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STB Ex Parte No. 711

Petition for Rulemaking to Adopt Revised
Competitive Switching Rules

Reply Comments of the
U.S. Department of Agriculture

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Date: May 30, 2013

Authority and Interest

The Secretary of Agriculture is charged with the responsibility under the Agricultural Adjustment Act of 1938 and the Agricultural Marketing Act of 1946 to represent the interests of agricultural producers and shippers in improving transportation services and facilities by, among other things, initiating and participating in Surface Transportation Board (Board) proceedings involving rates, charges, tariffs, practices, and services.

Comments

The U.S. Department of Agriculture (USDA) appreciates the opportunity to offer reply comments in this important proceeding and herein reaffirms its methodology and empirical analysis. We also address some of the concerns expressed by the rail industry in the opening comment phase.

Reaffirmation of USDA Position

As differing comments in the opening round illustrated, various understandings of how the National Industrial Transportation League (NITL) proposal would be implemented resulted in different methodologies to address the Board's request for an empirical analysis of the proposal. Nevertheless, the parties which supplied empirical analysis had similar findings, namely that impacted railroad revenues and traffic volumes would be relatively small. For example, while the analysis of USDA and the U.S. Department of Transportation (DOT) differed in methodology and scope, the conclusions showed the impacted carloads ranged between 1 and 6 percent (see Table 1 below). The estimates of percentages impacted by USDA were higher than those by DOT, but were focused only on grain and oilseed traffic instead of covering all rail traffic. Because the percentage estimates of both Departments were within the "ballpark" of one another, USDA is confident its estimates and the underlying methodology used present an accurate representation of the proposal's expected effects on agricultural shippers and related railroad revenue, given the limitations inherent in analysis of the STB Waybill data that was provided to USDA.

Table 1. Estimates of Impacted Class I Carloads and Revenue from Competitive Switching

Using an Eligibility Threshold of 30 miles at a 240 Percent R/VC

	Carloads		Percentage	Revenue (000)		Percentage
	Total	Impacted		Total	Impacted	
U.S. Dep. of Transportation (all traffic)	26,800,000	360,142	1.3%	\$ 51,800,000	\$ 1,086,300	2.1%
U.S. Dep. of Agriculture (grain and oilseeds)						
Near Perfect Competition	1,831,575	102,022	5.6%	\$ 4,841,000	\$ 176,172	3.6%
Duopoly Competition	1,831,575	99,032	5.4%	\$ 4,841,000	\$ 173,453	3.6%

Furthermore, USDA was able to show through its sensitivity analysis that while 3.6 percent of total grain and oilseed revenue is potentially subject to competitive switching at a threshold of 30 miles and R/VC ratio of 240 percent, the actual change in revenue would likely be much smaller. Given these parameters, rail revenue would only fall by as much as \$70.9 million, assuming near perfect competition, and by as much as \$49.3 million, assuming duopoly competition. This represents 1.5 and 1 percent, respectively, of total Class I revenue from grains and oilseeds (Table 2). This is why USDA suggested that the threshold for eligibility for agricultural shippers

be lowered to an R/VC ratio of 180 percent from an R/VC ratio of 240 percent. Such a change would provide an additional \$35 million in savings to agricultural shippers, assuming near perfect competition, or an additional \$13.2 million in savings, assuming duopoly competition (Table 2). Even at this lower threshold of eligibility, the change in Class I revenue from grains and oilseeds is still no more than 2.2 and 1.3 percent, respectively.

Table 2: USDA Estimates of Impacted Class I Carloads and Revenue for Grain and Oilseeds Using Eligibility Threshold of 30 Miles

Threshold R/VC	Assumption	Impacted Carloads	Change in Revenue	% of Class 1 RR Grain Revenue	% of Class 1 RR Grain Net Income
180	Near Perfect Competition	162,496	\$105,957,176	2.2%	13.8%
240	Near Perfect Competition	102,022	\$70,884,394	1.5%	9.2%
RSAM	Near Perfect Competition	81,684	\$56,941,469	1.2%	7.4%
180	Duopoly Competition	143,105	\$62,491,837	1.3%	8.1%
240	Duopoly Competition	99,032	\$49,260,759	1.0%	6.4%
RSAM	Duopoly Competition	80,094	\$40,757,055	0.8%	5.3%

Evidence Suggests Competitive Switching Can Work

USDA’s estimates of the expected impacts of the NITL competitive switching proposal are bolstered by the real world outcome between shippers and railroads under Canadian interswitching policy.

The comments of Highroad Consulting and the verified statement of Thomas Maville¹ for NITL provide evidence competitive switching does work under the Canadian system. According to Highroad Consulting, 38.7 percent of Canadian National (CN) and Canadian Pacific (CP) traffic was eligible for interswitching at both origin and destination and 91.4 percent was eligible at either origin or destination in 1999. A similar analysis by Maville showed that roughly 37 percent of all CN and CP traffic was eligible for interswitching in 2011. Yet, statistics show that less than 4 percent of all CN and CP freight traffic is interswitched annually.

Canadian interswitching has neither impeded railroad efficiency nor decreased customer satisfaction. Accordingly, USDA expects a similar outcome for competitive switching in the United States, if it is adopted. That is, the majority of traffic will likely remain with its current rail carrier rather than being switched. Under the conditions being considered by the Board, competitive switching should have a minor impact on the status quo rather than a wholesale restructuring of the railroad industry.

Addressing Concerns

In the sections below USDA provides comments addressing some of the concerns raised by the rail industry in opening comment phase.

¹ Opening Comments filed in STB Ex Parte No. 711, *Petition for Rulemaking to Adopt Revised Competitive Switching Rules*, by Neil Thurston of Highroad Consulting, Ltd. (filed March 1, 2013) and Maville V.S. for the National Industrial Transportation League (filed March 1, 2013).

Introduction of Competitive Market Forces into Non-competitive Markets. Opponents to competitive switching have expressed concerns that the proposed policy will interfere with the functioning of market forces. However, market forces do not operate in a vacuum. A well-functioning market operates under a well-conceived set of rules, ensuring transparency for market participants, predictability from market interactions, and penalties when rules are broken. Rather than overriding market forces, a new competitive switching policy would introduce competitive market forces into non-competitive markets.

Currently, there are two broad classes of shippers—those with competitive options and those captive to a single railroad. The proposal before the Board offers a market-based solution to expand the benefits of competition to some shippers while avoiding a major restructuring of the railroad industry. Thus, by expanding the class of shippers with competitive options, more shippers would be able to compete more vigorously in the world market. Meanwhile, the class of shippers left without competitive options would be reduced slightly.

The public interest is best served when the market determines that switching should occur. Yet, a market is composed of sellers and buyers. Railroads enter into voluntary switching arrangements where it makes economic sense to do so. Similarly, this proposal enables additional shippers to enter into voluntary switching arrangements where it makes economic sense to do so. If another carrier can provide more efficient service at a lower cost, a shipper has a clear incentive to take advantage of the alternative service through voluntary switching. In this fact, lies the crux of competitive switching—switching will only occur in instances where another Class I carrier is able to provide more efficient service at a lower cost than the incumbent railroad.

Inefficiencies from Interswitching will be Limited in Scope and Compensated by Shippers.

Opponents to the proposal claim that competitive switching will unconditionally lower revenues while simultaneously increasing railroad costs for each eligible shipment. However, prices and revenues will only decrease in instances where railroads actually choose to compete. The act of granting shipper eligibility for competitive switching will not on its own affect railroad prices or costs; only through competition will any change occur to railroad prices or costs.

In instances where railroads choose to compete, USDA believes the resulting prices offered by each railroad will not be arbitrarily reached but will instead reflect market forces. As such, railroads will still have the ability to price to the market.

Based on testimony in Ex Parte 705 and 711, railroads indicated that interchanges bring inefficiencies into the system, which result in higher costs. However, no additional costs would be incurred if the movement remains with the incumbent railroad, supporting the conclusion that only a small subset of eligible shipments will actually be interchanged under competitive switching.

In instances where interswitching does occur, the switching fee paid by shippers should cover the costs associated with any inefficiencies resulting from interswitching. Thus, the additional costs related to interswitching should be passed on to shippers and not borne by the railroads themselves.

Competitive Switching may Improve Market Efficiency. The additional costs associated with switching will be accounted for in the competing railroad's price. If the competing railroad can still charge a lower price than the incumbent railroad, then economic theory would indicate a shipper should utilize the services of the competing railroad. By not allowing the more efficient railroad to perform the movement, market inefficiency is being perpetuated, resulting in a misallocation of scarce capital by railroads and a deadweight loss to shippers. Therefore, competitive switching offers a method to improve market efficiency.

Competitive Switching may Provide Shippers Additional Markets. Competitive switching offers shippers the option to access additional markets not served by an incumbent railroad. If economically feasible, these new markets could translate into additional revenue for shippers, but may create less efficient routes from the railroad's point of view. In such a case, the inefficiency to the railroad is realized as a service component, convenience, or competitive option to the shipper. On the other hand, shippers' needs should not unilaterally bind the financial and logistical independence of the railroads. Thus, a market based solution would seem to strike a balance whereby additional inefficiencies can be captured through prices. This would present shippers with an expanded array of choices, priced accordingly by the railroads, ensuring the most efficient market outcome is achieved by weighing all the costs and benefits of a particular movement.

Prices Set by Market Forces Result in Economic Efficiency. If an incumbent railroad is pricing to the market, the magnitude of any rate reduction would be by the amount the incumbent's price exceeds the competing railroad's ability to price the movement. Accordingly, it is not the policy itself imposing an artificial rate reduction. Subject to competitive market forces, three possible scenarios emerge:

1. The competing railroad has higher costs than the incumbent railroad and is unable to price movements below the incumbent's price. Under this scenario, no switching would occur as the shipper has no incentive to utilize the higher cost railroad. As such, railroad operations and revenue would remain unchanged.
2. The competing railroad has lower costs than the incumbent railroad and is able to price movements below the incumbent's price. Under this scenario, the shipper has a clear incentive to utilize competitive switching. The incumbent railroad would lose revenue but the competing railroad would gain revenue. This ensures market efficiency.
3. The competing railroad and the incumbent railroad have similar costs. Both railroads would compete on price for the shipper's traffic. If the services are similar, the shipper would utilize the railroad offering the lowest price. How much the price is lowered in this situation depends upon how similar each railroad's costs are. Price could fall by a little or a lot, resulting in a small or large revenue loss to the incumbent railroad or a consequent large or zero revenue gain to the competing railroad.

It is important to keep these possible scenarios in context. Only in the second and third scenarios does a price decrease occur; but in the third scenario the price decrease could affect the railroads' combined ability to contribute to their overhead costs. There is no guarantee that competitive switching will necessarily lower prices for all eligible shippers and the consequent revenue to

railroads. On the flipside, as prices move towards the competitive market price, any unfavorable decrease in a railroad's ability to contribute to its overhead costs will be matched by a beneficial decrease in the deadweight loss to society that results from prices above the competitive price. Economic theory explains that total economic revenue increases as prices approach the competitive price. This ensures the most efficient market outcome as the full amount of shipper demand for rail service is met that otherwise could not in a less competitive market.

The empirical analysis provided by USDA in its opening comments takes into account these three scenarios. As best as possible, only situations from the second and third scenarios are reflected in USDA's impacted carloads and revenue. Stations eligible for competitive switching that fell under the first scenario were excluded.

Additional Benefits of Competitive Switching

Differential pricing is meant to help railroads achieve revenue adequacy, but once reached, it is no longer required under Staggers. With the railroads either being or closely approaching revenue adequacy, the proposal before the Board would appear to present a timely solution for lessening the burden of differential pricing on captive shippers.

In many ways, competitive switching offers some of the benefits of the Stand-Alone Cost (SAC) rate appeals procedure without the accompanying costs. Recognizing the barriers to entry into the rail industry, the Interstate Commerce Commission (ICC) and the Board have both relied upon the SAC test to simulate the competitive rates that would exist in a contestable market. The ICC stated that the "use of SAC introduces the competitive standard of contestability into a non-competitive market."²

Similarly, competitive switching introduces competition into a non-competitive market via an actual railroad instead of a hypothetical one. Actual railroad competition could help judge the reasonableness of rates instead of a costly, lengthy, and time consuming SAC test. Furthermore, the financial and legal burdens of a SAC test are discriminatory in that the ability to judge rate reasonableness is only available to shippers with sufficiently large means. To the contrary, competitive switching would enable all eligible shippers to have actual railroad competition judge the reasonableness of rates, regardless of a shipper's means.

Nevertheless, as shipper testimony in Ex Parte 705 indicated, the opportunity for competition is not always a sufficient condition guaranteeing competition. Thus, the implementation of competitive switching should not foreclose any existing options for rate relief available to shippers.

Conclusion

USDA reaffirms the empirical analysis submitted in its opening comments and believes the empirical evidence demonstrates the proposal for competitive switching before the Board will have only a minor effect on railroad revenues, traffic volumes, and efficiency. Competitive switching offers a market based solution to balance the needs of railroads and shippers and is in keeping with the goals of the Staggers Act. However, USDA believes establishing the

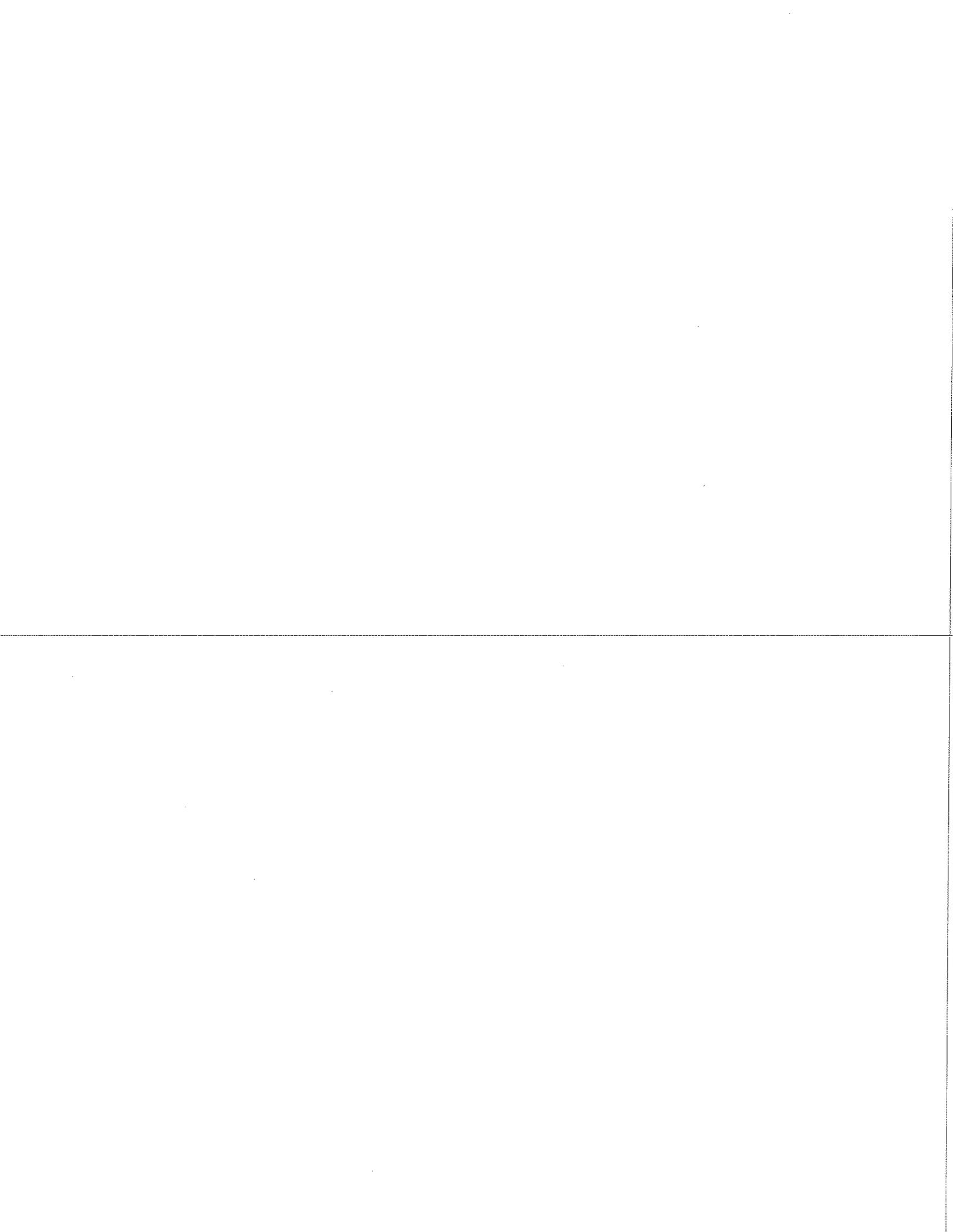
² ICC Ex Parte No. 347 (Sub-No.1) *Coal Rate Guidelines-Nationwide*

opportunity for competition should not foreclose other means of rate relief available to shippers or else competitive switching may have the unintended consequence of leaving shippers in a worse position.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Edward Avalos", written over a horizontal line.

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CERTIFICATE OF SERVICE

I, Brian McGregor, certify that on this 30th day of May, 2013, caused a copy of the foregoing document to be served by first-class mail, postage prepaid, on all parties of record in STB Docket Number EP 711.

A handwritten signature in black ink, appearing to read "Brian McGregor", is written over a horizontal line.

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