test. But there seems to be a contradiction between railroads being found revenue inadequate by STB standards, while at the same time having record earnings per share and near record levels of stock prices as the Burlington Northern Santa Fe had in the last quarter of 2003.

MARKET POWER OF RAILROADS IN PRICING

Extremely high grain rail rates for captive shippers are evidence of the monopoly power of railroads in our region. . Many revenue to variable cost ratios on wheat movements from our region are in the 250-350 range (some up over 400), as compared to a jurisdictional threshold of unreasonable rates that has been established by both statute and the STB at 180 percent of variable cost.

A grain shipper in western North Dakota made the following observations and calculations: The BNSF 2002 Annual Report to shareholders shows revenue on all hauls per thousand ton miles is $18.10. His rate on wheat to Pacific Northwest export ports such as Seattle, Washington or Portland, Oregon yields $27.11 revenue per thousand ton miles, and his 52-car rate to Minneapolis, MN yields $47.64. Differential pricing to these extremes seems unreasonable.

The pricing philosophy of the BNSF is explained in the following comment from its Ag Products Vice President Steve Bobb at a U.S. Senate field hearing in Bismarck, ND in March 2002: "What we do as a rail transportation provider is look at the difference between value of the grain at the origin and value of the grain at destination, and try to determine the level of charges for transportation with margin for the elevators to operate and make money." In other words the BNSF is inserting itself as a participant in the marketing of grain instead of serving as a transportation provider, taking the maximum it can out of the middle. Discussion among Rail Customer Coalition members suggests that the railroads are moving into pricing in other commodities such as coal and chemical movements. Only when a railroad has such monopolistic power over so many of its origin and destination customers, is it in a position to extract for itself any efficiencies added to the system by those customers and force pricing within the market. We find this trend alarming and don't believe it is reasonable.

We saw further evidence of commodity price and market manipulations when the BNSF put in inverse rate structures which relocated non-traditional wheat into the PNW markets in 2001-2002, thereby lowering the price of wheat in the traditional areas of supply in the Dakotas and Montana. A similar program is reportedly being operated again.

RAILROAD POWER DISPLAYED IN POLICIES AND PRACTICES

Market power is also demonstrated by one-sided policies and practices of the railroads. In a Rail Issues Summary dated July 15, 2003 the National Grain and Feed Association (NGFA) said the following "*For the last two years, NGFA's Rail Shipper/Receiver Committee has engaged the railroads in additional dialogue on a number of current topics which agricultural rail customers believe need to be addressed. Among these issues (not all of which apply to all the carriers) are: 1) high deductibles and minimums on loss and damage claims; 2) rail seals and rail car security on food grade shipments and the impact of broken seals on loss and damage claims; 3) reciprocity and equity in credit terms between railroads and their customers; 4) storage charge policies on empty private cars when such additional cars are required, because of less than optimal rail service, to keep plants operating; 5) demurrage charges that are not related to the market value of rail cars; 6) fuel surcharges passed back to rail customers in ways that create inefficient transfers of risk (forcing added costs on the customer), and in some cases creating hidden rate increases; 7) mergers of railroads that have both improved access to on-line points and created higher* *barriers to accessing off-line points; 8) railroad pricing decisions that are not necessarily based upon different investments by customers in facilities and equipment; and 9) inverse pricing policies (lower rates for similar moves more distant from market on the same line) that can create unpredictable shifts in markets, making future rational investment decisions by affected shippers very challenging."*

In addition, NGFA has publicly expressed its concern that "*...there is no avenue of relief on "small" rate cases (for lower volume point-to-point shipping corridors which dominate in the agricultural sector), where the rail customer considers the railroad's capacity to differential price is being abused in establishing rates for a particular captive move. The rules adopted by the STB, have, through legal and financial barriers, virtually precluded any relief on rates with the exception of large coal rate cases. For agricultural shippers that confront excessive rates (about 30 percent of farm product shipments move at rates in excess of 180 percent of variable costs), there is no real remedy under the law as it is currently being applied. However, the STB has acknowledged there are regulatory issues to be addressed with smaller rate cases and is in the process of considering changes....*

In conclusion, NGFA remains concerned with how the market power of rail carriers affects the business relationship with agricultural and other shippers. We share the frustrations of other shipper organizations with the lack of protections under current law and the slow and extremely challenging processes for rail customers to obtain any meaningful form of relief through the STB."

Another example of one-sidedness in favor of the railroad is the contrast between demurrage penalties assessed by the railroad for delayed loading or unloading of grain cars and the penalties paid by railroads for late delivery of railcars. For example, on a BNSF non-shuttle Certificate of Transportation (COT) car order the railroad does not consider itself late until the 16th day after the want date. The order then goes on penalty and a one-time \$400 per car rate credit will be given when the carload is shipped. But had the shipper held the car for 16 days he would have to pay 14 days of demurrage at \$50 per day, total \$700. If the penalty on the railroad continued to accumulate, as it does on the loader and unloader, there would be additional incentive for it to deliver the car on time. After the shipper loads the car and turns it over to the railroad, the railroad may let it sit on the shipper's track for additional days before being pulled to market. There is no payment to the shipper for this delay, in spite of increased costs to him.

Why aren't these penalties equal and offsetting? Because the railroad has chosen not to impose the same conditions on itself as it imposes on it customers.

RAILROAD MARKET POWER PICKING WINNERS AND LOSERS

Market power of railroads is also exhibited by railroad attempts to shape the grain marketing industry and domestic grain processing industry into fewer larger locations that fit the railroad's definition of efficiency. There are various sizes of grain shipments by rail. Not every railroad offers the same configurations, but generally speaking there are unit trains of 50-54 cars, unit trains of 25-27 cars, and so-called "single car" movements that are blocks of one to 24 cars. There are markets calling for these various sizes of shipments. The export market is usually fed with the larger trains. The domestic market uses more of a variety. Meeting stringent grain quality specifications and capturing associated quality premiums, are a strong suit of the smaller shipments.

Some railroads have been advocating and giving preference to "shuttle trains". In our area the pace of this has accelerated in the past five years with BNSF's 110-car shuttle trains. The Canadian Pacific has been encouraging its 100-car shuttles. The BNSF in particular is focusing more and more of its attention and resources on these shuttle trains. Shuttle trains have their place for certain crops and in certain markets. But they are not the end-all for everyone. And that brings me to a topic some of you are likely interested in – the grain shipping crisis of the past 6-8 months.

This past fall the BNSF concentrated so much of its resources on shuttle trains that while those were running on time or only a few days late, movements such as 52-54 car or 26-27 car trains, and smaller shipments, were at times 50 days behind. That is not a typo, that's 50 days. There were isolated reports of 60-70 days behind.

Also, in various stages throughout last fall and winter, the BNSF refused to accept further orders for 52-54 and 26-27-car trains through its top-of-the-line assured service Certificate of Transportation car distribution program. This denied an entire class of shippers access to even ordering that type of service. Meanwhile it continued to sell and service 110-car shuttle trains. One can see some justification in a railroad not taking further orders if it can't keep up with orders it already has. But the discrimination between sizes of shipments and shippers is very apparent and unreasonable in our opinion.

The BNSF blames these recent grain car distribution problems on there being a large crop. We're glad to have a large crop. It means more money in the pockets of our farmers, more grain to handle for our elevators, if they can get cars, and more business for the railroad. But a large crop does not explain why supposedly assured service purchased by grain elevators several months in advance of the harvest was not delivered on time. For example if in the month of July a railroad sells 1,000 carloads of pre-booked freight for delivery in October, a surge in demand to 2,000 cars for October does not explain why only 500 were delivered in October. That is a round number example of the situation.

The Canadian Pacific Railway also fell way behind in its service obligations. Up until about mid-January it was not as late as the BNSF, but since then it has fallen down even more. At a meeting in North Dakota on March 4, CP officials said it is 45 days behind on shuttle trains and 60 days behind on the rest. It expects to be caught up sometime in June.

The extremely poor service on any railroad costs grain elevators in a number of ways. There is interest expense on grain that has been bought from the farmer but can't be shipped. One large BNSF shipper in North Dakota said back in January that this cost alone was $2,300 per day for him. Grain elevators' credit lines are stretched to the maximum and beyond. Buyers can and do assess late delivery penalties for grain delivered 30-40-50-60 days late. Try to imagine operating a business with that kind of service. If there were options you would use them. But in our case for this service there is no option.

Farmers who have contracted their grain to these elevators also experience increased frustration and cost. They too can't get their grain delivered to get their money. Now we are into spring time and that means load restrictions on our roads and farmers soon getting busy with spring planting, thus unable to haul their grain. Load restrictions are decreased limits on allowable truck weights, announced and enforced by county and state road authorities to protect the surface and subgrades of our roads while they are thawing from the winter weather.

TRYING TO RESOLVE TRAIN SIZE SERVICE DISPARITIES

On December 16, 2003 North Dakota Governor John Hoeven, his Ag Policy Advisor, North Dakota Public Service Commission Chairman Tony Clark, a couple North Dakota grain elevator managers, and I, met with STB Chairman Roger Nober and several of his senior staff at the STB offices here in Washington, DC. We pointed out this disparity in service between shuttle trains and all others. We asked the STB what powers it had to intervene to restore some balance among rail customers. The majority of North Dakota rail customers were suffering the ill effects of this shift in resources.

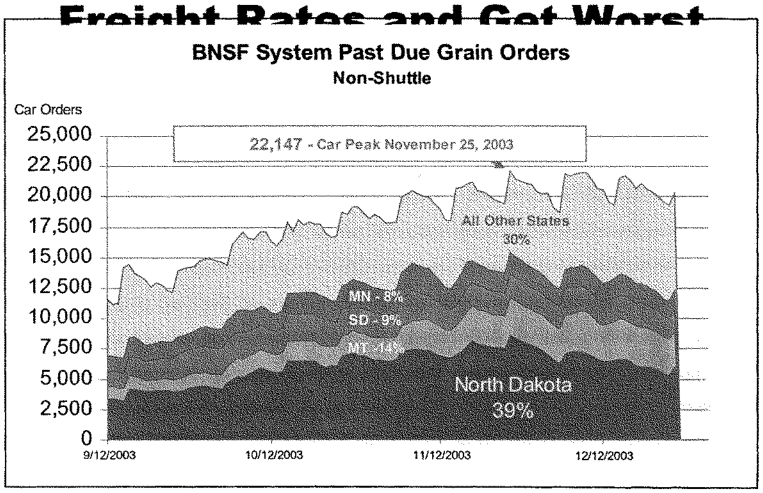
Chairman Nober offered to facilitate a meeting between the North Dakotans and BNSF leadership, and that took place on January 5, 2004, again back in the STB offices. Our Governor, PSC Chairman and others were there again. BNSF was represented by its President, Matt Rose, Ag Products Vice President Steve Bobb, Operations Vice President Carl Ice, and attorney Jeff Moreland.

Our entire Congressional delegation, Senators Dorgan and Conrad, and Congressman Pomeroy, also became involved through meetings and correspondence with BNSF officials, urging them to meet their obligations.

When North Dakota interests came to the STB with this problem we were not asking that cars be taken away from other states and given to us. We were seeking a return of some balance between service to the various train sizes. This would have been a benefit to shippers across the entire BNSF system who use those sizes of trains. Some shippers in our region who load the large shuttle trains also use the 52 and 26-car trains to access important markets. They were getting shuttles on time, but couldn't meet shipping obligations on the other sizes because the railroad wasn't providing cars for those. As stated above, these markets often command a premium price. Elevators that handle those sizes of trains were being discriminated against by the BNSF practices. There was evidence that the BNSF had actually diverted cars away from 52, 26 and single car service into shuttles. We wanted to reverse that. Our concern with the car distribution imbalance was not brought on by a large crop, but by BNSF's decision to move that crop in more profitable shuttle trains, while allowing its other shippers and car orders to lag far behind. We were not trying to create a preferential situation, but to cure one created by BNSF. We were trying to restore balance in car distribution. The STB should not have responded by implying that possession is 100% of the law, forcing those elevators and markets using only the smaller trains to continue on without cars.

Included in this testimony is a rather colorful chart that shows BNSF System Past Due Grain Orders, non-shuttle. This is the BNSF's own chart, presented at the January 5 STB meeting. I added the commentary across the top about captive areas paying the highest freight rates and getting the worst service. Thirty-nine percent of those past due orders were from North Dakota. Add in adjacent states, and the figure rises to 70 percent, on less than 25% of the BNSF system.

Captive Areas Pay The Highest Freight Rates and Get Worst



One of the BNSF's comments about this was that 40 percent of non-shuttle orders are from North Dakota and so 39 percent of past due orders is okay. But that ignores the dependence of our area, its crops, and its markets on the non-shuttle type of shipments. Our area has a greater diversity of crops than just about anywhere in the country. While shipments from corn belt states are mostly corn and soybeans, which more easily lend themselves to the larger shipments, North Dakota ranks number one in the production of spring wheat, durum wheat, barley, flax, sunflowers, dry edible beans, and canola. These crops and the markets they move into do not entirely fit the BNSF 110-car shuttle mold.

Instead of getting into more detail on that I will use the following example. It would likely be more efficient for grocery stores to sell potatoes in 100 lb sacks only. But customers want 5, 10 and 20 lb sacks, and so that is how potatoes are sold. If a grocery store went to a policy of 100 lb sacks on time and all others 30 days late, its customers would go elsewhere. That's the benefit of competition. But in the case of these railroad customers there was no competitive alternative so they could only sit and wait, absorbing associated costs in the process.

A rail carrier has a duty to provide transportation and service on reasonable request, and another duty to "furnish safe and adequate car service and establish, observe, and enforce reasonable rules and practices on car service" under Sections 11101 and 11121 of the ICC Termination Act of 1995. It is incorrect to regard that standard as being met merely because the carrier imposes systemwide practices. What is reasonable for corn shippers in Nebraska, or winter wheat shippers in Kansas, is not necessarily reasonable for spring wheat shippers in the northern plains, whose markets depend more heavily on serving 26 and 52 car customers than do the corn markets or the winter wheat markets. What BNSF did was openly discriminatory against a whole class of shippers, and this fell far more heavily on far more elevators and farmers in the northern plains than it did elsewhere, and that deserves consideration whenever "reasonableness" is the standard. The term "reasonable" does not just mean reasonable for the railroad.

The railroads may say that they move more grain more efficiently in these larger volumes. That might be true, but that does not entitle the railroad to put the shippers of mid-size and smaller trains out of business. The 26 and 52 car rates are plenty profitable for the railroad, and shippers pay through higher rates for the fact that these units are relatively less efficient than shuttles. If a railroad holds out to provide a profitable service, it should deliver, not abandon its common carrier obligation to those other shippers. They should not be bypassed just because they have not moved into the shuttle mold. By the way, most of those shippers loading 52 and 26 car trains are not "small". Some of them are quite large and among the most modern facilities around.

Calendar year 2003 grain shipments of 52 car trains from 52 car loading elevators in North Dakota on the BNSF were down slightly more than 50 percent from 2002. This was not those elevators' choice. It was more about squeezing shippers into the 100-pound sack mold.

STATE OWNERSHIP OF RAILROAD CARS

This concept has been discussed in the Dakotas. It could be risky and costly. No railroad can be compelled to use private cars. Even it did use them, it might not want to pay enough mileage allowance to cover the cost of ownership including maintenance. These cars would likely be the last to be put into service and the first to be idled. Unless the rental cost is minimal, the railroad wants to get use out of its own cars first.

SHIPPERS FEEL COMPELLED TO EXPAND

Many of the grain elevators that have converted to shuttle train loading in our region have done so because the railroads, particularly BNSF, are making it the only dependable source of grain car supply. The grain industry doesn't spend millions of dollars on new facilities unless it has to. It is true that lower rates are offered. It is reported that that some undisclosed other incentives are offered to certain facilities for certain lengths of time. Railroad claims that they are not pushing the issue are false.

If the country grain gathering system is converted to all shuttle loaders, for the railroad's convenience and greater profits, there will be no reason for advantageous rates to be offered. Meanwhile the farmers will have to haul their grain much farther to a declining number of competitive locations, and severely damaging our road systems. The efficiency gains will go to the railroad, and the increased burdens will fall on its customers and the States. This is economic strangulation of significant agricultural areas of the nation by a few railroad companies that wield enormous economic power granted to it by the federal government. If you believe that might makes right, then this might be okay. If the railroad franchises were granted with the understanding that they should continue to operate in the public interest, then it is not.

EMERGING ECONOMIC TRENDS AND THE EFFECTS ON RAIL CUSTOMERS

Mr. Chairman, another topic mentioned in your letter of invitation is emerging economic trends in the railroad and shipping industries. From our part of the country, and I think in the grain business all across the nation, one of the trends the railroads are advocating is fewer but larger locations and shipments. I've already explained that in the train size service examples above. It is the "bigger must always be better" philosophy. We don't agree with it. It sometimes leaves out important smaller players and is often contradictory of what end-use markets really want. But it is the railroads' way and without some change in approach those rail service users who don't fall in line will simply lose their service.

NDGDA BELIEVES IN FREE ENTERPRISE AND FREE MARKETS

I want to emphasize that our organization and its members support free enterprise and free markets. But there's nothing free about monopoly and oligopoly control of customers, markets, industries and regions by one or two railroads.

IN CONCLUSION

Through their use of legislative and regulatory powers the Congress and the Surface Transportation Board have allowed, or maybe in some cases promoted, this concentration of great economic power in the hands of a few large railroad companies. We believe it is now the Congress's and the STB's responsibility to rein-in the abuses visited upon captive rail customers by those railroads. In this testimony I have given evidence of service and rate problems and abuse from market domination by railroads. We believe that the freight rail marketplace does not behave like a marketplace at all. They are given the federal protection of the anti-trust exemptions. In addition, we believe that over the years the regulatory mechanism has skewed what was the intent of Congress when it passed the Staggers Act in 1980.

We believe that Congress needs to act on necessary reforms now, to let competitive forces govern railroad-customer relations as much as possible, but use oversight and restrictions to check abuses where effective competition is not present. Rail customers, captive or not, and the public want and need a financially strong railroad industry, but one that is restrained from abusing captive shippers.

Railroads can be expected to act in their own best interests. From that perspective, it is understandable that they wish to move grain volumes from the fewest number of origins possible using the least number of railcars possible for the maximum revenue possible. The problem lies in that railroads have gotten so huge and so dominant in some areas that no effective competitive transportation keeps their rates and policies in check. Competitive choice is a scarce commodity in the Northern Plains, and elsewhere, and that is why more assertive Congressional and STB oversight must act as a proxy for competition.

Although Northern Plains shippers pay grain rates that are three and four times the railroad's variable costs – probably the highest margins for grain rates anywhere in the United States – there is no adequate remedy to seek a reduction of those rates before the STB, as Chairman Nober has acknowledged. This is an outrageous situation, considering that the Staggers Act has been law for nearly 25 years, during which time we have essentially been precluded from challenging these excessive rates.

To add insult to injury, although we provide the highest rates of return of any unprocessed grain moving on the railroad, most grain elevators in our region receive just about the worst service. Shuttle train shippers represent less than 10 percent of the grain elevators in my state, and the other 90 percent of our elevators have been waiting for months for BNSF railcars. On the Canadian Pacific the pain is spread more evenly among shipment sizes, with everyone being in the range of 50 days behind. The fact that railroads will eventually catch up does not undue the great economic harm done to rail customers.

The STB's responsibility is not to only railroads, or to bushels of grain; it extends to shippers, receivers and markets as well. And that doesn't mean only those who use shuttle trains. A railroad that takes resources from the majority of its shippers, to concentrate them into what it feels is its most efficient service, is ignoring its common carrier obligation to those other shippers. Those other shippers have paid their dues over the years with business volume to the railroad.

Regarding our particular situation, the BNSF may argue that, in concentrating its equipment in shuttle trains, it acted uniformly throughout its system. In those regions of the country where shuttle trains are used to a greater extent than in our area, this BNSF policy brings about less of a change in car distribution than for us, where 90 percent of the elevators are not shuttle facilities. That distinction was overlooked by the STB when we brought our car distribution problems to its attention this past winter. Taking cars from profitable 26 and 52-car trains for smaller shippers who constitute 90 percent of the rail grain customer base in North Dakota is not reasonable when there is no real crisis to solve. BNSF was not trying to move grain more quickly to save animals and poultry from starving. It did, however, manage to shift grain capacity to its most profitable service.

The STB appears to take the position that it will not respond to a car distribution complaint by restoring balance in among shippers. That's similar to saying it would be stealing for the police to return stolen property to its owner. This STB policy literally closes the door on any efforts by smaller grain shippers to retain the resources and service that the railroad decides to shift into use by larger shippers. Unfortunately, that leaves most North Dakota grain shippers without either an effective means to bring down the high railroad rates we pay or to obtain improved service.

The North Dakota Grain Dealers Association shares with ARC, the Rail Customers Coalition and other concerned parties the view that something substantive must be done. The day has long since passed when anyone can credibly say that there is no problem, or that things are just great as they are. For you who make policy to avoid acting, will only produce a larger problem for the country as time passes. And given time, the problems will surely be larger; they will be more complex and they will be more expensive to fix. The time to begin solving this is now.

COMMENTS FROM RALPH PECK, MONTANA DEPT OF AG DTR REGARDING BNSF GRAIN RATE INCREASES IN JANUARY 2004

The company(BNSF) has decided to increase its rates significantly at a time when people are complaining that their service is as bad as it's been for years. What they are doing is boosting their bottom line on the backs of captive shippers-specifically grain farmers in the state of Montana.

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COMMENTS FROM NEBRASKA GRAIN & FEEDASSOCITION EXECUTIVE VICE PRESIDENT PAT PTACEK:

I am starting to hear from many small or single car shippers who had 5 - 10 cars ordered per week since October 2003, all sold FOB, and who have not yet or are just starting to see a few cars thrown their way from time to time. Some of these guys are loosing their rail market all together from this poor service, or their own banks are threatening to pull their line of credit because they are sitting on sold but not delivered corn.

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COMMENTS FROM MINNESOTA GRAIN AND FEED ASSOCATION EXECUTIVE DIRECTOR BOB ZELENKA:

The situation hasn't changed much in Minnesota since late fall and early winter for the less-than-shuttle loaders. Some are still up to two months behind on BNSF and CP Rail. According to our survey the average negative impact is over $300,000 per affected grain elevator firm.

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COMMENTS FROM IOWA GRAIN AND FEED ASSOCIATION PRESIDENT ED BEAMAN:

We remain concerned with the same issues as we have had; poor "on time" delivery of cars, lack of access in some of the smaller 20 car and less facilities, lack of or poor upgrades to the tracks, limited competition, charges to the elevator for failure to complete loading per the agreements even though the train may have been very late in arrival at the facility. Peak demand movements place a strain on railroads. If we could find a way to level out I think both our members and railroads would be more satisfied.

COMMENTS FROM SUE HAYS,WILD BIRD FOOD INDUSTRY ASSOCIATION

We are a trade association whose membership includes companies in New York, Wisconsin, Florida, Kansas, California, Pennsylvania, Missouri, Oregon, Maryland, Iowa, Indiana, Illinois, and Minnesota, as well as other states.

This industry perhaps exemplifies the gravity of the lack of service by the US railroads. These companies are small businesses. They do not ship quantities to use the unit train systems which the railroads are forcing on us. These companies need single cars to perhaps 5 cars.

The point I want to make here is that they need the rail cars delivered, and that's not happening now. The result is financial harm to these businesses and the families affected by the megalopoly the US railroads have been allowed to become. These small companies ask that you act to provide remedy to this situation as soon as possible.

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SUPPLEMENTAL COMMENTS OF THE NORTH DAKOTA GRAIN DEALERS ASSOCIATION
Steve Strege, Executive Vice President (witness at the hearing)
TO THE U.S. HOUSE RAILROADS SUBCOMMITTEE.
MARCH 31, 2004 HEARING ON THE ECONOMIC REGULATION OF RAILROADS

In both his written (page 19) and oral testimony Surface Transportation Board Chairman Roger Nober painted a very rosy picture of the "informal facilitation" STB conducted between North Dakota parties and the Burlington Northern Santa Fe Railroad this past winter about grain railcar delays. We were initially glad to have him make this attempt. But the results were much less satisfactory to us than what he describes.

The North Dakota parties did not "agree to a series of steps" as Mr. Nober stated at the hearing. Neither did we agree "who would say what" at a news conference in North Dakota shortly thereafter, that Mr. Nober did not arrange nor participate in. Mr. Nober supports an informal facilitation process. To say that it worked in our circumstance is not how we characterize it. The BNSF leadership told us what it was going to do. There was no negotiation.

At the time of that January 5 meeting the BNSF was running about 50 days behind on it its non-shuttle railcar service. BNSF said it would catch up by the end of the March. BNSF claims it did, although reports from the field don't necessarily confirm that. But we don't believe this was a "success". It certainly wasn't or isn't a solution to the discrimination between shippers and shipment sizes practiced by BNSF.

At that subsequent news conference in North Dakota BNSF President Matt Rose promised to have an ombudsman "on the ground here in the North Dakota within 60 days". More than 100 days have now passed, and there is no ombudsman.

As said in my oral statement, the STB refuses to enforce an Eighth Circuit Court of Appeals decision that calls for some balance in service to grain shippers. So what we have is a regulatory agency that refuses to assertively intervene on behalf of shippers, overstates the results of its informal facilitation, but yet tells Congress it need not act.

Mr. Ed Hamberger of the Association of American Railroads said during the questioning that we must convert to fewer grain elevators and larger shipments because the railroads are trying to keep the American farmer competitive in world markets. That statement is directly contradicted by the excessive rates imposed on captive grain shippers.

The statutory threshold for a rate reasonableness case is 180 percent. Railroad rates charged to captive grain shippers in this region are in the 250-350 percent of variable cost range, some up over 400 percent.

My point in bringing this up is to let all who hear and read the testimony from that hearing know that there are some wide gaps between what the railroads say and what they do. Gouging captive grain shippers and farmers with rates three and four times variable cost is not the altruistic behavior railroads would like to portray. And the rate relief mechanisms are so cumbersome, expensive, one-sided, and uncertain that abused rail shippers are left with no remedy.

April 22, 2004
Nine pages via fax
202-225-2256

The Honorable Corrine Brown
Ranking Democratic Member
Subcommittee on Railroads
House Committee on Transportation and Infrastructure
2444 Rayburn House Office Building
Washington, DC 20515

Dear Representative Brown:

Thank you for your letter of April 8, asking followup questions regarding the March 31 hearing on "The Status of Railroad Economic Regulation". I appreciate the opportunity to elaborate on matters of your particular concern.

Q1: Hasn't the State of South Dakota undertaken a program of acquiring rail cars so they are available in times of excess demand?

A1: According to South Dakota Department of Transportation authorities the State of South Dakota does not own rail cars. I was told there is a specific state law prohibiting such ownership.

Q2: If the railroads would have diverted cars from shuttle operations to smaller elevators wouldn't the total volume of grain moved out of North Dakota been reduced? Are we simply observing the "Wal-Mart" phenomenon in the sense that smaller operations cannot economically complete with the large ones?

A2: What happened across the BNSF system this past winter and fall was diversion in the opposite direction - more and more resources from non-shuttle service to shuttle service. Most of BNSF's customers, both shippers and receivers, do NOT load or unload shuttle trains. So the shift in concentration of resources robbed Peter (non-shuttle) to pay Paul (shuttle). What we sought was to restore the service to pre-booked and partially prepaid non-shuttle service.

A related question for a different transportation mode would be: "If an airline sells tickets from Jacksonville to Chicago, and then learns that it can make more money by flying to Chicago from Miami, where there are more passengers, would the airline be justified in ignoring its Jacksonville passengers and shifting those aircraft to Miami?"

In North Dakota on the BNSF Railroad and its regional railroad affiliate there are 15 grain elevators that load and ship grain in 110-car shuttle trains, and about 225 elevators that do not. The 225 elevators load and ship grain in 52-car and smaller unit trains. By railroad design the shuttles have a shorter round trip transit time than other grain unit trains. But the concentration of railroad resources into shuttles has come at the expense of service to the other 94 percent of the grain elevators and the thousands of farmers who would normally do business with those grain elevators. A primary reason why the shuttles have moved more grain is because by limiting service to many non-shuttle elevators the railroad forced farmers to truck grain long distances to the few shuttle elevators in order to gain market access.

There was no market-driven need to justify favoring six percent of shippers at the expense of the other 94 percent. Just because BNSF chooses to use shuttle trains to move more grain in a given period of time than it does in other grain train units, does not mean that there is a market-driven need to do so. BNSF was not favoring its shuttles to rush corn to feed starving hogs or chickens, or wheat to supply flour mills on the verge of shutting down, or grain to overcome a backlog of empty ships waiting to load at a port. Instead, BNSF seized upon a situation partly of its own making (lack of adequate equipment and crews), which resulted in a backlog of grain car orders, as an excuse to take equipment from a majority of its elevators and place it in a more profitable service, shuttle trains. BNSF does not lose money on 52-car, 26-car, and smaller grain units; in fact they are highly profitable. But BNSF makes even more money on shuttles. So, what it did was allocate equipment away from grain elevators that had partially pre-paid for some of the service to give it to other customers from whom BNSF made a greater profit, when there was no external market need driving that decision. Please see paragraph 5 of my attached oral statement for an everyday analogy on different sizes of service. Also, for your information, I attach an article from the Bismarck (ND) Tribune dated March 27, 2004, describing in a totally objective fashion the financial losses inflicted by BNSF on North Dakota's farmers by virtue of this unnecessary reallocation of grain equipment.

I'd like to clarify that many of the non-shuttle elevators are not "smaller" operations. Many are big modern complexes into which owners – mostly farmers – have poured millions of dollars. Up until the past couple of years, when BNSF became so captivated with its shuttle concept, the non-shuttle loaders of 52 and 54-car trains were the cream of the crop on BNSF's system. Now they are being pushed aside, put out of business because they won't or can't double in loading capacity. Please also understand that the loaders of the huge 110-car shuttle trains also have need for the other train sizes to access important markets that usually pay a better price. BNSF seeks to impose its shuttle concept on shippers and receivers, and to change marketing methods, all because it has the market power to force the issue.

I don't believe that this is the "Wal-Mart" phenomenon. This is not the case of a new, larger and more efficient competitor coming into a free market. It is instead the case of a railroad service provider deciding that its own needs will be better served by concentrating grain flows through fewer larger collection points for its convenience and greater profits. Consumers are very mobile and can easily travel from small town stores to the Wal-Marts 50 miles away. In contrast, the productive farmland from which this grain comes is not mobile, and moving large volumes by truck to ultimate destinations or the fewer larger sites chosen by the railroad from which to move shuttle trains is very expensive.

Wal-Marts and shuttle stations come into being under different circumstance. When Wal-Mart decides to build, it buys or leases property in an open market with no assurance that K-Mart or Target won't open a store right across the street, likewise having acquired property in an open market. No one landowner or developer controls all of the land where such stores can locate, or access to it, and so each store can make the best deal for itself that the market allows. But shuttle stations are a different story. In an area where it would like a shuttle station built the railroad has "induced" construction by granting undisclosed rebates or other subsidy to help defray construction costs. Because the shuttle system receives lower rates and priority car service (everything else up to 50 days behind this past winter) other shippers in the area feel compelled to build shuttle stations just to stay in business. The railroad has less desire to provide them the same subsidy. It may provide less subsidy or nothing at all. The subsidy gives the first elevator a distinct competitive advantage, enabling it to offer better prices for grain and to earn better margins. In effect, therefore, the shuttle system is sort of a railroad franchise chain, allowing the railroad to pick likely survivors in the grain market. Wal-Mart may put smaller stores out of business, but not because it is being subsidized by a landlord that wants to see the smaller stores die.

It might be more efficient for an electric utility to serve only its largest industrial customers and forget about comparatively small residential service. But we don't let them get away with that in this society. Representative Oberstar said at the hearing that the railroads have lost their sense of public service. This push for ever-larger trains from ever-fewer locations that railroads are trying to force on the grain industry, farmers, and local government in general is an example of that. Over time, the only winner will be the railroad.

Q3: Differential pricing calls for charging what the market will bear. Would North Dakota grain shippers accept less than what the market would pay for their crops?

A3: Differential pricing, as I understand the term, means that those with a greater need for a commodity or service should be charged more for that commodity or service than those who can forego use of the product or service if they wish. When applied to railroads, this principle leads to vastly disparate prices. Railroads operating in North Dakota handle intermodal freight through here and elsewhere (traffic which might move via truck or water) at narrow margins, while captive grain shipped from North Dakota is charged 300 percent or more of variable costs. (The jurisdictional threshold for a rate reasonableness complaint is 180 percent.) Grain shippers are unable to engage in differential pricing because they, unlike railroads, are not monopolists.

Everyone would like to sell high and buy low, to get the most for their products and economic services while reducing the cost of producing and providing those. A key word in your question is "market". A true market consists of a number of willing buyers and sellers. The market for farmers' grain is the grain shippers/grain elevators within reasonable delivery distance. These grain shippers can sell to a number of domestic mills and processors, or into the export market. But the link between the local grain elevator and the destination market is the railroad. In most cases that railroad has monopolistic power over transportation of grain from these grain elevators. Throughout most of our region there is no effective transportation alternative such as trucking to river barges or an export port. Railroads are in the position to gouge the shipper, and there's plenty of evidence that's what they do.

There is a section in my written testimony regarding the MARKET POWER OF RAILROADS IN PRICING. Part of that reads as follows: *The pricing philosophy of the BNSF is explained in the following comment from its Ag Products Vice President Steve Bobb at a U.S. Senate field hearing in Bismarck, ND in March 2002: "What we do as a rail transportation provider is look at the difference between value of the grain at the origin and value of the grain at destination, and try to determine the level of charges for transportation with margin for the elevators to operate and make money." In other words the BNSF is inserting itself as a participant in the marketing of grain instead of serving as a transportation provider, taking the maximum it can out of the middle.* This is what can be called playing both ends against the middle.

In a true market, competition will keep prices within reason and based on cost plus a reasonable profit. But in a monopoly situation a service provider such as a railroad can impose its monopolistic control between the seller and buyer of the product and wipe out any pretense of there being a real market. So besides our concerns about poor service, the railroad can expand its slice of the pie and thus limit what a true market would pay for these crops.

Another aspect to this is its effect on our competitiveness in world markets. When railroads are free to charge unreasonable rates the competitiveness of our product is damaged. We are keenly aware of this because half of North Dakota's leading crop, hard red spring wheat, is exported.

Another example of monopolistic pricing is in the second paragraph of page 5 of my written testimony. It describes an inverse rate structure – charging more to haul a shorter distance – that effectively shuts out of a market the producers and shippers in the areas intentionally disadvantaged by the railroad.

Q4: You seem to dismiss out-of-hand the state ownership of railcar solution that has been implemented in South Dakota. Can you elaborate on your opposition?

A4: South Dakota's DOT has told me that the state does not own grain rail cars and that there is a specific state law prohibiting it.

I am probably more skeptical and cautious than outright opposed. No railroad can be compelled to use someone else's cars. Railroads want to use their own cars in preference to paying rental on someone else's cars. State-owned cars would therefore be the last ones put into service in a demand surge and the first ones put into storage at a time of slower movement. In regions of greatest captivity to railroads, such as the Northern Plains, rail rates are higher and generate a better rate of return on equipment than in other areas. In a free market this would encourage railroad investment in extra cars so as to capture a higher percentage of demand surge traffic. But in the current situation the railroad can operate with a smaller fleet of cars, capturing the more competitive traffic on demand, while letting the captive traffic wait. The greater return on investment in service to captive/higher rate regions, coupled with the fact that state-owned cars would be the last used and the first stored, magnifies these inequities.

In other words, shippers in captive areas already pay higher rates. Therefore they are providing the railroad with a higher return on investment for the equipment used to serve those captive areas. For the captive areas to have to furnish equipment that would be last on and first off the rail system, is doubly unfair.

Putting aside the question of whether it is lawful for a state to own railroads cars, I suppose that states could consider grain car ownership if the railroads serving those states would agree to not block the use of those cars and agree to compensate the car supplier adequately. So far as I am aware, BNSF and other railroads serving North Dakota have neither policy in place.

Another observation is more of a philosophical one. Should widely dispersed and mostly small business grain elevators and their states have to provide rail equipment when the law says there is a common carrier obligation for a railroad to furnish service upon reasonable request? Will the railroads next want us to furnish locomotives or have standby crews? Providing transportation is the job of the railroads. There is also a public service component. Railroads need to do a better job at both.

Sincerely,

Steven D. Strege
Executive Vice President

Che/Congressional/Rep. Brown quests 3-31-04 Hse rail hrg

Rail backlog leads to empty pockets

By LAUREN DONOVAN, Bismarck Tribune

ELGIN -- Harlan Klein's pockets are $5,000 lighter than they ought to be.

The money went to his bank, instead of to him.

Like a lot of guys, he borrowed money he shouldn't have had to borrow.

He had the money in the form of grain sitting in the bin. He couldn't sell the grain because the local elevator couldn't take it, and the elevator couldn't take it because the railroad wasn't sending cars as promised.

It was a costly trickle down. Like snow melt finally running down the prairie creeks, it's still trickling.

Klein's plight can be multiplied by hundreds and thousands, equaling a big sum of money forever lost to crop producers and their communities, most already struggling to keep businesses afloat.

"Those are real dollars, and it was laying in the bin," Klein said.

Klein, of rural Elgin, can be considered a financial victim of a Burlington Northern and Santa Fe railroad backlog of trains that were scheduled for grain pickup and never arrived.

The situation has improved.

BNSF spokesman Pat Hiatte said the railroad has reduced the backlog from 8,600 undelivered cars to around 1,000, a week sooner than expected.

He said BNSF will reduce the backlog more in the next two months.

State and grain association leaders leaned hard to get BNSF to move trains here.

"The fact is, there's still a long ways to go," said Don Canton, spokesman for Gov. John Hoeven. "We're keeping an eye out on the ramifications."

That makes Klein, who couldn't deliver 95,000 bushels under contract between November and January, a "ramification."

"That's money we should have had, but the railroad, in its wisdom, took it away from us," Klein said. "They took money that would have helped people heal up a little bit."

At nearby Mott, Commercial Bank ag loan officer John Fielder saw Klein's dilemma repeated over and over again.

"The cash flow problems were just huge," he said.

Fiedler said his bank services close to half of the county's farmers and about one-fourth of them asked to have their loans extended 90 days.

All those producers paid interest on a grain asset they had but couldn't convert it to greenbacks.

The Mott Equity Elevator isn't served by a railroad and is on the brink of closing.

Area farmers there truck their grain where the market's best, often to the super shuttle elevator at Southwest Grain near Gladstone.

Southwest Grain is set up to take 110-car super grain trains out to the export docks in Seattle and super trains were not part of the backlog.

This year, though, the domestic grain market was stronger than the export market, though that could change with China in the grain market now.

But even Southwest couldn't summon the 26- and 52-car units needed to fill the domestic slot.

When it could get rail service, word spread fast.

Farmers lined up a mile long to unload grain.

Fielder said one of his clients spent the entire month of February hauling single loads because the long lines prevented him from turning loads around.

"He didn't get anything done," Fielder said.

That particular farmer ended the month with half of his grain still not moved off the farm.

Klein is board chairman of Southwest Grain.

The problem that trickled down to farmers like him trickled up at Southwest.

Over the winter, Southwest took in grain and paid farmers. Then it waited and waited for rail cars, sometimes for nearly two months.

Often, the cars would come in "dirty," sides wedged with corn or sugar beet pellets.

If Southwest rejected the cars, it paid a penalty for not delivering enough bushels to the buyer.

"It was complete frustration," Klein said.

Manager Jim Bobb said the elevator had to borrow money to cover payments to farmers.

It its 20-year history, Southwest Grain never paid more interest than this winter, as much as $2,500 a day.

Bobb said the window for train delivery is down from nearly 40 days to about 15 days now.

While that's not acceptable, it is tolerable, he said.

Klein said Southwest will weather the crunch because it has to.

Back at the farm, some producers still have grain to move. Klein said it's impossible to know how much is still out there, but he figures it's "a lot." At the same time, Fiedler said the 90-day loan extensions are coming due.

Farmers need to make their payments, which in turn means they have to fire up their trucks and semis and head to an elevator that's buying and moving grain. Making that drive might be hard, with one eye on their bank notes and the other on the calendar.

It's spring and a new crop year.

"Now they've got to plant, so they can't deliver grain," Fiedler said.

Richard F. Timmons
President
American Short Line and Regional Railroad Association
Testimony before the United States House of Representatives
Committee on Transportation and Infrastructure
Subcommittee on Railroads
Hearing on the Surface Transportation Board and Railroad Economic Regulation
March 31, 2004

Good morning Mr. Chairman and Members of the Committee.

My name is Richard Timmons and I am President of the American Short Line and Regional Railroad Association. I appreciate the opportunity to appear here today.

Mr. Hamberger of the AAR has highlighted the many successes of railroad deregulation under the Staggers Act. The Staggers Act is very important to ASLRRA because it spurred the creation of the modern short line industry. Eighty-one percent of total short line mileage is operated by railroads that were established after 1980. These railroads have survived because of the success of the Staggers Act.

While it has been forgotten in the mists of time, creating a short line railroad industry was not the driving consideration behind this policy choice. Twenty-four years ago almost no one envisioned the rapid growth of short lines and the economic impact they would deliver to customers and the nation's freight system. The real driver at the time was the preservation of rail service for thousands of rural customers that would otherwise lose their connection to the national railroad network. Rail customers were the ultimate beneficiary of our creation, and our customers will be the beneficiary of our success in the twenty-first century.

Today, short line railroads serve over 11,500 rail customers. These customers employ over one million workers. For the majority of those customers, the short line rate is far more economical than the truck rate they would have to pay if the short line was not there today. In many instances existing truck rates are also depressed because of the threat of a short line competitor. Short lines also benefit the larger rail network since the Class I's harvest between 18% - 24% of their bottom line revenue from short line railroads. This is a testament to the success of the Staggers Act.

There is no denying the existence of disagreements and issues between short line railroads and the large railroads. Likewise, there are outstanding issues between some railroads and some customers. Many of those issues do not have a simple solution. These may be tough issues, but they need not be incendiary issues that impede business growth. Our industries must continue to work together because railroads and rail customers have an equal interest in building the most efficient and safe transportation system possible. And I strongly believe that we are.

Although it is important to focus on areas in our relationships that need further attention, we should not overlook those things that are going well. Differences and disagreements occur in every industry. What is different in our industry is that short lines and Class Is are working to streamline our relationships to benefit customers.

Over the past year we have spent more time than ever improving communications between railroads in ways that result in more meaningful discussions and real decision-making on rail issues.

Let me take a moment to review the forums for discussion and problem resolution that are in place today. At the industry level, the AAR and ASLRRA confer every 90 days within the North American Rail Alliance to review major policy issues and problems. The Railroad Industry Working Group continues to be a valuable forum for reviewing issues and disagreements between short lines and the Class I's. At the end of 2003 the group completed an amendment to the Railroad Industry Agreement that defines new conditions under which paper barriers that prevent interchanges between certain railroads could be removed. The final document incorporating this agreement will be completed this year.

At the technical level the quarterly meetings of the Safety Operations and Management Committee and the Network Efficiency Management Committee work through operational, marketing and equipment questions that impact all classes of railroads.

Each of the Class I railroads hosts an annual meeting of their short line interchange partners to discuss operating problems, performance successes and shortfalls, and future opportunities for growth and economic development. Throughout the year the Class I's also sponsor quarterly caucus meetings with their short line partners to listen to issues and opportunities for improved business relationships.

The short lines complement the Class I forums through regional meetings and an annual conference that concentrates on short line matters of concern regionally and nationally. These meetings also incorporate industry updates from the FRA, STB, rail suppliers, Class I's, and other industry experts. The ASLRRA also conducts a confidential survey each year for the Class I railroads related to their performance with short lines over the past year. This survey will become the foundation for high value problem resolution in the coming years.

The point of all this is to highlight the extensive and continuous exchange of information between the large and small railroads as they strive to develop seamless, reliable, and consistent service for our customers.

ASLRRA has also begun to engage groups that represent our customers. I have recently had the pleasure of addressing a gathering of the National Industrial Transportation League, and NIT League President John Ficker has been a speaker at recent ASLRRA events. Indeed, one short line railroad now sits on the Board of both the NIT League and ASLRRA, and several short lines have recently joined the NIT League. By bringing customers and railroads closer we hope to open lines of communication to resolve differences and benefit our customers.

One sterling example of this cooperation and communication is support for HR 876, introduced by Rep. Moran of this committee, and co-sponsored by every Subcommittee Member. This legislation would help short lines overcome the tremendous investment shortfalls that threaten service to our customers.

Only 18 other pieces of legislation in this Congress have amassed more supporters than the 264 Congressmen co-sponsoring HR 876. This bill has made important progress because of the active support of short lines, Class Is, rail customers and unions, and this committee.

HR 876 does not represent a new policy, but rather the end of a journey began in 1980 with the passage of the Staggers Act. Congress determined that rural freight service must be preserved, and short lines were the agents for that preservation. Today these lines are threatened by unmet investment needs and the ever increasing weight of rail cars. Congress should now take the final step and ensure the continued survival of these lines; not just for the benefit of railroads, but for the benefit of our 11,500 customers.

Before I conclude I ask permission for two articles highlighting recent improvements in short line, Class I and customer relationships be included in the record.

Mr. Chairman, thank you very much for you time and your support. I will be happy to answer any questions.

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short line/regionalperspective

Russ Harrison

Saving small roads saves service *and* shippers

I own and operate two gypsum quarries in Oklahoma that ship more than 600,000 tons annually to 26 cement plants nationwide, and I employ 80 people. Transportation is one of my largest expenses. Twenty-three of the cement plants I serve are 200-plus miles from my quarries, and for those shipments, rail transportation is the most economical way to go. In the 1990s, I lost most of my Class I service because the railroad could no longer afford to operate in rural areas like mine. My business was saved because short line railroad entrepreneurs bought the track and began operating a successful new local railroad, with a lower cost structure and more flexible service than the Class I could provide.

This great story has been repeated in thousands of rural communities across the country. But it's an unfinished story that will have an unhappy ending if shippers like me don't get involved. I'm leading a growing shipper group that has organized an ad hoc coalition, Saving Our Service, whose goal is to convince the federal government to provide at least part of the funding required for small road rehab efforts through a rehabilitation tax credit. The legislation, introduced as H.R. 876, already has 173 House co-sponsors.

While small roads have preserved service, their trackage suffered from years of neglect under Class I control as underperforming branch lines. The advent of new, heavier 286,000-pound railcars makes this problem even more immediate. The American Short Line and Regional Railroad Association estimates that it will cost approximately $7 billion to make the 50,000-mile national short line railroad system "286-capable." Yet the nation's 550 small roads combined generate only $3.2 billion in annual gross revenues.

Because small road capital needs often far exceed available resources, there are few examples of major short line rehab projects. However, a member of SOS has brought one to my attention, and I think it illustrates the potential benefits.

The shipper is Lester Myers, CEO and general manager of a large catfish feed mill in Indianola, Miss. His company, Indi-Bel, receives inbound shipments of soybean meal and grain products by rail from the Columbus & Greenville Railway. C&G, a 170-mile short line that bisects Mississippi from east to west, has struggled for years to preserve service over aging lightweight rail, substandard bridges, and worn out ties. Three years ago, one of C&G's Class I connections provided a large financial contribution toward rehabilitation of the line used by Indi-Bel. Completed in 2002, the rehab allows C&G to handle the heavier loads that the Class I carries on unit trains from Iowa.

As the leading beneficiary of rail rehab efforts, shippers should lead the charge to promote federal tax credits.

The result: Indi-Bel has access to markets it could never before reach. In those markets, there is greater soybean supply and its price is lower than it is closer to home. Indi-Bel estimates that, even when the transportation cost is included, it saves about $6 per ton. For a facility that uses 275,000 tons per year, that's significant. In addition to the financial savings, the newly rehabilitated short line has solved an operational problem for the shipper. "Just-in-time" delivery is important to Indi-Bel, which depends on a dedicated, consistent supply of feed ingredients for its catfish. The Class I delivers large blocks of cars out of the Midwest to interchange in Greenwood, Miss. Previously, product often arrived in larger capacity cars than expected, and C&G couldn't handle them. That meant that Indi-Bel had to scramble to find replacement product. Now, such a scramble is unnecessary.

Based on improved economics and new service reliability, Indi-Bell is making a multi-million dollar investment to expand its grain storage capacity by about three million bushels.

"I never would have made this investment without a rehabilitated rail connection," says Myers. "This investment created jobs and will result in expanded economic activity in an area that needs it badly. That's a pretty good return on investment."

Like my company, Indi-Bel is a relatively small operation in small town America. The ASLRRA estimates that small roads serve some 10,000 similar companies nationwide, which employ tens of thousands and generate much of the economic activity that occurs in rural America. If the Indi-Bel experience is any indication, we, the shippers, are the ultimate beneficiaries of rehabilitated short lines and regionals. Given that stake, we should be leading the charge for this important federal legislation.

Russ Harrison is the owner and operator of Harrison Gypsum, headquartered in Lindsay, Okla. He is a founding member of Saving Our Service, an organization of rural shippers and local economic development officials dedicated to preserving the nation's local railroad system.

Reprinted from Railway Age December 2003

short line/regional perspective

Richard F. Timmons
President, American Short Line and Regional Railroad Association

Who says we can't cope with Class I requirements?

This month, I will attend the last of the seven Class I/short line railroad meetings, my first such meetings as president of the American Short Line and Regional Railroad Association. Sponsored by the Class I's and attended by a majority of their connecting short lines, these annual sessions are intended to improve communication, address operating issues, and focus on new business opportunities.

When I became ASLRRA president last year, numerous individuals indicated that I would find significant issues dividing the Class I's and the short lines that deserve serious attention. I heard much about them during these meetings. But I also heard something else that doesn't get enough attention. For the Class I's, short line traffic is an increasingly important source of revenue, and short line managers are an increasingly important marketing force in bringing carload business back to the national railroad system.

While the Class I's do not produce uniform data, it appears that short lines contribute 15-23% of their annual revenues. CN measures that statistic with and without intermodal traffic: Without intermodal, short lines contribute 28% to its annual revenues. Since 2000, CN has been tracking the relative growth in revenue from short line related traffic vs. CN's overall revenue growth. The Class I has found that short line traffic revenue growth has consistently outpaced CN's overall revenue growth by 2%.

CSX Transportation indicated that its merchandise traffic with short lines grew by 6% in 2002. That growth alone generated $31.9 million in annual revenues. CSXT's goal is to grow by an additional 8% in 2003, for additional annual revenue of $48 million. Symbolic of and consistent with its commitment to short line business, CSXT has created three cash awards for short lines that bring the most absolute carload growth, the highest percentage of carload growth, and the most significant industrial development site announcement in 2003.

Norfolk Southern has created six individual short line awards that focus on joint business development in various commodity areas and has adopted specific targets for short line carload and revenue growth. As one NS presenter said at its meeting, "you can't beat the value-added component that the short lines have brought to the NS marketing equation."

One Class I said you "can't beat the value-added component" we bring to the table.

These trends are very encouraging. Equally encouraging are the unmistakable signs of a new and much more innovative relationship between the Class I's and the short lines. Consider these examples:

- BNSF and its Watco short line connections have completely reversed the traditional Class I/short line working relationship to move a large piece of business from truck to rail. The move involves small unit trains of cement between Kansas and Oklahoma. In this new move, the short line has the line haul while the Class I does the switching work in its yard in Oklahoma City. The short line manages the inventory of cars, the demurrage arrangements with the shipper, and the per diem arrangements with the car owner. BNSF leased the short line track and land to handle the incoming unit trains and is required to do the switching based on the short line's schedule.
- Coal is traditionally viewed as the near-exclusive preserve of the Class I's, but NS and Wheeling & Lake Erie have teamed up to turn a rail/barge coal move into an all-rail move. About 2,500 cars a year of Powder River Basin coal move to a utility plant in Ohio. This is the farthest east that western coal has moved into the U.S. W&LE terminates the move over 168 miles of its track and was responsible for initiating this joint marketing effort. The cars arrive from destination in eight days vs. the 14 days the rail/barge move required.
- Union Pacific's Express Lane service, which handles fresh and frozen agricultural commodities from California and the Pacific Northwest to the East via CSXT, sees about 50% of its origin loads from short lines. The San Joaquin Valley Railroad increased service from three to five times per week to accommodate new melon shippers participating in this service. California Northern Railroad designed and installed a new shipper spur in ten days to take advantage of a new perishable opportunity. Express Lane has been so successful that UP has tripled its order for new mechanical refrigerator equipment.

The Class I system is in the midst of significant change. The railroads are building new business models requiring trains that are heavier, longer, faster, and more scheduled. These changes present real challenges for the short line industry. The pessimists among us might say we cannot cope with those changes.

Yet, it appears that we are coping, and, according to our Class I partners, coping in a way they believe is making a significant, lasting contribution to their bottom lines.

STATEMENT OF
THE AMERICAN FARM BUREAU FEDERATION
TO THE
HOUSE COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE
RAILROADS SUBCOMMITTEE
REGARDING
RAILROAD ECONOMIC REGULATION

MARCH 31, 2004

The American Farm Bureau Federation is pleased to submit this statement for the record to the subcommittee regarding the railroad industry.

As massive rail consolidation over the last 20 years has reduced the number of railroads serving U.S. agricultural shippers, farmers have become increasingly concerned about the monopoly market power enjoyed by large railroad companies. Farmers who are not fortunate enough to live in areas where railroads compete directly with each other, or with another mode such as barge service on the inland waterways, find that they pay a substantial premium to transport grain from their local elevator to the final point of use or export. Agricultural shippers also suffer from poor railroad service in many regions that inhibits their ability to conduct their business.

Many agricultural commodities are experiencing an increase in export demand. The decline in rail service performance in 2003 and the shortage of grain cars has raised many concerns from agricultural shippers who completely depend on rail service to market their production. Those farmers who utilize elevators situated on a short-line track have experienced the greatest delays in service.

Opening foreign markets to U.S. production is a long process. Retaining those markets for U.S. agriculture depends on a timely and efficient transportation system that can respond quickly to foreign demand. Rail service is a vital, and for some shippers the only, method to move that production to the ultimate consumer, domestic or foreign.

Legislation currently introduced in the House would help improve rail service to agricultural shippers. H.R. 876, the Local Railroad Rehabilitation and Investment Act, amends the Internal Revenue Code to establish a tax credit for railroad track maintenance expenditures by the Class II and Class III railroads. This measure will assist the short-line railroads, which are so important to the movement of products in the farm sector, to invest in their infrastructure. The Class II and III railroads are a necessary complement to the Class I railroads across the country and we urge support for this measure.

Agricultural producers are concerned about the lack of competition that exists in the rail industry. Certain areas of the country, especially the Northern Plains, depend on a single Class I railroad to move their grain. These 'captive shippers,' without access to barge service and with truck transport uneconomical for long distance hauling, must use rail to market their grain.

Without competition from other railroads or other modes of transportation the rates that they pay for rail service are higher than in other areas of the country. This higher marketing cost leads directly to lower returns to farmers for their products.

To help address these concerns of shippers H.R. 2924, the Railroad Competition Act, seeks to improve the relationship between shippers and carriers. The implementation of dispute resolution processes between shippers and carriers on rates and service will help address some concerns. Overall, this legislation will begin a necessary correction to assure increased competition in the provision of rail service to American agriculture and industry.

Farm Bureau policy supports the promotion of competition in the railroad industry as the most effective way to improve service and provide reasonable rates. We also favor legislation to remove the imposition of 'paper and steel' barriers that limit rail service to rural America. Additionally we support the elimination of the wide variance in railroad rates in different areas of our nation that negatively affects farmers.

H.R. 2924 addresses these issues of importance to agriculture and we urge your support for this important measure.

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National Grain and Feed Association

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March 31, 2004

The Honorable Jack Quinn
Chairman, Subcommittee on Railroads
Committee on Transportation and Infrastructure
589 Ford House Office Building
Washington, D.C. 20515

Dear Chairman Quinn:

The National Grain and Feed Association respectfully requests that this statement be made a part of the record of your Railroad Subcommittee's hearing, Wednesday, March 31, 2004, on the "Status of Economic Railroad Regulation."

The National Grain and Feed Association is the national voluntary trade association comprised of 1,000 member companies involved in grain buying, warehousing, merchandising, feed manufacturing, livestock feeding, grain processing, and exporting. Our members include privately owned, public corporations and farmer-owned cooperatives. Companies in our membership range from the largest bulk handlers and processors in the U.S. to relatively small country elevator and feed mill operations. We have about 400 companies in our membership that are active rail shippers or receivers.

Our Association and industry have had a long-term interest in national rail policy. We are not aware of any current regulation or enforcement of current regulation that to any demonstrable degree inhibits railroads in their ability to manage their businesses profitably. While the Surface Transportation Board is the primary regulator of the carriers, no one can fairly accuse the STB of exercising a heavy regulatory hand on the carriers. This does not mean that all is well in rail freight transportation markets. There are reasons to be concerned about long-term directions, and whether railroad service will continue to be viable in agricultural and other markets.

The railroads will not be surprised by what they read in these comments, as the National Grain and Feed Association has worked directly with the Association of American Railroads and many of the individual railroads to address differences in viewpoints. In the last few years, a few issues have been resolved, but many matters of significant concern remain open. With this testimony, we offer our perspective on the current situation.

The railroads continue to lose market share to barge and trucks in agricultural markets:

In 1980, the year that the Staggers Act was approved by this Congress, the freight railroads of the U.S. were carrying a full 50% of the bulk grain and oilseed shipments within the U.S. There has been a steady decline in the rail modal share, and today rail is at 35% or less in some years. The barge proportion of movements has remained fairly steady through this period, so that the rail loss of modal share has largely gone to trucks.

Two primary factors have contributed to this loss of market share for railroads. Some infrastructure shifting has occurred so that points of consumption, such as grain processors, over a period of years, have been relocated closer to grain production points, thus replacing long rail movements with short haul trucking from origin to consumption. Secondly, rail service has not measured up to trucks for timeliness, reliability and cost, forcing longer and longer distance moves to go by truck.

While railroads have pushed forward with higher volume movements (unit trains, shuttle trains, etc.) they have not been able to compete for smaller movements and specialty grain shipments. In many cases it appears that the railroads are not interested in anything less than high-volume moves in the bulk commodity sector. That works for some shippers and receivers, but in other cases, the facilities are simply not equipped to handle the highest volume shipments being promoted by the carriers. As an industry, we want to be collectively viewed by the railroads as an attractive customer base to pursue, but we are concerned that at least some railroads are not making much of an effort to go after the business of small or even moderate-sized shippers. This will create either massive structural adjustments in our industry and/or continued loss in business volumes for the railroads, because some of that business will ultimately find a way to reach market that does not include a rail segment.

Service issues appear to becoming more acute:

Agriculture is admittedly a partly cyclical and seasonal business, as grain is harvested once per year and some grain movement cycles are driven by fluctuating export demand. Thus, our industry has become accustomed to having to wait on rail service, sometimes for considerable lengths of time. Such service problems can be costly because of price differences on delayed shipments, and for the difficulty of finding replacement supply sources for grain processors or livestock feeders.

Even with the understanding that rail service will not always be wholly predictable to the agricultural sector, the experiences of 2003 and the first quarter of 2004 were very troubling. Yes, we did have more demand for agricultural products during this time. But the decline in railroad performance, particularly for western carriers, was noticeable in May and June of 2003, well before any surge in demand occurred. There were shortages of power and equipment that were mostly driving the service problems. But the strength in other sectors of the economy prevented the railroads from using any surplus capacity for agricultural markets. And, our industry has been surprised at how long it has taken the carriers to catch up. Only now are we beginning to see some of the carriers starting to reduce the backlog of service orders. And some of the rail carriers are already predicting service shortages in the summer and fall of 2004, and urging their customers to bid higher prices for "guaranteed freight" to protect themselves.

Another troubling aspect of the rail service for bulk agricultural shippers is the varying levels of service and the degree of disparity between various classes of service. There is a concept called "common carrier obligation" embedded in the law, but many wonder what it really means. In general it says that railroads should provide reasonable service on reasonable request. But that gets more complicated by the fact that railroads have many tiers of service to the agricultural community---single car, multi's, unit trains, guaranteed forward freight, and shuttle trains, each with varying degrees of profitability for railroads and costs to shippers. The railroads don't lose money on any of these services, but they make the most on shuttle trains, which are operated by relatively few shippers. Is it appropriate under a common carrier obligation for railroads to delay service to profitable traffic and concentrate on only the MOST profitable traffic? What represents a fair distribution of equipment and crews among so many classes of service?

The railroad is in the position of primary decision maker regarding how rail service is allocated to its customer base. And what is equitable and how much flexibility should be permitted as the market shifts from surplus capacity to shortage are questions that beg some attention.

The courts have made at least one recent statement on this topic. In a court case challenging an ICC decision before the 8th Circuit in 1993, that Court stated, "Congress intended the common carrier obligations to continue to apply to a rail carrier's conventional tariff service....Although a rail carrier may offer other forms of service through contracts or premium tariffs, no shipper must... (use) these special offerings simply to receive common carriage. Thus, the special service may not so adversely affect the carrier's conventional tariff service as to prevent or frustrate its ability to meet its common carrier obligations through that conventional tariff service." With the current direction of rail service, in particular during service shortages, pushing more of the risk to various market segments, the Surface Transportation Board or some other body may need to determine a reasonable standard of service distribution under the law. Rail customers need some degree of predictability in their operations regardless of the type of rail service they request.

Arbitration is providing some dispute resolution in agricultural rail markets:

In 1997, several points of potential business conflict between rail carriers and agricultural shippers were jointly identified by railroads and shippers as arbitrable, and NGFA, the major carriers and AAR agreed to develop a private arbitration system to handle such disputes. Issues subject to this arbitration system include: 1) application of demurrage terms; 2) misrouting of rail cars; 3) disputes regarding bills of lading; 4) disputes on rail contracts; 5) disputes involving the mishandling of private cars; and 6) disputes involving the lease of property owned by a railroad or affiliate company (including real estate leases). This arbitration system has proven to reduce friction and litigation between railroads and agricultural shippers and continues to serve the industry well today. Amendments to these arbitration rules are subject to review by a committee consisting of one-half rail shippers/receivers and one-half rail company representatives. The system is administered by the corporate secretary of the National Grain and Feed Association. Findings of arbitration panels are binding upon both parties and readily enforceable in courts, if necessary. This arbitration system has been an important business tool for the members of the National Grain and Feed Association, but of course, is not a tool that is available to other rail users outside our membership.

While the NGFA's Rail Arbitration System has reduced friction, it has not eliminated all policy disputes and points of contention between NGFA members and major rail carriers. For the last two years, NGFA's Rail Shipper/Receiver Committee has engaged the railroads in additional dialogue on a number of current topics which agricultural rail customers believe need to be addressed. Among these issues (not all of which apply to all the carriers) are: 1) high deductibles and minimums on loss and damage claims; 2) rail seals and rail car security on food grade shipments and the impact of broken seals on loss and damage claims; 3) reciprocity and equity in credit terms between railroads and their customers; 4) fuel surcharges passed back to rail customers in ways that create inefficient transfers of risk to customers, and in some cases creating hidden rate increases (this issue is particularly troublesome for our industry as tight margins are heavily impacted by monthly adjustments in rail rates caused by fuel surcharge pass-throughs); 5) mergers of railroads that have both improved access to on-line points and created higher barriers to accessing off-line points; 6) railroad pricing decisions that are not necessarily based upon different investments by customers in facilities and equipment; and 7) inverse pricing policies (lower rates for similar moves more distant from market on the same line) that can create unpredictable shifts in markets, making future rational investment decisions by affected shippers very challenging.

While our strong preference is to continue to pursue our concerns directly with carriers, rather than pursuing litigation or legislation, we do have concerns about how the economic concentration of many of the major carriers continues to manifest itself in today's marketplace. Increasingly, it seems that some railroads unilaterally establish the terms and conditions of transportation rather than more actively pursuing customer needs. While there is no doubt that the major carriers have significant market power in the short term, and can in fact dictate terms, the long-term implications of not responding to customer needs may well be loss in profitable business volume. That's not good for our industry, because we want to continue to have access to the opportunities that rail markets provide. In some cases those rail markets are the best markets with the highest prices being offered. But grain will, in the long term, not wait forever for rail service. At some stage, and under some set of circumstances, the grain that appears rail-captive will find a different way to get to market. Of course, the individual rail shippers may not survive the transition, and the rail industry may lose business that is not recoverable.

The challenges to the rail industry, including serving a diverse customer base efficiently while also meeting the profit expectations of Wall Street, are as challenging as ever. In the grain and feed industry, there is still substantial diversity of sizes and business needs among shippers and receivers of grain and grain products, and we see this continuing into the foreseeable future. In an effort to sustain rail business volume and rail modal share within our industry, we would urge that Congress and the STB to support policies that will permit the railroads to be more responsive to customers and provide reasonable rail service to a diverse agriculture-related customer base.

We appreciate the opportunity to comment for the record of this hearing.

Sincerely yours,

Kendell Keith

Kendell W. Keith
President

cc: The Honorable Corrine Brown, Ranking Member
The Honorable Thomas Petri
The Honorable Sherwood Boehlert
The Honorable Howard Coble
The Honorable John Mica
The Honorable Spencer Bachus
The Honorable Jerry Moran
The Honorable Gary Miller
The Honorable Jim DeMint
The Honorable Rob Simmons
The Honorable Shelley Moore Capito
The Honorable Todd Platts
The Honorable Sam Graves
The Honorable Jon Christopher Porter, Sr.
The Honorable Nick Rahall
The Honorable Peter DeFazio
The Honorable Jerrold Nadler
The Honorable Bob Filner
The Honorable Elijah Cummings
The Honorable Earl Blumenauer
The Honorable Leonard Boswell
The Honorable Julia Carson
The Honorable Mike Michaud
The Honorable William Lipinski
The Honorable Jerry Costello

BEFORE THE

HOUSE TRANSPORTATION AND INFRASTRUCTURE COMMITTEE

SUBCOMMITTEE ON RAILROADS

STATEMENT OF THE WESTERN COAL TRAFFIC LEAGUE

MARCH 31, 2004

Mr. Chairman, Members of the Subcommittee:

This statement is submitted on behalf of the Western Coal Traffic League ("WCTL") to the Subcommittee on Railroads on the hearing denominated the Status of Railroad Economic Regulation. WCTL is pleased to share its views on this important topic and respectfully requests that this statement be included as part of the Subcommittee hearing record.

I.

IDENTITY AND INTEREST OF WCTL

WCTL is an association formed in 1976 whose membership is composed of electric utilities and power generators, located throughout a broad geographic spectrum in the country, that purchase and ship coal mined west of the Mississippi River. WCTL members collectively consume more than 140 million tons of coal annually that is moved by rail. A list of WCTL's membership is appended as Attachment 1.

The topic of this hearing, the Status of Railroad Economic Regulation, is of considerable interest to the members of WCTL, all of which are subject to monopoly or duopoly pricing power. The cost of rail transportation is a significant component of the cost of generating electricity, and these costs ultimately are borne by millions of residential and commercial electric utility ratepayers as part of their monthly electric bills.

WCTL has actively participated in matters before the Surface Transportation Board ("STB") and its predecessor, the Interstate Commerce Commission ("ICC"), the courts, and Congress for many years in promoting pro-competition policies and in helping to ensure that, in the absence of competition, sufficient regulatory measures remain in place to provide protection for captive rail shippers from railroad monopoly pricing and service failures.

II.

THE STATUS OF THE RAILROAD REGULATORY SYSTEM

A. The Failure of the STB to Implement the Staggers Act Mandates

WCTL believes that a central role of the STB in the railroad regulatory arena is to provide transportation policies that help ensure that free enterprise, commerce, and competition are allowed to flourish while protecting consumers from economic abuses by the highly concentrated railroad industry. Unfortunately, the STB has failed in this mandate. The agency has interpreted its regulatory authority in a manner that does not allow competitive forces to operate as Congress intended when it enacted the Staggers and ICC Termination Acts. The Staggers Act's core principals; i.e., (1) the protection of shippers who are dependent on a single railroad for service and (2) the promotion of intra-rail competition, have gradually been whittled away, largely as a result of the failure of the ICC/STB to promote policies that would create a level marketplace playing field between railroads and shippers.

1. ICC/STB Approval of Mergers and the Rationalization of Rail Lines

Since 1980, the number of major Class I railroads has shrunk from 42 to 4, and the ICC/STB has approved almost every merger that has come before it. Today, two major railroads control the western marketplace, the Union Pacific Railroad ("UP") and The Burlington Northern and Santa Fe Railway Company ("BNSF"). This reduction in railroads has resulted in a decline in service and competitive options for railroad customers. Meanwhile, since 1980 Class I railroads have sought and received approval from the ICC/STB to shed more than 60% of their route miles. Some of these lines were spun-off to short line operators and others were permanently abandoned.

2. The Economic Exploitation of Shippers

While the ICC/STB has steadfastly approved railroad merger and abandonment applications, the agency unfortunately has failed to achieve balance in its decisionmaking. There is no question that captive shippers are exploited economically by the railroads because of their captivity, and the railroads readily admit this. Such rate pricing strategies are called "differential pricing." However, the Staggers Act was designed to achieve a balance: railroads would be allowed to consolidate and shed off certain unprofitable rail assets, while shippers subject to market dominance would receive rate protections under the Board's rate reasonableness standards and the agency would promote policies to promote intramodal rail competition to protect shippers from the economic power of the concentrated rail industry.

The recent results of rate reasonableness cases before the STB raise serious questions about the regulatory backstop protections afforded under the law. For example, for typical unit-train western coal movements from the Powder River Basin ("PRB") coal mines, the prescribed rates in the STB's 2003 Texas Municipal Power Agency decision (STB Docket No. 42056) results in shipper charges on a ton-mile basis that are significantly higher than the rates prescribed in the Board's 2001 Wisconsin Power and Light decision (STB Docket No. 42051) for very comparable movements, and the rate differential under the two decisions is expected to increase significantly in future years. Also, in the Wisconsin Power and Light decision, the involved carrier obtained substantial profits as the Board prescribed rates under the governing Coal Rate Guidelines at 180% of the variable costs of service.

More recently, in the past five months, the Board has issued decisions in three eastern coal rate cases. In those cases, the Board has authorized the involved carriers to impose rates that are at least 50% higher than the involved expiring contract rates, and 4-5 times higher than the rates prescribed in its Wisconsin Power and Light decision. In these eastern decisions, even where the Board awarded the shipper rate relief, the prescribed revenue/variable cost ratios for involved individual movements based on the Board's cost findings are upwards of 450%.

It is important to stress that existing STB statutory protections are the absolute minimum necessary to protect shippers against economic abuses of the railroads in the provision of rail transportation service. With that said, serious questions have been raised as a result of the Board's recent decisions as to the effectiveness of the governing railroad rate remedies, as currently interpreted by the STB, even for high-volume, unit-train, bulk commodity shippers.

WCTL fully agrees with the viewpoint voiced by STB Chairman Nober in the trade press that in order to improve and grow their business, the railroads must focus on customer service and improving operations and "[t]he only way railroads will succeed in the long term is to shed the mindset that their return on investment should be guaranteed." Unfortunately, from the perspective of railroad customers, what the STB has failed to recognize is that there is no incentive under the existing regulatory regime for individual railroads to improve their business models in a manner that will benefit themselves and their customers. History demonstrates that as long as the railroads continue to operate under statutory/regulatory policies that favor protectionism over competition, there will be no such needed business transformation.

It bears noting that the recent railroad rate case successes appear to have emboldened the railroads to seek additional incremental revenues -- even from their customers that possess dual carrier rail service at destination. UP has very recently published on its website a new pricing circular applicable to PRB unit coal train operations. UP characterizes its circular, denominated UP Circular 111, as a method to "simplify" coal transportation pricing. This program is designed to provide UP with a standardized contract, and favorable rate and service terms that it desires to impose on its captive and competitive customers. UP claims that its program is designed to ensure its customers will engage in "a fair sharing in the overall financial burden associated with Union Pacific's significant coal-related capital needs."

UP is not alone in its public pricing initiative. UP's marketplace competitor, BNSF, implemented a very similar public pricing program in 2002, denominated Common Carrier Pricing Authority BNSF 90068, also applicable to PRB unit train coal operations. Under this program, BNSF has published on its website certain rates available for various coal shippers. BNSF announced that its "public market-based pricing" initiative was "an opportunity to better balance supply and demand at prices that reflect market conditions."

While it is too early to determine the results of UP and BNSF's coal pricing programs, or how or if these two initiatives will interplay, what remains clear from the information provided is that both railroads believe that their programs will help provide them with incremental economic (and other) benefits at the expense of coal shippers. There is no indication that either of these initiatives will provide shippers with more competitive rates or better service.

B. The Need for Modest Pro-Competitive Statutory Corrections

A central role of Congress is to provide effective oversight of the STB, and in particular, to ensure that the agency administers the law in an efficient, open, and evenhanded manner and implements appropriate and reasonable standards consistent with its statutory directives. In light of the problems in the administration of the existing rail regulatory system, clearly much more must be done to improve railroad competitive balance.

WCTL remains extremely concerned that the Board has effectively ignored the need for substantive administrative relief in favor of the implementation of certain process initiatives. Through its Ex Parte No. 638 proceeding, the STB has taken actions to "streamline" rate reasonableness proceedings and improve the process for resolving discovery disputes in individual adjudications. The Board also has been holding public voting conferences and hearings, requiring parties to file public versions of pleadings and evidence, and promoting the private resolution of disputes through the implementation of alternative dispute resolution (i.e., mediation). While these procedural initiatives benefit both shippers and the railroads, and contribute to more open government, they will do little to quell concerns by affected captive rail shippers about the prospects for substantive relief before the STB, or the need for the implementation of more pro-competitive railroad policies.

In light of the considerable concentration in the rail industry, and the failure of the agency to implement more pro-competitive railroad policies, WCTL believes that it is essential that actions be taken by Congress to protect shippers from the economic power of the concentrated rail industry and restore balance to the decisionmaking process. In this regard, WCTL has participated with other shipper associations in the development of STB regulatory reform legislation, including H.R. 2924, the Railroad Competition Act.

WCTL has long recommended that the STB take several of the specific steps included in H.R. 2924 to improve the competitive rail transportation options of rail shippers. These legislative revisions include: (i) reconsideration and reversal of the Board's 1996 "Bottleneck" decision, (ii) modification of the Board's "competitive access" rules (involving reciprocal switching and joint use of terminal facilities) by eliminating the requirement that the shipper prove anticompetitive conduct on the part of the incumbent rail carrier, and (iii) elimination of the railroads' implementation of so-called "paper barriers" in the future (and those that have been in place for at least 10 years) that effectively block a shipper's ability to receive competitive rail service from short lines and their connecting Class I carriers. Thus far, the STB has refused to adopt these proposals, indicating that it is the Congress, and not the Board, that should consider whether changes in the Board's enabling statutes to promote intercarrier competition are warranted.

The STB, unlike other similar agencies such as the Federal Energy Regulatory Commission, has been unwilling to take a leadership role on core competitive issues affecting the nation's rail commerce. It is therefore up to Congress to change the regulatory status quo and the existing special competitive protections enjoyed by the railroads. Modern economic policy and the history of deregulation of similarly situated industries (e.g., the airlines, telecommunications, and natural gas pipelines) demonstrates that the maintenance of entrenched protected monopolies is detrimental to consumers, the economy, technological innovation, and service improvements. In these industries, Congress has correctly declared that promoting competition -- not protecting monopolies or guaranteed rates of return -- should drive national policy.

The Congress should enact modest changes to the statutory scheme administered by the STB as contained in H.R. 2924 in order to promote more efficient and competitive rail service, and help assure fair and reasonable rates where competition is absent.

1. The Railroads' "Revenue Inadequacy" Fallacy

Unfortunately, to the detriment of the economy, rail customers, and even the railroads themselves, the railroads have thus far been able to stave-off the implementation of pro-competitive, deregulatory policies by the Congress. The railroads' steadfast resistence to the enactment of policies enhancing rail competition has in large-part been driven by a harkening back to the dismal state of the rail industry a quarter of a century ago, prior to the enactment of the Staggers Rail Act of 1980. The railroads claim that any measure to enhance rail-to-rail competition will cripple the industry financially, cause a reduction in service, prevent it from making necessary capital investments, and return it to never-ending unprofitability.

Suffice it to say, WCTL would not be supporting H.R. 2924 if it believed that the legislation would result in economic calamity for the rail industry or harm essential services. The reality is nothing could be further from the truth. What WCTL desires, and what it strongly believes H.R. 2924 would accomplish, is a modest step forward in enhancing rail competition and service and an improvement in railroad profitability. H.R. 2924 would cause no abrupt changes in the industry or the way railroads operate, other than to direct reasonable changes to help ensure that competitive forces, rather than protectionism, should guide the industry, as well the STB in its application of the law.

In fact, the railroads themselves have been touting the very same benefits of competition when it serves their interests in the context of recent rail merger proceedings. For example, CSX and NS justified their huge, multi-billion dollar investment to acquire Conrail largely on the premise that they would gain additional revenue from new competition (at reduced rates) for north-south intermodal traffic along the East Coast that would divert one million trucks annually off the highways and onto rail. These carriers have been highlighting such competitive accomplishments over the past several years in their annual filings with the STB as part of the agency's ongoing oversight of the Conrail acquisition.

This premise that competition actually results in improved revenues, and enhancements in innovation, service, and investment is borne out by experience in transporting coal from the Wyoming PRB since BNSF's monopoly over rail transportation of this coal was removed in 1984. BNSF had argued that the new rail-to-rail competition would result in a loss of traffic and revenue and cause it to "sharply curtail its investment to increase capacity on affected coal routes." In fact, BNSF's Powder River Basin coal tonnage grew by more than 95% from 1985 to 1999, its coal revenue grew by nearly 90% during the same period, and BNSF continued to invest huge sums for capital improvements to enhance its coal-carrying capacity.

Even if the railroads could demonstrate that the adoption of pro-competitive policies would result in a modest reduction in their revenues, which they have not come close to establishing, the railroads' claims concerning a possible return of the industry to the bankruptcy days of the late 1970s holds no water given the dramatic rationalization of their systems and their removal of inefficient assets that have occurred since the passage of the Staggers Rail Act of 1980. As referenced above, since 1980, Class I rail carriers have sought and been allowed to reduce their physical rail route structure by over 60% through abandonments or sale of non-essential facilities which the railroads profess has been a "resounding success" in promoting their ability to profitably and efficiently serve their customers. With the significant rationalization of their systems, the railroads are no longer retaining unprofitable assets that have the potential to drain their resources and drag down their systems.

Finally, the railroads have constantly proclaimed the need for regulatory protections because of their failure to earn their STB-determined "cost of capital." Even if it were determined that as a matter of policy, some level of railroad profitability should be guaranteed and subsidized by railroad customers -- a policy WCTL firmly believes is indefensible -- such statements are highly misleading.

The railroad industry certainly is not the pauper it claims to be. For example, in the past year, BNSF has raised its dividend by 25% and has announced that it will generate significant free cash flow of between $350 - $500 million annually over the next several years. This is cash available after providing for all of its capital investments. Additionally, BNSF has re-purchased approximately 20% of its outstanding shares over the past five years, spending nearly $3 billion to repurchase 119 million shares from the market. Clearly, BNSF's officers and shareholders would not allow it to engage in such an enormous a stock buyback program if they truly believed BNSF was not making a good investment or otherwise had a better place to invest its significant cash profits. Elsewhere, UP generated $500+ million in free cash flow in recent years, and forecasts similar levels of free cash flow into the future. UP also has substantially raised its dividend in the past year. The railroads' cost of capital arguments are dubious at best.

WCTL respectfully submits that the facts show that the railroads are generating enormous and enviable cash flows that belie any claims to the contrary and Congress need not be concerned about the demise of the rail industry should it inject a small measure of additional competition into the industry.

* * *

Current railroad statutory and regulatory policies that give preference to railroad revenue maximization at the expense of shippers and the public's ability to receive an adequate and economical service are questionable at best, and have led to an unbalanced economic playing field between the railroads and their customers. The Subcommittee should closely examine the propriety of such policies as it engages in the review of the STB and the railroad transportation laws. WCTL understands that railroad competition issues are contentious, and that more than one option exists for dealing with the competitive problems in the rail industry. WCTL welcomes the opportunity to participate in a further dialogue on these issues and will be pleased to provide the Subcommittee with any additional information it may desire on any of the matters discussed in this statement

Attachment 1

WESTERN COAL TRAFFIC LEAGUE MEMBERS

Alliant Energy

Arizona Electric Power Cooperative, Inc.

Associated Electric Cooperative, Inc.

Cleco Corporation

City of Austin, Texas

City Public Service Board of San Antonio

Kansas City Power & Light Company

Lower Colorado River Authority

MidAmerican Energy Company

Minnesota Power

Nebraska Public Power District

NRG Power Marketing Inc.

Omaha Public Power District

Texas Genco, LP

Texas Municipal Power Agency

Westar Energy

Western Farmers Electric Cooperative

Wisconsin Public Service Corporation

Xcel Energy

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KENNETH W. THOMPSON

PAUL F. NAUGHTON

April 20, 2004

The Honorable Jack Quinn
Chairperson, Subcommittee on Railroads
Committee on Transportation and Infrastructure
U.S. House of Representatives
Room 589 Ford Building
Washington, D.C. 20515

Dear Chairman Quinn:

I am enclosing a statement by Mr. B. K. Chin, Chief Operating Officer of Air Liquide America regarding your March 31st hearing on the Surface Transportation Board. I ask that Mr. Chin's statement be included in the official record of the hearing.

Thank you.

Sincerely,

Kenneth W. Thompson

AIR LIQUIDE

April 16, 2004

B. K. Chin
CHIEF OPERATING OFFICER

The Honorable Jack Quinn
Chairperson, Subcommittee on Railroads
Committee on Transportation and Infrastructure
U.S. House of Representatives
2165 Rayburn – Building
Washington, D.C. 20515

Dear Chairman Quinn:

I am writing in support of H.R. 2924, "Railroad Competition Act," and to inform you of the economic disadvantage that Air Liquide America is suffering as a result of the monopolistic practices exercised by rail carriers.

Air Liquide America is one of the largest industrial gas suppliers in the United States with our North American headquarters based in Houston, Texas. We supply oxygen, nitrogen, argon, hydrogen, helium, carbon dioxide, and many other gases and services to most industries, including steel, oil refining, chemicals, glass, electronics, healthcare, food processing, metallurgy, paper, and aerospace. Air Liquide America has 132 production facilities and employs 3,300 people in the United States. We supply a broad range of products and services to our customers in all 50 states. We deliver product direct to our customers via compressed cylinders, bulk liquid transports, on-site generating plants, pipelines, and tank cars. The primary products that Air Liquide ships via rail are bulk liquid argon and bulk liquid carbon dioxide in cryogenic tank cars. These products are shipped from primary production facilities located throughout the U.S. directly to customers as well as to other Air Liquide distribution centers for repackaging and/or further distribution via truck/transport.

Our Gulf Coast network, with its hub in Pasadena, Texas, is one of the largest argon producing complexes in the world. From this network, we ship argon to customers in California, Arizona, Utah, Colorado, and several points in the Midwest. We also ship argon from Plaquemine, LA and Beaumont, TX to locations in the Midwest, Northeast, and Southeastern states. We are dependent on rail carriers to provide efficient transportation from the Gulf Coast to these markets at a fair and reasonable cost. Monopolistic rail practices threaten our ability to compete with local and foreign producers.

Air Liquide also utilizes rail to transport bulk liquid carbon dioxide from 14 facilities to supply food, beverage, oil recovery, and other industrial applications throughout the U.S. Of these 14 locations, only two are "open" to competition. Air Liquide offered over 2700 tank car shipments to rail carriers in 2003. The majority of this rail transportation is "captive" rail traffic. The lack of competitive rail service ultimately increases the cost of consumer goods in the broad range of industries in which we serve.

Congress enacted the Staggers Rail Act in 1980 with the objective of deregulating competitive rail traffic and retaining certain targeted protections for "captive" rail traffic that have no realistic transportation alternative except a single rail carrier. Congress also expected the rail industry to evolve toward a competitive environment, where the market governed the relationship between rail carriers and their customers. Air Liquide America endorses Congress' objective in the 1980 legislation and welcomes any market environment where willing buyers and willing sellers gather toward mutual agreement.

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Unfortunately, three regulatory actions have distorted and undercut the provisions passed by Congress in 1980. These actions were:

- The "bottleneck" decision.
- The "competitive access" ruling of the mid-1980's
- The approval of "paper barriers" imposed as a condition to the sale of track from major carriers to short line railroads.

The impact of these three regulatory actions has reduced the number of major carriers from over forty in 1980, when the legislation passed, to only seven today. As can be expected with industry monopolies, this featured an increase in market power exerted by the remaining carriers. Air Liquide America, and our customers, suffer the imposition of that market power as "captive" rail customers.

The higher rates paid by "captive" rail customers penalize United States industries in highly competitive global markets. Air Liquide also distributes argon from our production facility in Scotford, Alberta, (Canada). Air Liquide America's Gulf Coast production facilities are "captive" rail traffic moves. Our transportation rates are substantially higher than those from our Canadian plant that is not a "captive" line of rail traffic. Due to the higher transportation costs we incur as a "captive" rail user, we are able to sell argon to Canadian customers at a price less than we can sell to comparable customers in the United States. Air Liquide America has facilities at twenty-four other locations throughout the United States that are also "captive" rail users, and subject to the burden of monopolistic rail freight rates.

Air Liquide America is pleased that you are holding hearings on the operation of the Surface Transportation Board and the challenges faced by captive rail customers. I urge the subcommittee, as well as the full committee to report H.R. 2924, favorably to the full House of Representatives. Only with the enactment of H.R. 2924 can Congress restore the original intent of the Staggers Rail Act of 1980 and ensure movement towards a competitive environment.

Sincerely,

BK Chin

PCA
Portland Cement Association

April 29, 2004

The Honorable Jack Quinn
Chairman, Subcommittee on Railroads
Committee on Transportation and Infrastructure
U.S. House of Representatives
Washington, DC 20515

The Honorable Corrine Brown
Ranking Democratic Member, Subcommittee on Railroads
Committee on Transportation and Infrastructure
U.S. House of Representatives
Washington, DC 20515

Subject: **March 31, 2004, Hearing on the Status of Railroad Economic Regulation Statement for the Hearing Record**

Dear Chairman Quinn and Ranking Member Brown:

On behalf of the Portland Cement Association (PCA), a trade association representing virtually all domestic producers of portland cement, I appreciate the opportunity to submit a statement to the House Subcommittee on Railroads regarding the March 31, 2004, hearing on the status of railroad economic regulation.

Portland cement is a manufactured powder which acts as the glue or bonding agent that forms concrete. As an essential construction material and a basic component of our nation's infrastructure, portland cement is utilized in numerous markets, including the construction of highways, streets, bridges, airports, mass transit systems, commercial and residential buildings, dams, and water resource systems and facilities. The low cost and universal availability of portland cement ensure that concrete remains one of the world's most essential and widely used construction materials.

PCA's 45 member companies, which operate 101 manufacturing plants in 35 states and distribution centers in all 50 states, rely on rail transportation for more than 50 percent of cement shipments annually. More than 80 million tons of cement was domestically produced in 2002, while 104 million tons was consumed. Most bulk cement shipments are from the manufacturing plants to the more than 400 regional distribution terminals, where it is then delivered by truck to local contractors and ready mixed producers. It is vitally important to our industry that the railroads provide reliable, efficient and cost-effective service to meet the widespread demand for our product. The railroads also transport millions of tons of coal to

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fuel cement manufacturing plants each year. Most cement facilities are captive to one railroad.

As you know, the Staggers Act of 1980, which limited railroad industry regulation, has improved the industry's efficiency and financial stability over the past 24 years. However, since deregulation, there has been a sharp decline from 63 Class I railroads in 1976 to just four major Class I railroads today. This consolidation has contributed to diminished competition as well as inconsistent and ineffective rail service for our industry and others. Inadequate rail service is the principal reason PCA supports H.R. 2924, the Rail Competition Act of 2003.

Service Issues

Unreliable service from the Class I railroads is the most serious problem the portland cement industry confronts bringing an affordable product to market. Service encompasses many aspects of the shipment, including picking up cars, on time delivery of cars, providing empty cars, handling issues, questions about the condition of the cars, and settling claims for service failures. The cars supplied by the railroads are typically old, poorly maintained and frequently a safety concern. In some instances, as many as 15 percent of the empty cars delivered to manufacturing plants in a given week can be rejected.

In recent years, some cement companies have been forced to purchase private cars since the Class I railroads have refused to add cement cars to their fleet. This, in addition to the declining and inconsistent service, has increased the need for more cars to deliver the same tonnage. Meanwhile, the railroads have added tariff provisions charging for the storage (demurrage) of private rail cars. This results in further increased costs to the cement shipper while providing no incentive to the rail carriers to improve their service.

Further compounding the problem is the fact that at some locations, the railroad will only quote freight rates if you use their system cars. In short, no product will move from that origin unless the railroad is collecting revenue for the use of their cars. In other instances, the railroad will quote rates such that the difference in cost of a move in a system or private car is so great that private car transports are not economical. Car supply is a classic "Catch 22" situation that unnecessarily adds to the cost and efficient shipment of our product.

Rail Rates

As rail service continues to decline, cement manufactures are experiencing sharp rail freight rate increases (in some cases more than 25 percent in one year), transit times on empty return cars have increased by more than 13 percent in some instances, increasing fleet storage costs.

The railroad industry's claim that rates have decreased since deregulation is misleading. There was a period of several years after deregulation where the rail carriers reacted very competitively and many rates were reduced. However, a large percentage of these reductions were for unit trains of coal shipped to large utility companies. There were also some rate reductions as rail carriers reacted to some shippers switching to alternative modes.

Other Cost Increases

Over the past few years, cement companies have experienced dramatic total cost increases from the Class I railroads. These increases, while not applied directly to the freight rates, have greatly increased the cost of doing business with the railroads. The following are a few examples of such costs.

Within the last few years, the railroads have instituted a new rule called "Storage of private cars on railroad property." These charges can be significant and are similar to demurrage, which is charged for railroad-owned system cars. Conversely, the carriers have been unwilling to compensate cement shippers as car owners for "car days" they cause by poor and inconsistent service.

Some cement shippers have experienced situations where the carriers have changed routings for their operating convenience. These changes often increase the miles a car travels from its origin to destination, as well as increased the transit times. This is a real cost, and the carriers will not compensate for days lost due to their error. Cement shippers are also experiencing cases where the carriers have increased empty return transits. Again, this has cost cement shippers "car days," for which the carriers will not accept responsibility.

Real estate leases and right-of-ways are areas where carriers have increased costs dramatically. Many cement companies lease property, track, or right-of-ways at plant and terminal locations and have experienced increases up to ten times the existing leases up for renewal.

The carriers have instituted fuel surcharges, over and above regular annual increases. At least one cement company has disputed the methodology and amounts of these increases. The data, which was presented to the carriers, indicate they are more than recovering the increased cost of fuel. The response has been smug and unrelenting. One carrier recently said, they cannot apply fuel surcharges to some of their long-term coal and steel contracts, so they must recover those incremental fuel increases from shippers of other commodities.

Administratively, the railroads have dramatically cut staff and have done a good job of cutting their overhead costs over recent years. Unfortunately, the shipping public has suffered for it. Working with the carriers has become even more frustrating as shippers try to dispute incorrect invoices, resolve service failures, or just get answers to questions. While these issues also increase the "cost" of doing business with the railroads, they are difficult to quantify.

Finally, the railroads recently implemented a program called WILD (Wheel Impact Load Detector) to measure wheel roundness with an automated device as railcars run over the tracks. The railroads replace the wheel(s) of cars violating the specification standard and the car owner is then billed. The theory is this will reduce track wear and thus reduce track repair costs for the railroads. The result is higher overall costs; however, the railroads win twice as they make money at their shops and probably slightly reduce track maintenance. We perceive this as another method for the railroad to shift costs to shippers and owners of cars.

The lack of rail competition is the fundamental issue associated with many of these problems. PCA believes it is important to strike a balance between regulation of the railroad industry while also assuring rail competition. We urge Congress to approve H.R. 2924, the Railroad Competition Act of 2003, which provides greater flexibility to address service and competition problems. PCA appreciates the opportunity to express its views on rail shipping issues.

Sincerely,

David S. Hubbard
Director, Legislative Affairs

Submitted by:
ATOFINA Petrochemicals, Inc.
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ATOFINA

ATOFINA Petrochemicals, Inc.

Carville, LA
STB Enforces Railroad Bottleneck

ATOFINA Petrochemicals, Inc. operates a plastic resin production facility at Carville, LA, which employs 400 people and produces more than 3.4 billion pounds of product annually. Carville is an industrial area located on the lower Mississippi River approximately 15 miles south of Baton Rouge, and is served exclusively by the Canadian National Railway (CN) (which obtained the route from Illinois Central Railroad (IC) in its 1999 merger). The CN route follows the river between New Orleans and Baton Rouge.

In 1995 Kansas City Southern Railway (KCS) proposed to extend its Louisiana rail network, which runs inland between New Orleans and Baton Rouge, to serve the Geismar, LA industrial area, approximately 3 miles down-river from Carville. The proposed line was less than 9 miles in length. That effort was cut short in 1998 when, while awaiting Surface Transportation Board (STB) approval, KCS and CN entered into a joint marketing agreement in conjunction with the proposed merger of CN and IC. As part of that arrangement, CN agreed to provide haulage on behalf of KCS for the traffic of three chemical shippers at Geismar who furnished supporting statements for the KCS build-in. The STB then ordered the Geismar build-in application to be held in abeyance.

In approving the CN/IC merger, the STB granted the request of three other Geismar shippers, located adjacent to the plants to be served via haulage, to be included in the haulage arrangement. The STB found that the Geismar haulage arrangement ("Access Agreement") clearly was related to the CN/IC merger. The STB further found the Access Agreement would cover the preponderance of traffic necessary to make the construction economically viable, and so concluded that it was improbable that KCS would pursue, or the STB would approve, the construction project, and consequently that the arrangement would result in a reduction in competition. For all practical purposes, the joint marketing arrangement and the Access Agreement extinguished the KCS build-in to Geismar and its surrounding area; and the STB recently dismissed the KCS build-in application.

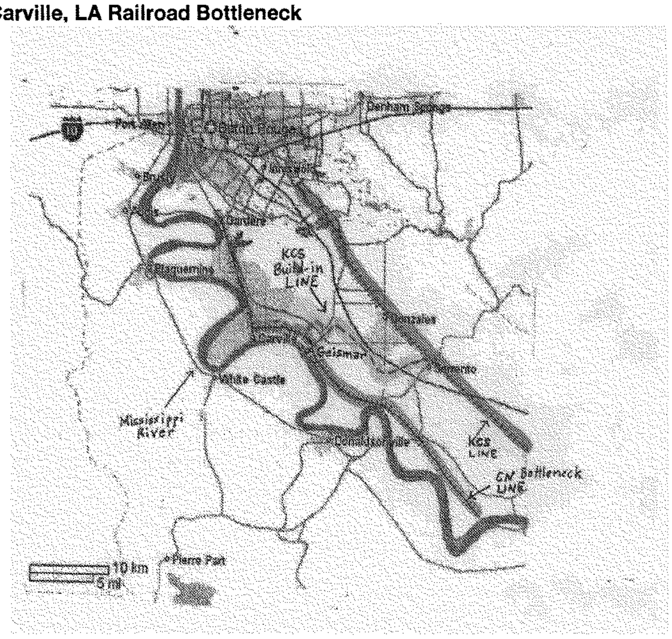
In June, 2002, ATOFINA and KCS jointly asked the STB to interpret and enforce its expansion of the Geismar haulage arrangement as extending to all parties who could have been served by KCS through the build-in. This would include ATOFINA, conditioned on construction of a rail line of approximately 3 miles from its Carville plant to Geismar. That remedy would have preserved ATOFINA's rights as if the KCS line had been built.

The ICC Termination Act requires the STB to consider whether a rail merger "would have an adverse on competition among rail carriers in the affected region . . ." 49 U.S.C. §11324(b)(5). Regardless of the number or identity of shippers who ask for remedial relief in a merger proceeding, it is the Board's duty to consider the effect of the merger on "competition among rail carriers in the region." In this case, the region is Geismar, not individual shippers; and all shippers in the region who could have been served by the line proposed by KCS suffer the same competitive loss as those specifically included in the haulage arrangement either by agreement of CN and KCS or by the STB.

While the STB retained oversight over the CN/IC merger in order to address issues of competition in the Baton Rouge--New Orleans corridor, it denied the ATOFINA/KCS request on procedural grounds. Thus, twice the STB failed to protect competition for Carville traffic against loss in a merger: first when it ignored the loss of competition to the Geismar region in the CN/IC merger—facts clearly before it in the KCS build-in application proceeding which the STB on its own motion incorporated into the merger proceeding—but instead addressed loss of competition only for the complaining shippers, and second when the STB denied the ATOFINA/KCS petition on procedural grounds and refused to address the merits and to correct its earlier failure to comply with its statutory duty. Effectively, the STB has reinforced CN's bottleneck control at Carville.

The Railroad Competition Act of 2003, S. 919 and H.R. 2924, would cure the STB's failure to protect the Carville shippers by requiring CN to quote rates to New Orleans or Baton Rouge, where competitive service is available.

Carville, LA Railroad Bottleneck



Submitted by:
ATOFINA Petrochemicals, Inc.
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ATOFINA
ATOFINA Petrochemicals, Inc.

Bayport, Texas Build-in
An Opportunity for Rail Competition

In June 2001, ATOFINA Petrochemicals, Inc., joined with three Bayport based petrochemical producers, Basell USA Inc., Equistar Chemicals, LP and Lyondell Chemical Company, and with The Burlington Northern and Santa Fe Railway Company (BNSF) to form San Jacinto Rail Limited (SJRL) to develop a new rail line of approximately 12.8 miles in length to bring competitive rail service to the Bayport Industrial District. The area currently is exclusively served by Union Pacific Railroad (UP). The joint venture was formed after approximately 2 years of negotiation.

SJRL, once established, will be able to serve not only the four producer partners, but also the majority of the more than 20 petrochemical production facilities at Bayport, one of the largest petrochemicals industrial areas in the world. The line is expected to carry an average of two trains per day, one of loaded cars—principally inert plastic materials—and one of empties.

The proposed new rail line is a by-product of the 1996 merger of the Union Pacific and Southern Pacific railroads (UP/SP). To insure a fair and competitive market the STB (Surface Transit Board) imposed conditions in approving that merger that included granting BNSF extensive trackage rights over the lines of the newly formed UP/SP and the right to use its trackage rights over the lines of either pre-merger railroad to serve industries through a build-in to facilities served pre-merger exclusively by the other railroad. These conditions were designed to preserve rail-to-rail competition which otherwise would have been lost due to the merger.

Competitive rail service will enable ATOFINA and other Bayport producers to negotiate transportation rates and service levels, and to be competitive in the world markets for their products. Studies by the American Chemistry Council show that producers captive to a single railroad have rates approximately 25-30% higher than those with competitive options.

SJRL and BNSF applied to the Surface Transportation Board (STB) in August 2001, for authority to construct the new Bayport line. In August 2002, the STB found the new rail line to be in the public interest and granted approval subject to a final environmental review. The STB conducted an extensive environmental review of the proposed rail line construction, which included participation by and input from federal agencies, Texas state agencies, and the City of Houston and other local governmental agencies. The STB conducted 4 field hearings and received over 600 written and verbal comments. In May 2003 the STB issued a final Environmental Impact Statement approving 4 alternative routes and setting forth 80 conditions for route construction. The STB then granted final construction authority.

All routes approved by the STB, both those north and south of Ellington Field, cross City of Houston land. The STB's preferred route is south of Ellington and would require use of approximately 15 acres of a 240 acre tract of land south of Ellington Field, bordering on State Highway 3 and Space Center Boulevard where the new line would connect with a line of the UP. This route, along with those north of Ellington Field, had been developed in consultation with representatives of the City. The nearest residential area, Clear Lake, is across Space Center Boulevard and at the closest to the proposed route is approximately 1/4 mile away.

After having supported increased rail competition and new railroad infrastructure at the time of the railroad service meltdown in Texas and other western states following the integration of UP and SP in 1997-1998, the City opposed the SJRL line construction before the STB. Once construction was approved, the City refused to negotiate over the sale of land for any of the 4 approved routes.

Following the refusal of the City to negotiate, BNSF initiated condemnation of the parcel of land needed for the route preferred by the STB under its power of eminent domain. In a decision issued December 12, 2003, a judge of the County Civil Court dismissed the condemnation action. This decision essentially blocks construction of the new rail line and nullifies the STB's exhaustive environmental review and approval. BNSF filed an appeal with the Court of Appeals for the Fourteenth District of Texas.

As of March 2004 the appeal is in progress.