BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 705

COMPETITION IN THE RAILROAD INDUSTRY

REPLY COMMENTS OF

HIGHROAD CONSULTING, LTD.

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Interest of Highroad Consulting, Ltd.

I am President and CEO of Highroad Consulting, Ltd., a transportation consulting firm that was founded in 1996. Prior to starting my firm, I had a 27-year career working for two Class I railroads. Over the past fifteen years, we have provided consultation to a diverse client base that includes shippers, carriers, and other organizations involved in, or affected by, freight railroads. Because of my experience, I have the ability to take into account the differing points of view and to focus on assisting with development of practical solutions that are needed to ensure reasonable rates and services for rail customers. The views I present in this proceeding are strictly my own, based on what I believe to be in the public interest.

The Board has requested comments in advance of the hearing that address the following issues:

- the financial state of the rail industry;
- alternative through routes;
- terminal access;
- reciprocal switching;
- bottleneck rates;
- access pricing standards; and
- the impacts of any proposed change upon the rail industry.

The purpose of this statement is to respond or support points made by others in Opening Comments in this proceeding. For the purpose of this statement, I will focus my comments on:

1) The financial health of the rail industry.

2) The state of competition in the rail industry.

3) Unreasonable practices.

4) Alternative routes – routing protocols.

5) Modifications to rate reasonableness rules.

6) Reciprocal switching.

The Financial Health of the Rail Industry

My first marketing position with a Class I railroad started prior to passing of the Staggers Rail Act; I was part of Chicago & North Western's management team that planned for operating in the new *deregulated* environment and, to be honest, that is when the fun began. The competitive environment changed for the better and all parties (shippers and carriers) were the benefactors. One cannot attribute the success to any single rule change. It is obvious that Staggers was carefully planned and the success was the result of the numerous rules changes, including abolishment of collective rate making, the right to discriminate when pricing, and the right to establish rate and service contracts.

The railroads embraced the new rules, we developed strategic plans and marketing strategies, we were aggressive and we secured business in contracts. Of course, there was a learning curve and some mistakes were made along the way, but the new competitive environment generated enthusiasm and shippers selected their *Preferred Carriers* and the railroads booked business and revenues that they could use to plan for capital programs for equipment and infrastructure. Concurrently, the shippers had the ability to plan their supply chains because they had rates committed in multi-year contracts. Concepts such as *Strategic Site Selection* and *Logistics Modeling* were developed and shippers could justify locating new manufacturing plants and distribution facilities to their boards of directors, based on access to markets, efficiency of operations, and costs.

However, the business landscape of the railroad industry has changed since the 1980's. Railroads have merged creating duopolies in the Eastern and Western United States, the railroads abandoned and retired track, passing tracks, and yards. Some have admitted they went too far so now they are re-installing passing tracks and expanding infrastructure to address the increasing capacity needs of the freight industry. However, the railroad industry has made significant progress, they have become more sophisticated and creative, and productivity has improved dramatically due to new technology and labor agreements.

Today, it seems the railroads are no longer committed to the customers and they have three very different stories when talking to various parties:

1. When talking to their customers, the railroads justify double digit rate increases citing capacity issues and *Market Based Pricing*[1] (railroads have re-defined the term as "pricing as high as we can, because we can").

[1] There are two main types of pricing methods, these are: cost based pricing methods and market orientated pricing methods. With cost based pricing methods, no account is taken of market requirements but a set amount is added to the costs. The disadvantage is that if costs increase, the price of the product must also increase. Market based pricing methods depend on accurate analysis of the market and consumer requirements. Project Alevel, AS A2 Revision.

2. When they (the railroads) are talking to the Surface Transportation Board, Mr. Elliott's agency, they act like it's still 1980. They say they're barely making enough money to keep the lights on...[2]
3. But when they're on their quarterly calls with Wall Street Investors, it's a very different story. These companies tout their high profit margins and their power to dictate prices to their customers...[3]

Wall Street believes their story, as they should. First of all, the United States Department of Transportation has forecasted dramatic growth in freight volumes by the year 2030. Further railroad Board members and senior management with fiduciary responsibility could be sued if they falsified their financial position.

Wall Street has a bullish view of the Class I railroads. The quantitative stock report published by Standard & Poor in September of 2010 gave rankings of "A" to Union Pacific, "A-"to Norfolk Southern, and "B+" to CSX. Union Pacific and Norfolk Southern scored above the 90th percentile on S&P's "Investability Quotient", and CSX received a score of 89%, which further confirms the continued attraction of investments in the industry.[4]

<u>The State of Competition in the Rail Industry</u>

In the Christensen Study, they summarized qualitative, anecdotal input the researchers received from rail shippers and the report included the following statements:

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[2] *Hearing on the Federal Role in National Rail Policy before the U.S. Senate on Commerce, Science, and Transportation.* (Sep. 15, 2010) Majority Statement by John D. Rockefeller IV).

[3] Id.

[4] Initial Comments of Omaha Public Power District, the AES Corporation, Oklahoma Gas & Electric Co. and Colorado Springs Utilities, *STB No. EP 705, Competition in the Railroad Industry.*

"some shippers who had access to more than one railroad said that the advantages of having service from more than one railroad has diminished in recent years, i.e., the competitive behavior of railroads has decreased…."[5]

"….shippers have stopped seeking authority to construct tracks to create rail-to-rail competition which is a strong indication that they doubt such competition will occur and justify the significant costs of building out."[6]

One of our clients asked us to perform an assessment of his transportation operations with the objective to identify opportunities to improve efficiency of operations and to reduce costs. At the time, and still to this day, that manufacturing plant is captive to one railroad, even though there are two other Class I railroads within five miles of the plant. I met with Industrial Development personnel of the two railroads and confirmed it was feasible and practicable for at least one railroad to build in to serve our client. If that project had gone forward, we would have explored all alternatives including the second carrier operating over the current carrier's tracks under a trackage rights agreement to directly serve the plant, or to file to open the plant to reciprocal switching before we would have proceeded with a build-in project. However, soon after the Industrial Development representative issued an internal report of the results of our meeting, I was informed by a senior marketing officer that they would not be willing to compete for the business because his railroad was more vulnerable to the serving railroad (relative to build-ins) than the serving railroad was to his.

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[5] Joint Initial Comments of Omaha Public Power District, the AES Corporation, Oklahoma Gas & Electric Co. and Colorado Springs Utilities, STB Docket No. EP 705, *Competition in the Railroad Industry*, p. 15.
[6]Id p. 16.

Frequently, we encounter situations where it seems the railroads have decided it is not in their best interests to compete. One indicator is the recent trend to force customers to tariff rates. Typically, these are commodity specific. For example, with few exceptions, railroads will not contract grain rates. Further, because they are public tariff rates, they are posted on the railroads' websites which gives their competitors the ability to confirm their competitors' rates when competing, or deciding not to compete, for business. We have negotiated rates in lanes with two competing carriers. The railroads turned down our requests to establish the rate in a contract forcing our client to tariff. When we requested the rates be established in private, non-distribution tariffs, they also turned down those requests. The only conclusion we could reach was this is the railroads' way to signal their competition so they can control future pricing.

The railroads' approach to customers is inconsistent at best. Even within any Class I railroad, the approach to customers can vary depending on the business unit involved. While there is no question that the railroad sales and marketing personnel represent their company, some business units seem to have customer focus and the zeal to win your business while other business units within the same company have an abrasive and abusive approach to customers, even if it means losing business.

One of the participants in his initial comments stated there is no competition in the railroad industry. I have seen indications that the railroads are, at times, willing to compete. However, there is no question that railroad competition is currently inadequate and I am gravely concerned about what will happen with the state of competition as the freight volumes increase in the future.

This is a topic that should receive intense review as we need practical solutions, rules and processes that not only protect large shippers with the volumes and resources to pay the litigation costs for formal complaints at the STB, but we also need to find ways to protect the interests of small shippers.

Also, while it would require approval by Congress, it should not be the responsibility of the shippers to police the railroad industry and to file complaints each and every time the railroads have illegal publications or methods to publish rates that border on violation of anti-trust laws. The Board should have the authority to monitor tariffs and to intervene when needed to protect the public interests.

UNREASONABLE PRACTICES

The railroads have adopted a number of unreasonable charges and practices. Again, because competition is inadequate, they seem to have little regard for the customers and they do what they do because they can. For the purpose of this statement, I will focus on only three, (1) mileage equalization, (2) fuel surcharges, and (3) application of rates.

Mileage Equalization –

A group of shippers filed a petition with the STB, asking the Board to determine the reasonableness of the calculation of mileage equalization charges[7].

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[7] STB Docket NOR 42117, *Cargill, Inc.; Exxon Mobil Corporation; Jones-Hamilton Co.; PPG Industries, Inc.; Reagent Chemical and Research, Inc. v. Aberdeen & Rockfish Railroad*

However, that petition is on hold pending mediation. We support the Complainants' position in this proceeding and encourage the Board to review this unreasonable practice and the impact it has on all tank car owners and shippers.

The rule provides that carriers in the United States will haul shippers' empty cars tank for a maximum 106% of the loaded miles. The *"Penalty Rate Per Mile"* assessed against car owners and shippers for empty miles that exceed the 106% threshold on a calendar basis is $0.65 per mile, even though the cars should be reverse routed but move via alternative routes for railroad convenience, and even though car owners and shippers have no control over the routing of the empty cars.[8] Further, it seems there is no incentive for the railroads to be more efficient when routing the empty cars.

Highroad manages a tank car fleet for a chemical company. It is our responsibility to audit and approve invoices received from the car leasing companies for payment. The railroads collect mileage equalization charges annually from the car owners (often the car leasing companies), and the car leasing companies pass the charges through to the lessors. When the rail customer receives invoices from the car leasing companies, the charges have already been

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Company; Baltimore & Ohio Chicago Terminal Railroad Company; BNSF Railway Company; Boston & Maine Corporation; Buffalo & Pittsburgh Railroad, Inc.; Canadian National Railway; Canadian Pacific Railway; Cedar Rapids and Iowa City Railway Company; Central Washington Railroad Company; CSX Transportation Inc.; Elgin Joliet & Eastern Railway Company; Gary Railway Company; Indiana & Ohio Railway Company; Iowa, Chicago & Eastern Railroad Corporation; Iowa Northern Railway Company; Kansas City Southern Railway Company; Maine Central Railroad Company; Montana Rail Link, Inc.; New York Susquehanna and Western Railway Corp.; Norfolk Southern Railway Company; Pan Am Railways, Inc.; Portland Terminal Company; Rochester & Southern Railroad, Inc.; Sandersville Railroad Company; Springfield Terminal Railway Co.; Union Pacific Railroad Company; Association of American Railroads; Railinc.

[8] A similar rule applies for movement of empty tank cars in Canada, but the threshold and charge per mile are different. However, we assume those rules would not be under the jurisdiction of the Surface Transportation Board.

paid to the railroads, so it is sometimes a major challenge to dispute the bills. In the mileage equalization bills received by Diversified CPC, and we have been successful when negotiating mitigation of charges (80% - 100% of the charges have been cancelled). Disputes have been based on routes of empty moves for railroad convenience. Also, we have found a high degree of railroad reporting errors. Examples include incorrect routes compared to our historical movement data, and incorrect miles. One records for an empty move of 48 miles was reported as 444 miles. Auditing the invoices and disputing charges even for a small fleet is a labor intensive process and over the long term, the extra miles result in additional maintenance and repairs, thereby impacting on the availability and efficiency of our client's tank car fleet.

Fuel Surcharges –

Fuel surcharges continue to be a problem, they continue to be profit centers for the railroads, and shippers are required to pay for fuel costs that have no relationship to the freight they are shipping. Therefore, in accordance with the Board's decision in STB Docket Ex Parte No. 661, they constitute an unreasonable practice.

One of the problems with the railroads' fuel surcharge programs is the way they apply the surcharges. The railroads have established inter-carrier agreements to apply the origin carrier's fuel surcharge on the through route, even though the

Board instructed the carriers to change their fuel surcharge program to reflect actual fuel cost increases[9], an even though fuel costs differ for each carrier.[10]

The manner in which the railroads are assessing fuel surcharges do not comply with the Board's decision to assess surcharges that are more closely linked to the increases of its fuel cost that is attributable to the movement to which the fuel surcharge is applied.

Further, since the railroads' fuel surcharge programs have been in effect since 2002, we believe the fuel surcharges should be subject to Board review and the real question is whether or not the carriers should continue to assess fuel surcharges.

It is reasonable to expect that fuel costs would have increased over the past nine years, even without a fuel crisis. Therefore, it is not reasonable for shippers to compensate the carriers for the total fuel cost increase that has occurred since 2002. A potential alternative is to calculate the difference in fuel costs after factoring in the normal cost of inflation. Our analysis has shown that surcharges adjusted to reflect the normal cost of inflation would be reduced significantly (as much as 50%). This is a potential alternative that could be considered fair to both parties.

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[9] Decision Notes, Surface Transportation Board Decision Document, EP 661-0, Rail Fuel Surcharges, p. 1 "(1) Stipulated that a carrier wishing to assess what purports to be a fuel charge would need to develop a means of computing the surcharge that is more closely linked to the increases of its fuel cost that is attributable to the movement to which the fuel surcharge is applied..."

[10] Differences in fuel costs are confirmed in the railroads' quarterly fuel surcharge reports and in the annual R-1 financial reports to the Surface Transportation Board.

However, the real question is whether or not the fuel surcharge programs should apply at all. Since 2002, rates that were based on costs that included a cost component for fuel, have undergone a series of annual rate increases and the railroads have modified their fuel surcharge programs after rolling former fuel surcharges into the rates. This practice has produced higher base rates so subsequent rate increases are also higher as they are applied to higher base rates. We submit the rail fuel surcharge proceeding should be re-opened and the surcharges should be subject to Board review to consider potential changes or cancellation of the fuel surcharge programs. If a decision is made to continue the fuel surcharge programs, they should be subject to periodic review.

Application of Rates –

In the course of working on projects for numerous clients, we have discovered that the railroads are not applying the lowest applicable rates on some moves. This has become such a frequent occurrence that Highroad has modified its analytical model to include confirmation of tariff rates for all benchmarking projects. To date, we have discovered and ultimately collected overcharges from five of the Class I railroads.

With the exception of one overcharge, all of the overcharges developed because contract rates were higher than tariff rates. In every case, we received push back from railroad sales personnel, stating a contract is a contract and the shipper had to pay the higher rate. It is inconceivable that a rail carrier would expect a customer who commits and ships significant volumes to pay rates higher than the public rates which can be used by other shippers who have the ability to ship lower volumes, as low as one car/year. There were no special services provided for the contract moves that would warrant higher rates, so the higher contract rates were not justified.

The other overcharge situation was much more complex. The shipper had a contract, plus two tariff items that applied on the same moves. One of the tariff items was a mileage scale, and the other tariff item published point-to-point rates. The overcharges applied over a three-year contract term. Depending on the dates of shipments, there were times when the contract rates were lower. However, on other moves, tariff rates were lower. We quickly discovered the need to put assumptions aside when performing the audit, when we discovered some rates in the mileage scale were lower than point-to-point rates and lower than the contract rates. (Typically, point-to-point rates are lower than mileage scale rates, as point-to-point rates are developed to address specific competitive situations not addressed by the rates in the mileage scale).

Further, there was not a consistent pattern in the application of mileage scale rates versus the point-to-point rates. While the railroad could have made a case that the point-to-point rates supersede the mileage scale rates, whichever produced the higher rate was the rate that was applied. In some cases, the rates in the mileage scale rates were higher and that was the rate applied; for other moves, the higher point-to-point rate was applied.

When our client confronted the railroad with our findings, the sales and marketing representative stated, "Point-to-point rates are always lower than mileage scale rates." That was not the case; it was obviously inadvertent.

In every case when overcharges have been discovered, sales and marketing personnel on line with the customers have defended the charges as billed, stating a contract is a contract. Ultimately, the overcharge claims were processed and collected. However, this seems to be a general problem and it appears there is a lack of understanding on the part of railroad personnel that the customer is entitled to the lowest applicable rate. We respectfully request that the Board confirm the rule that the customer is entitled to the lowest applicable rate.

ROUTING PROTOCOLS

When the concept of routing protocols was first introduced by Canadian National in 2005, it seemed the objective was to improve operating efficiencies, and to develop a plan to operate over the most efficient routes. However, that has not been the case. The railroads have developed inter-carrier agreements and established routing protocols that are simply focused on giving the carriers their desired maximum line haul, sometimes the origin carrier receives the longer haul; on other moves the destination carrier has a longer haul, indicating there was some give and take in the carriers' negotiations.

Point is the routing protocols do not always produce the most efficient, least distant and least cost routes. An example is a move from an origin on Union Pacific Railroad to a destination in Washington on Burlington Northern Santa Fe. The current route is UP – Kansas City – BNSF. The least distant route is UP – Portland – BNSF, but that would seriously penalize BNSF (BNSF miles would be reduced to 8.3 miles). Instead, we recommended a route UP – Colton, CA – BNSF which reduces the circuity by 11%, miles were reduced 350 in each direction:

	Current Route	Recommended Route
UP miles	822	1,585
BNSF Miles	2,332	1,219
Total Miles	3,154	2,804

This is creating a myriad of problems. First of all, when shipments occur in private cars, the additional miles have a direct impact on the efficiency and costs of the customers' private fleets. Further, it inflates the carriers' costs and no doubt impacts on rate levels. More important, there are instances where the railroad's refusal to quote rates for alternative interchanges is based on the objective to control markets and to eliminate competition.[11]

The railroads have confirmed policies regarding routing protocols and they have refused to quote rates via alternative interchanges, or Rule 11 rates to alternative interchanges, citing the need to comply with routing protocols. Rail shippers should have some control over routing their shipments, and the railroads should be required to quote rates for more efficient routes. It is our recommendation that the Board initiate a rule making proceeding to address routing protocols.

Modifications to Rate Reasonableness Rules

There are a number of topics that should be addressed relative to the rate reasonableness rules. For the purpose of this statement, I will comment on a few general points.

First, we commend the Board for progress made with development of procedures enabling "small" shippers to file complaints and to seek relief from unreasonable rates. However, even though the timelines and associated litigation

[11] Comments submitted by Olin Corporation, Exhibit A, pp. 26 - 31, *STB Ex Parte No. 705, Competition in the Railroad Industry.*

costs have been reduced, even the Small Rate Case and Simplified Rate Case procedures are not practical solutions for most small shippers. While moves of 30 – 150 cars/year in a single lane may seem small to a Class I railroad, the transportation costs often impacts on the shipper's ability to be market competitive and to stay in business. Sometimes these are small niche industries, such as the aerosol propellant industry, so shipping volumes for the industry as a whole are relatively low. However, these industries contribute to the economy, they create jobs, and their products are used by large manufacturing companies that depend on those suppliers and products. We submit the Board should establish an alternative method so smaller shippers have a way to seek relief from unreasonable rates (possibly an arbitration procedure).

The Board should also review the Small Rate Case and Simplified SAC Rate Case procedures standards for potential change. The current limits and potential benefits from prescriptions compared to litigation costs have precluded shippers from filing rate cases. Also, the inclusion of the 3-benchmark process has forced rail shippers to file Stand-Alone (SAC) rate cases. (If the railroad is assessing extremely high, unreasonable rates, against all shippers, then the 3-benchmark analysis does not contribute to the shipper's case).

A large, SAC case can only be an option for very large shippers. First of all, the litigation costs are extremely high, so the shippers need very high shipping volumes to justify the risk and expense of filing a large SAC case. Even large shippers are wary of filing rate cases because they incur the additional expense of paying tariff rates for more than three years. One of our clients estimated the cost of filing a large rate case would exceed $80 million – quite a gamble. On the other hand, the railroads seem to be willing to assume the risk and expense, probably because their costs associated with defending a rate case are offset to some extent by the higher tariff rates.

Finally, as submitted in the previous URCS proceeding, the URCS cost model requires update or replacement.[12] Costs calculated by the current model do not reflect contemporary railroad operations, and those costs are highly inflated. Using the URCS model to measure rate reasonableness is very unfair to the shippers and it has been our experience that some shippers with unreasonable rates do not have the option to seek relief from the Board because the rates do not pass the URCS test. This is a very important issue and the decision regarding methods to replace or modify URCS should not be based solely on least cost alternatives. The decision should be based on the public interest.

Reciprocal Switching –

Other participants in their opening comments for this proceeding have asked the Board to review and modify its competitive access rules for reciprocal switching. We support that recommendation. Further, the Board should take action to preserve competition that exists as the result of reciprocal switching arrangements.

Recently, it has come to my attention that some carriers have terminated reciprocal switching operations, thereby closing the industries to reciprocal switching, without notice or process. An example is a shipper with a facility in the eastern U.S. who confirmed his industry was open to reciprocal switching to another carrier. He approached the second carrier and secured competitive rates.

[12] *Comments submitted of Highroad Consulting, Ltd. regarding review of the Surface Transportation Board's General Costing System*, STB Ex Parte No 431, (Sub No. 3)

Several cars moved on the new rates before the serving carrier retaliated and closed the industry without notice.

We submit termination of reciprocal switching arrangements should be subject to Board approval. Standards should be established and the railroad seeking termination of reciprocal switching arrangements should be required to comply with the standards and to show just cause.

SUMMARY

Shown below is a summary of our requests and recommendations:

- The status of competition in the railroad industry warrants intense review. We need practical solutions, rules and processes that not only protect large shippers with the volumes and resources to pay the litigation costs for formal complaints at the STB, but we also need to find ways to protect the interests of small shippers.
- While it will require approval by Congress, the Board should have the authority to monitor tariffs and to intervene when needed to protect the public interests.
- We encourage the Board to review the AAR mileage equalization rules and charges as a potential unreasonable practice and the impact it has on all tank car owners and shippers.
- STB Ex Parte No. 661, Railroad Fuel Surcharges, should be re-opened and the surcharges should be subject to Board review to consider potential changes or cancellation of the fuel surcharge programs. If a decision is made to continue the fuel surcharge programs, they should be subject to periodic review.

- The Board should confirm the rule that customers are entitled to the lowest applicable rates.
- The Board should initiate a rule making proceeding to address the concept of routing protocols.
- The procedures for large rate SAC cases should be reviewed and changes should be made to develop a more simplified, contemporary process. The Board should also review the Small Rate Case and Simplified SAC Rate Case procedures standards for potential change. Further, the Board should establish an alternative method so smaller shippers have a way to seek relief from unreasonable rates (possibly an arbitration procedure).
- The URCS cost model requires update or replacement. This is a very important issue and the decision regarding methods to replace or modify URCS should not be based solely on least cost alternatives. The decision should be based on the public interest.
- The Board should take action to preserve competition that exists as the result of reciprocal switching arrangements. Termination of reciprocal switching arrangements should be subject to Board approval. Standards should be established and the railroad seeking termination of reciprocal switching arrangements should be required to comply with the standards and to show just cause.

We appreciate the opportunity to participate in this proceeding and I am prepared to assist the Board in their endeavor to develop a comprehensive decision.

Respectfully submitted,

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