BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE 705

COMPETITION IN THE RAILROAD INDUSTRY

REPLY COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION

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The big railroads 1/ contend that the current regulatory framework governing access to competitive rail service is perfect and should not be changed in any way. See, e.g., Initial Comments of the Association of American Railroads ("AAR Comments"), at 2.

However, the federal government agencies participating in this proceeding, seeking to promote public and not merely private interests, reject the big railroads' "no change" agenda. The U. S. Department of Agriculture recognizes that changes in the railroad industry since the mid-1980's "make it appropriate for the Board to consider means of increasing competitive access in the U.S. railroad industry", Comments of the U. S. Department of Agriculture ("USDA Comments"), at 2, and USDA proposes several specific reforms in current competitive access regulations. The U.S. Departments of Transportation and Justice, in their joint comments, do not take a position on specific regulatory changes, but they do "believe it is appropriate to investigate the extent to which relevant circumstances (such as rail capacity

1/ We refer to the Class I railroads participating in this proceeding, and the Association of American Railroads, as the "big railroads".

constraints, industry consolidation, and increasing revenue adequacy) have changed, and whether a proper balance of these or other considerations warrants different policy choices (e.g., on rate regulation or access or trackage rights) to serve the same underlying statutory goals." Initial Comments of the United States Department of Transportation and the United States Department of Justice ("USDOT/USDOJ Comments"), at 4.

AECC concurs with these agencies that it is appropriate for the Board to undertake this proceeding, and to consider meaningful changes in its practices regarding competitive access and the Bottleneck Rule.

A. SUMMARY OF A.E.C.C.'S REPLY TESTIMONY

The attached Reply Verified Statement of Michael A. Nelson ("Nelson RVS") provides evidence and analysis regarding the following issues:

1. The "absolutist" positions taken by the big railroads are unsubstantiated and inconsistent with the evidence. The railroads claim increased competitive access will deprive them of revenues needed for investment, but the Christensen Study indicated they were fully able to access needed capital by as early as 1995.
2. The railroads ignore or deny the relationship between revenue sufficiency and the need for differential pricing. As stated by USDOT/USDOJ: "Shippers should not be required to pay more than necessary for carriers to earn adequate revenues." USDOT/USDOJ Comments, at 4. The railroads have presented no evidence or credible argument for the proposition that differential pricing should extend above this level.
3. The railroads argue that the Board is bound by Congressional affirmations of the Board's restrictive competitive access interpretations, but those affirmations were not made

with any awareness of the revenue sufficiency that had been achieved. The statutes plainly anticipate that Board actions are subject to change based on new information and changed circumstances, and affirmatively are pro-competitive in a way the railroads have not acknowledged.

4. The railroads then argue (inconsistently) that the Board should permit them to attain high earnings to maximize their role in meeting environmental and resource needs (such as reduced pollution, lower fuel use, and less highway congestion). Congress explicitly defined and limited the criteria that establish revenue sufficiency, and provided the Board with absolutely no authority or mandate to place a valuation on such externalities and intangibles in the revenue sufficiency context.
5. As major statutory objectives are achieved, the need for rebalancing regulatory priorities to assist in the achievement of other objectives is unavoidable. On its face, the Staggers Act and the NTP were not and have never been perfectly ordered on the achievement only of ever-improving financial health by railroads.
6. The railroads frequently reference the Cambridge Systematics study for estimates of large future capital needs, but the conclusions of that study have been refuted by Christensen as well as by a past AECC filing.
7. The big railroads exhibit the world view of a fiefdom. They argue that they should be insulated from any possibility that another carrier might offer better price/service options, and change the distribution of traffic between carriers. This view belies an absence of competition.

8. The small railroads and KCS argue that they could be harmed by increased competitive access. On the contrary, competitive access can be highly beneficial to small railroads. For example, in STB Docket No. 42104, the through route requested by Entergy and AECC would have extended MNA's haul and substantially increased its traffic. In any event, the Board must not permit the big railroads to hide behind the "human shield" of shortlines they have created.
9. The big railroads highlight the supposed benefits of their mega-mergers, but then seek to rely on the fragile nature of the service they are able to provide as a defense against changes in access policies. This is particularly incongruous for UP, which was at the center of two massive service failures subsequent to its acquisition of SP. More generally, the lack of competition has been harmful to the economic health of the railroads.
10. Anticompetitive behavior is behavior that deviates from the competitive norm. There is no "differential service" or "differential efficiency". AAR witness Willig (at 2) substantiates that the "public's interest in the efficient allocation of an economy's scarce resources is best served by reliance on well-functioning market forces". The railroads provide no foundation whatsoever for disregarding inefficiencies of any magnitude that result from the exercise of market power.
11. Increasing private car ownership gives shippers a stake in routing that they didn't have before. If, as the Board asserted in the through route case, differences between routes may affect rolling stock costs, it is appropriate for those who increasingly bear such costs to have an expanded say in their incurrence.

12. The big railroads make various erroneous claims regarding the competitive benefits of the major mergers. They claim the merger conditions prevented anticompetitive effects, but Christensen explicitly measured the harm associated with "3-to-2" reductions. Likewise, the big railroads assert that the mergers were justified on the basis of cost savings, but Christensen showed that both fixed and marginal costs increased. As noted previously, the promises of "better and more responsive service" have been replaced by systems too large and unwieldy to adapt to routine perturbations.
13. The claims made in some "form letter" statements submitted to the Board are patently false. Excess earnings likely hinder, rather than facilitate, recovery from the recession, and tend to push down investment and employment. Indeed, the evidence indicates that the adverse effects of the mega-mergers on source competition have been substantial, and now are acting to favor export of U.S. jobs.
14. The big railroads' claims also ignore the adverse impacts of market power and the Bottleneck Rule on efficiency, and on investment by parties other than railroads.
15. The observed decline over time in the percentage of captive traffic and the avoidance of rail-oriented economic development at exclusively-served sites are, in part, indicative of a failure of differential pricing to prevent substantial resource misallocations.
16. AAR witness Willig appears to suggest that rates above SAC would justify competitive access.

B. THE BOARD HAS THE POWER TO CHANGE ITS REGULATIONS

The Board's present competitive access rules were adopted by the ICC over a quarter century ago, and were upheld as reasonable by the D. C. Circuit in Baltimore Gas &

Electric Co. v. United States, 817 F.2d 108, 206 U.S. App. D. C. 1 (1987), and Midtec Paper Corp. v. United States, 857 F. 2d 1487 (D.C. Cir. 1988). Those rulings, however, did not hold that the mid-1980's competitive access rules were mandated by the statute and could never be changed by the agency, only that they represented a permissible exercise of the agency's discretion, because the ICC "provide[d] a reasoned analysis that is not manifestly contrary to the purposes of the legislation it administers." 857 F. 2d at 1499.

> We could not say in *Baltimore Gas*, and cannot say now, that the Commission's narrowing of its own discretion is manifestly inconsistent with the terms or the purposes of *section 11103*, or with the broader purposes of the Staggers Act; it is not "unreasonable," . . . .

Id. If circumstances have changed in the last quarter century – and it would be difficult for anyone to argue with a straight face that the railroad industry hasn't changed dramatically – the Board has the discretion to change its competitive access rules to promote "the purposes of the legislation it administers" under the new conditions.

Other parties have provided detailed analyses of the legislative framework under which the Board operates and the cases that have interpreted it. See, in particular, Joint Comments of Alliance for Rail Competition, et al. ("Interested Parties Comments"), at 32-46; and Comments of Concerned Captive Coal Shippers ("Captive Coal Shippers Comments"), at 53-62. There is no need for AECC to repeat these analyses. But there is one point that merits all the emphasis we can give it.

In evaluating actual or prospective agency regulations, case law and legislative history can, of course, be useful guides, but the actual language of the statute is the true touchstone. The clear language of the statute gives the Board broad discretion to promote competitive access:

- Under Section 10705 the Board has broad discretion to prescribe through routes, even in a "short-haul" situation, to improve rail transportation.
- Section 11102 (a) grants broad discretion to the Board to order terminal access to promote the public interest.
- Under Section 11102 (c) the Board can order reciprocal switching to serve the public interest or to provide competitive rail service.

The Board's predecessor decided, more than a quarter century ago, that under the circumstances that then existed these broad powers should be constrained. Now the Board has initiated this proceeding to investigate whether changed circumstances today should lead to different policy judgments.

The purpose of this proceeding is not, as the big railroads seem to believe, to provide an opportunity for private interests to squabble over the division of private benefits. See, e.g., AAR Comments, at 13; Initial Comments of the Kansas City Southern Railway ("KCS Comments"), at 12. This proceeding is, rather, an appropriate and responsible exercise of the Board's statutory authority and responsibility to determine what regulatory changes are appropriate to reflect changed circumstances.

C. INCREASED COMPETITION IS APPROPRIATE FOR THE BIG RAILROADS

The initial comments of many shipper parties, as well as federal agencies, identify reasons why the current condition of the railroad industry makes it appropriate for the Board to place increased emphasis on competitive access. Support for that position is also found (perhaps surprisingly) in the Initial Comments of the American Short Line and Regional Railroad Association ("ASLRRA Comments").

In the course of arguing that any changes in the Board's regulations to increase intramodal competition should be designed to assure that small railroads and their customers "are not adversely harmed", ASLRRA Comments, at 3, ASLRRA identifies several factors that indicate why increased competition is appropriate for the big railroads, even if not for small railroads. 2/ Thus, for example, ASLRRA points out that "small railroads have a limited ability to affect the overall price charged to a customer for interline traffic." ASLRRA Comments, at 6. Big railroads do have that ability.

ASLRRA says that the "median length of haul [for small railroads] is 42 miles", so they face major competition from trucks. Id. at 7. Trucks are not a competitive option for big railroads' long haul/heavy haul traffic, such us unit coal train movements of coal from the Powder River Basin to power plants in Arkansas.

ASLRRA says that "small railroads . . . are fundamentally different from the classic 'bottleneck' situation involving a Class I railroad", because small railroads "have no long haul to protect." Id. at 18. Obviously, big railroads with control over bottlenecks, do have long hauls, and do protect them, sometimes to the detriment of economic efficiency and the public interest.

ASLRRA's comments suggest the following additional factors that highlight why increased competition is appropriate for big railroads, although not appropriate for small ones:

2/ Although ASLRRA says it supports the big railroads' position that no changes should be made in the Board's regulations for the purpose of increasing competition, it offers no evidence for that position, and the focus of its Comments is to show how small railroads differ from big railroads in terms of the need for competitive access and relief from the Bottleneck Rule.

ASLRRA Comments	Small Railroads	Big Railroads
P. 6	"[Small railroads] operat[e] approximately 32 percent of the nation's rail system and participat[e] in approximately 40 percent of all carload movements, [but] small railroads earn barely five percent of national freight revenues."	Therefore, big railroads operate 68% of the nation's rail system and earn 95% of national freight revenues.
P. 6	"[Small railroads] set rates with respect to only a small portion of most interline moves (if at all) . . . ."	Big railroads set rates with respect to a large portion of interline moves and have a substantial ability to affect the overall price charges to a customer for interline traffic.
P. 6	"[S]mall railroads are not in a position to exercise, let alone abuse, market power."	Big railroads are in a position to exercise, or abuse, market power, in the absence of competition.
P. 7	"The average small railroad operates 99 route miles of rail lines and handles approximately 14,000 carloads of traffic per year."	"To put these numbers in perspective, the smallest of the seven Class I railroads operates 3,076 miles of rail line and handles 361,695 carloads of traffic per year."
P. 7	"For the small railroads, intermodal and intramodal competition is intense. Traffic moving over shorter distances - 500 miles or less - is particularly susceptible to diversion to truck transportation. In recent years, larger numbers of heavier and longer trucks and combination vehicles have made the competition even more difficult. As noted in the Joint Study, 'trucks provide excellent service and are most cost-effective for shorter hauls (up to about 500 miles).' Joint Study at 201."	Truck competition is not feasible for the long haul/heavy haul traffic handled by the big railroads.

ASLRRA Comments	Small Railroads	Big Railroads
P. 8	"[A]s noted in the Joint Study, [a]s the Class I railroads build larger intermodal facilities in urban areas, many small intermodal terminals in rural areas [many of which would likely have been located on smaller railroads] have been closed or have had their service discontinued.' Joint Study at 343."	"[S]mall railroads [are] susceptible to traffic diversion in ways that generally do not affect Class I carriers."
Pp. 8 - 9	"[S]mall railroads generally have an extremely small 'plant,' most of the railroads being less than 100 miles in length. (Martland V.S. at 15-16). That plant size, and the substantially lower volumes, limits the small railroads' ability to spread their fixed costs making the "first or last mile" inordinately costly in relation to long distance line hauls."	"Class I carriers, on the other hand, can spread their fixed costs over a much larger system and traffic base. (Martland V.S. at 21-22)."
P. 9	"[T]he Joint Study pointed out that . . . the small railroads averaged only a little more than $85,000 per route mile. Joint Study at 292. Mr. Martland believes that figure to be even lower - $80,000 per route mile. (Martland V.S. at 21).	"[T]he Joint Study pointed out that the major railroads averaged more than $560,000 in revenue per route mile . . . ."
P. 19	"Small railroads provide service from their customers to nearby Class I connections, and seldom have meaningful opportunities to move traffic over longer distances to a more distant alternative connection. Their pricing reality simply does not include the ability to preference a long haul."	"Class I's [have the] ability to price service on the bottleneck segment in a manner that favors longer-haul single-line service over interline service with the other carrier. This traditional bottleneck paradigm ignores the very existence of the small railroads' movements."
P. 19	"[S]mall railroads simply do not have the ability to impose unreasonable pricing on segments where they may meet a technical definition of a 'bottleneck" carrier.'	Big railroads do have that ability.

D. SMALL RAILROADS WOULD BENEFIT FROM INCREASED COMPETITION FOR THE BIG RAILROADS

AECC agrees with ASLRRA that any enhanced pro-competitive remedies that the Board adopts should be designed to avoid imposing unnecessary burdens on small (Class II and III) railroads. 3/ The competitive problems that AECC and others have highlighted generally relate to the big railroads, not to the small ones. The differences between small and big railroads identified by ASLRRA and discussed in the preceding section show why this is so. On the other hand, it is certainly possible for captive customers of a small railroad to suffer from inadequate service or inefficiency, just as customers of big railroads do. Where appropriate, competitive access remedies should be available to customers of small railroads.

AECC has proposed that, in the case of a competitive access application directed to a big railroad, the burden of proof should be on the railroad to show that access would not be in the public interest. AECC Comments, at 8-9. In the case of a competitive access application directed to a small railroad, AECC believes that, because of the different characteristics of small and big railroads, it would be appropriate for the burden of proof to be on the applicant (as it is under the current rules) to show that access would be in the public interest. However, in evaluating whether such applicants have met their burden, the Board

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3/ However, the big railroads must not be allowed to use short lines to circumvent pro-competitive remedies. If a big railroad uses its influence over, or contractual relationship with, a short line to achieve an anti-competitive objective, the presence of the short line must not be allowed to shield the big railroad from the application of appropriate remedies. See Nelson RVS at 19-21.

should give due weight to the importance of competition in the current railroad industry environment. 4/

However, a more fundamental issue regarding small railroads is this: Although ASLRRA treats increased competition as an inherent threat to the interests of small railroads, in fact, small railroads and their customers stand to be significant beneficiaries of increased competition among big railroads.

Why this is so is illustrated by the Board's 2009 decision in Entergy Arkansas, Inc. and Entergy Services, Inc. v. Union Pacific RR, STB Docket No. 42104, Decision served June 26, 2009. There, the Board held that the through route provisions of 49 USC § 10705 were "a straightforward path" for a rail customer to obtain a competitive route to its plant, notwithstanding the incumbent carrier's claim that its contract with the short line that solely served the destination precluded such a routing. The short line, Missouri & Northern Arkansas Railroad (MNA) would have obtained a huge increase in its traffic if the Section 10705 application had been granted. 5/

4/ AECC does not endorse KCS's claim that, as the smallest Class I, it should be exempt from pro-competitive regulations that are applicable to the other Class I's. KCS Comments, at 12-16. Under AECC's proposals for amending the competitive access rules, KCS would have an opportunity, on a case by case basis, to show why an application for competitive access relief should not be granted against it. Based on AECC's experience, KCS has been more responsive to customer concerns than have the mega-railroads. To that extent, it is less likely that KCS would face successful competitive access applications.

5/ Of course, as the Board is well aware, in a subsequent decision the Board denied the through route application on the ground that the applicants had failed to satisfy applicable requirements of the competitive access rules. That ruling (which AECC is asking the Board to reconsider) does not change the fact that Section 10705 has the potential to provide substantial benefits to short lines, particularly if, as AECC is urging in this proceeding, the Board eliminates some of the barriers its current rules present to the use of competitive access remedies.

The potential for increased competition to benefit short lines is also illustrated by the comments filed in this case by Four Rivers Transportation, Inc. ("Four Rivers"). Four Rivers:

> controls three common carriers subject to the Board's jurisdiction (hereinafter, the "Four Rivers Railroads"): Paducah & Louisville Railway, Inc. ("P&L"), Evansville Western, Inc. ("EVWR"), and Appalachian and Ohio Railway, Inc. ("A&O"). P&L is a Class II common carrier railroad that owns and operates approximately 262 miles of rail line, all of which is located within the Commonwealth of Kentucky. EVWR is a Class III common carrier railroad that operates approximately 124 miles of rail line in Illinois and Indiana. A&O is a Class III common carrier railroad that leases and operates over 158 miles of rail line, all of which is located within West Virginia.

Four Rivers Comments, at 2. P&L and EVWR each connect with at least two Class I railroads, but A&O connects with only one carrier, and at only one interchange point. Id. at 7. Four Rivers asserts that A&O could not benefit from a through route, which may be true, although this does not necessarily mean that A&O and its customers could not benefit from some other kind of competitive access. 6/

The other Four Rivers railroads, with multiple connections, are interesting because they

> actually connect with more than one Class I carrier, but perhaps unlike others, they also have independent pricing authority, for the most part, and have very little, if any, restrictions on their ability to interchange with

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6/ A&O's website says:

"There are many industries not directly rail served which can still enjoy the benefits of rail transportation.

"Team Tracks (available free of charge to the general public for loading and unloading of product to/from railcars) are located in at Buchanan, WV. Contact the Marketing Department for the A&O's sister company, the Paducah & Louisville Railway. Anyone in that department will readily assist you . . . ." http://www.a-orailroad.com/faq.htm.

> connecting carriers. This allows them to provide their shippers with multiple routing and pricing options.

Id. at 7. Thus, P&L and EVWR and their customers already enjoy the benefits of competition between Class I railroads. As Four Seasons delicately puts it, this makes these two short lines "perhaps unlike" the more typical short line, which may connect with only a single Class I, or may not enjoy "independent pricing authority", or may face "restrictions on their ability to interchange with connecting carriers." 7/ For these more typical short lines, liberalized competitive access rules could make it possible for them to "provide their shippers with multiple routing and pricing options", which P&L and EVWR and their customers currently enjoy.

Small railroads have succeeded in a tough competitive environment through "business acumen", and by taking advantage of a flexible regulatory structure that "enables them to react to the exigencies of an extremely competitive marketplace." ASLRRA Comments, at 23. The entrepreneurship, flexibility, and customer service that characterize the small railroads should position them well to take advantage of the new opportunities that could be opened by reforming the Board's approach to competitive access.

E. COMPETITION WOULD BENEFIT THE BIG RAILROADS AS WELL AS THEIR CUSTOMERS

The big railroads treat the issues in this case as though competitive access involved nothing more than a reallocation among railroads and their customers of a fixed quantity of revenues – divvying up slices of a pie – so that any gain by customers must be a loss to railroads, and vice versa. Thus AAR says that reduced rail rates resulting from competitive

7/ ASLRRA observes that most small railroads have "limited (and usually non-existent) discretion with respect to freight rate-making". ASLRRA Comments, at 8.

access would constitute "a revenue transfer from the freight railroads to select shippers". AAR Comments, at 13. But the whole point of competition is that it leads to a bigger pie and can benefit all market participants. 8/ For example, one of the explicit purposes of prescribed through routes is to address situations where a carrier is taking an inefficient long-haul. The pie gets bigger when the excess costs of the circuitous routing are avoided.

In a broader sense, a competitive environment puts pressure on each firm to improve its product or service, enhance efficiency, lower costs, etc. A railroad's cost structure is "central to [its] financial health and economic performance", and "competitive considerations" can drive the railroad "to improve its cost structure". See Nelson RVS, at 3. For example, double-stack intermodal technology was pioneered in the 1970's by Southern Pacific, at that time among the weakest of the western railroads, with a poor route structure for intermodal traffic. Competitive pressures led SP to develop an innovation that ultimately changed an important part of the railroad business, to the benefit of railroads and customers. Nelson RVS, at 3-4.

As Mr. Nelson explains:

8/ Even if the only question were how the slices of pie should be distributed, that would not mean that the current allocation of pie shouldn't be changed. There's no reason to suppose that the current allocation of revenues between railroads and customers is necessarily optimal under all circumstances. The financial condition of the railroad industry has improved tremendously since the 1970's. Mergers have dramatically reduced the number of railroads that might conceivably compete with each other. Technology has advanced. Of course, if you're used to getting the biggest slice of the pie it wouldn't be surprising if you objected to getting a smaller piece, but that doesn't mean that federal regulations have to enforce your preference. Moreover, as Mr. Nelson shows in his Reply Verified Statement, at 8-9, under AECC's proposals to reform the competitive access rules, a big railroad's slice of the pie would not be materially affected unless its conduct (inefficiency, bad service) triggered the competitive access criteria.

> In a competitive environment, carriers may gain or lose traffic based on the competitiveness of their price/service options. Firms that offer poor or unreliable service, or that expand beyond an optimal size (as discussed above), naturally tend to lose traffic to more nimble and efficient competitors.

Nelson RVS, at 11-12. As a result of the rail mega-mergers in the mid-1990's, intramodal competition in the railroad industry has been substantially reduced. Yet competitive access, which might have restored some of the lost competition, has continued to be restricted by rules adopted by the ICC before the mergers created the two regional duopolies we see today. As a result, the big railroads have faced only diminished competitive pressures in the rail-dependent markets they serve.

Mr. Nelson cited in his opening Verified Statement conclusions from the Christensen Study showing that reductions in competition caused by the big railroad mergers accompanied cost increases that ran contrary to the efficiency improvements promised by the merger sponsors and undermined achievement of revenue sufficiency. Thus, the mega-mergers "contributed to reduced competitive pressures" and "inhibited, rather than supported, the railroads' achievement of revenue sufficiency." Nelson VS, at 16.

In his Reply Verified Statement, at 4-5, Mr. Nelson examines the Board's own data regarding changes in productivity in the railroad industry. What the data show is that, before the mega-mergers, railroads were enjoying healthy annual improvements in productivity, but during the flurry of merger activity, productivity growth was cut in half. This was not merely a temporary phenomenon caused by problems in implementing the mergers; after the mergers were fully implemented, productivity growth continued its steep decline. See Nelson

RVS at 5. Thus, the reduction is competition caused by the mega-mergers caused the railroads to loss the benefits of increasing productivity that they had been enjoying before the mergers.

Healthy competition between big railroads would encourage increased efficiency, greater innovation, and better service. Weakened or non-existent competition creates the kind of environment that provides no accountability for UP's repeated service meltdowns. See Nelson RVS, at 11. Therefore:

> Competition by railroads may be chaotic and challenging, but it promotes long-term financial and economic fitness in ways that excessive reliance on market power does not.

Nelson RVS, at 6.

Restoring the competition that was lost as a result of the mega-mergers has the potential to restart the productivity gains that the big railroads were enjoying before the mega-mergers. This would mean that the big railroads themselves will be among the principal beneficiaries of increased competition.

F. INCREASED COMPETITION IS NOT "RE-REGULATION"

At least a dozen commenters erroneously characterize the regulatory issues on which the Board has solicited comment as attempts to "re-regulate" the railroad industry, contending (all of them in exactly the same words) that "any attempts to re-regulate railroads will have an extremely negative impact on our country." 9/ Whoever gave these form letters to these commenters was misleading them about what this proceeding is about.

9/ All South Warehouse D/C, Inc.; Associated Asphalt; Beasley Forest Products, Inc.; Circle S Ranch; D&I, LLC; FGDI Div of AGREX; Grand Worldwide Logistics Corp.; Hartwell Warehouse, Inc.; Inter-Chem International Chemical Company; Interstate Commodities, Inc.; PENN Warehousing & Distribution; Topflight Grain Co-Operative. There may well be additional examples of the same form letter. We stopped counting after a dozen.

AECC does not advocate "re-regulation" of the big railroads, and we are not aware of any other commenter that does so. No one who knows anything about what the railroad industry was like in the 1970's, preceding the Staggers Act, could possibly want to return to those conditions.

What AECC and other supporters of regulatory reform are advocating is not more regulation, but simply the reliance on competition contemplated in the existing statutes, under the current conditions in the railroad industry. Ironically, it is the big railroads that are proposing regulation as an alternative to such competition. Thus, for example, KCS provides a laundry list of regulatory provisions adopted by the ICC and Board that supposedly facilitate rate-reasonableness challenges (KCS Comments, at 3-10), and rhetorically asks advocates of reform "why is it, after 25 years of changes largely in their favor, that existing remedies cannot resolve their concerns". Id., at 12. BNSF claims that "[t]he parties urging the Board and others to alter the competitive access provisions have never explained why the STB's existing robust rate reasonableness remedies do not adequately address shipper's concerns." Initial Comments of BNSF Railway Company ("BNSF Comments"), at 3.

The answer to these rhetorical questions is two-fold. First, of course, is that rate reasonableness regulations aren't a very good solution to the problems that AECC and others have identified. If such regulations were the panacea, then the 1970's would have been a golden age, and it wasn't. That's why the goals of the Rail Transportation Policy in 49 USC § 10101 include both:

> to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail . . . .

and:

> to minimize the need for Federal regulatory control over the rail transportation system . . . .

The objective is for reasonable rates to be achieved through the effective functioning of competition, not through regulatory control over rates.

Second, rate regulation, even if it were effective, only regulates rates. It cannot deal directly with the serious problems of inadequate service and inefficiency stemming from the railroad exercise of market power. That's where competitive access comes in. Only the presence, or at least the credible threat, of competition can provide sufficient incentives for improved service and enhanced efficiency.

There's nothing radical about this idea. Even the Board's current approach to competitive access gives nominal recognition to the problems of inefficiency and poor service. In Central Power & Light Co. v. Southern Pacific Transportation Co., 1 STB 1059, 1066 (1996) ("CP&L"), aff'd MidAmerican Energy Co. v. STB, 169 F.3d 1099 (8th Cir. 1999), the Board held that a showing of anticompetitive conduct to support competitive access relief could be based on evidence "that the alternative routes sought are more efficient, or that the carriers have exploited their market power by providing inadequate service over their existing through routes." The Board cited CP&L with approval in Entergy Arkansas, Inc. v. UP, STB Docket No. 42104, Decision served June 26, 2009, at 3, in which it held that a through-route application under 49 USC § 10705 provided "a straightforward path" for rail customers to obtain competitive rail service where "a certain combination of carriers is providing inadequate service or is foreclosing the possibility of a more efficient route".

AAR discusses at some length in its Comments in this proceeding how the Board has applied these principles. Notwithstanding the language from CP&L and the 2009 Entergy decision about efficiency and service, AAR argues, the Board's current competitive access rules require that an applicant for competitive access relief show not only inefficiency or poor service, but also some sort of "competitive abuse". See AAR Comments, at 34-37. Thus, in practice the Board has not granted competitive access relief even where inadequate service or inefficiency was shown. In Entergy Arkansas, Inc. v. UP, STB Docket No. 42104, Decision served March 15, 2011, the Board refused to grant a through route application, even though the Board found that the through route would have been somewhat more efficient than the current route, and that the incumbent carrier had repeatedly provided inadequate service.

Assuming that AAR's interpretation is correct, 10/ this shows why the competitive access rules, as presently applied by the Board, are inadequate to address the issues that face the railroad industry and its captive shippers today. As discussed in our Initial Comments, we believe that the Board's rules should be revised to place the burden of proof on the Class I railroad opposing competitive access to show persuasive reasons why such relief is not appropriate in a particular case. Certainly, at an absolute minimum, a captive rail customer should be entitled to competitive access based on a showing that the current route is inefficient or that the incumbent has provided poor service, without having to prove some kind of competitive abuse in addition to the inefficiency or poor service.

10/ AECC has moved for reconsideration of the 2011 Decision in Entergy, but for purposes of the current proceedings we assume that the 2011 Decision represents the Board's current position on these issues.

G. CONCLUSION

The promise of the Staggers Act was that railroads would benefit from a reduction in regulatory burdens, and that rail customers would benefit from a more competitive rail industry. During the past three decades, the Board and its predecessor have placed more emphasis on the former goal than on the latter. Now, however, that the big railroads have become financially healthy, it is appropriate for the Board to begin to place greater emphasis on making the benefits of competition more widely available. The reforms proposed by AECC would be a good first step in that direction.

Respectfully submitted,

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Dated: May 27, 2011

REPLY VERIFIED STATEMENT

OF

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My name is Michael A. Nelson. I am an independent transportation systems analyst with over 31 years of experience in railroad competition and coal transportation. My qualifications are set out in detail in my initial verified statement in this proceeding.

In their opening comments and evidence, the big railroads[1] argue that it would be in the public interest for the Board to allow the relatively free exercise of market power by the major railroads, rather than rely on market forces. This proposition would have the Board set aside the reliance on market forces envisioned in the National Transportation Policy (NTP) and other specific statutes it administers and foster instead an environment where the duopolistic major carriers would face virtually no accountability for the efficiency and quality of service they choose to supply, and would face accountability for rates only through regulatory rate reasonableness procedures.

This proposition can be advanced only by disregarding the many beneficial features of market forces, and the many harms that can flow from the exercise of market power. This Reply Verified Statement discusses those features and harms, and specifically addresses the following topics:

[1] I refer in this verified statement to the Class I railroads and the Association of American Railroads (AAR) as the "big railroads".

- the big railroads overlook the fundamental determinants of economic health and soundness;
- the big railroads' own evidence substantiates the public interest problems of the Board's "competitive abuse" standard;
- competitive access does not unduly sacrifice differential pricing;
- the adverse impacts of the major mergers heighten the needs for competitive access relief;
- service arguments of the railroads corroborate the absence of effective competition;
- the traffic "fiefdoms" of the duopolies do not provide needed competition;
- market forces promote operating efficiency and investment; and,
- the decline in the "captive" percentage of rail traffic is a 2-edged sword.

This statement then addresses issues raised by the smaller railroads, and identifies and discusses further implications of the opening evidence for the prospective application of competitive access remedies.

The Big Railroads Overlook the Fundamental Determinants of Economic Health and Soundness

Most, if not all, of the public policy goals administered by the Board, including the achievement of carrier financial health, effective competition within and between modes, and sound economic conditions, depend ultimately not on the exercise of market power, but on the cost structure of the railroads. A railroad's costs determine the traffic movements from which it can earn a positive contribution, and the magnitude of the contribution it can achieve from any given movement.[2] While changes in a railroad's cost structure tend to be gradual, over time

[2] In the railroad context, this is understood to be a reflection of "Shephard's Lemma".

virtually all elements of the "technology" employed by a railroad are subject to change. Railroads that effectively manage such change can achieve lower costs, greater traffic densities, and greater contribution, all of which support attainment of both improved carrier financial health and multiple public interest goals <u>even if the rates paid by captive shippers are held constant or reduced</u>. In the course of arguing for free rein to exercise market power, the big railroads have overlooked the cost structure issues that are central to a railroad's financial health and economic performance, and the ways a carrier's motivation to improve its cost structure can be driven by competitive considerations.

An important example of the fundamental role of such competitive innovation in determining the financial health of this (or any) industry can be seen in the technological advancement and efficiency improvement for the movement of shipping containers that now is an industry standard (i.e., double-stack). Double-stack did not arise from the improving financial performance of rail carriers under the Staggers Act, or research conducted by the AAR, or the happiness of Wall Street with a given quarter's results, or achievement of a specified level of revenue sufficiency, or the unfathomably deep pockets of Berkshire Hathaway. Rather, it arose from a risk taken by Southern Pacific, a railroad with marginal finances and a limited route structure for intermodal, in the late 1970's, the bleakest of times for the overall financial condition of the industry.[3] This innovation now defines the competitive capabilities of rail intermodal service, including the increased volumes of intermodal that can be served profitably by rail, and the reduced costs and increased contribution resulting from such movements.

[3] "The first double-stack car for container traffic is designed and tested by SP." See <u>http://www.uprr.com/aboutup/history/uprr-chr.shtml</u> (1977).

While the railroads implicitly would like the Board to assume that duopolies generating formidable cash flows through the exercise of market power will be at least as well-equipped as "hungrier" carriers to make sure they achieve the lowest costs possible from innovation and improved technology, they notably have avoided any meaningful attempt to demonstrate that in their opening evidence. Double-stack offered SP the opportunity to improve its competitive capabilities relative not only to truck, <u>but also to the then-conventional methods used by other railroads to handle intermodal traffic</u>. In the duopolistic environment that was created after SP was taken over by UP, and Conrail was divided, the competitive incentives that encouraged SP's innovation have been eroded, and replaced by an openly-stated reticence by the big railroads to tamper with the volume and mix of traffic handled by individual carriers.[4]

As discussed in further detail below, the evidence – largely from the studies conducted by Christensen Associates for the Board - demonstrates that the mega-mergers had adverse impacts on competitive pressure that resulted in increases in fixed and marginal costs. Such cost increases plainly are detrimental in the long term to the economic health of carriers and the industry as a whole. Moreover, Christensen also found a dramatic slowdown in the rate of productivity improvement since the mega-mergers. While, as discussed in my opening statement, I think some of Christensen's specific findings of negative productivity in recent years are biased by a failure to account properly for the changing composition of traffic,[5] the Board's own data show changes in the rate of productivity improvement that fully support the conclusion that the

[4] For example, UP is worried that "(f)orced access and forced interchange would make it 'increasingly difficult to predict which lines, yards, and interchanges will be used in the future and therefore should be investment priorities.'" [citation omitted] See "Comments of Union Pacific Railroad Company" (April 12, 2011) ("UP Comments") at 5-6.

[5] "Initial Comments of Arkansas Electric Cooperative Corporation" (April 12, 2011), Verified Statement of Michael A. Nelson ("VS Nelson") at 11-12.

reduction in competition associated with the creation of the duopolies has adversely affected productivity improvement.

Specifically, as shown below, the 5-year average annual rate of productivity improvement as measured by the Board decreased from a robust 5.9 percent during the 5-year period preceding the mega-mergers to 1.9 percent during the 5-year period immediately following the mega-mergers, and to 1.4 percent in the most recent data:

Time Period	5-Year Average Annual Productivity Improvement (percent)[6]
1990-1994	5.9
1995-1999	2.8
2000-2004	1.9
2005-2009	1.4

Even leaving out the effects of the recession, the average annual rate of productivity improvement during the 5-year period from 2003-2007, which started within the oversight period for the Conrail transaction, was only 1.5 percent. That is barely ¼ of the "pre-duopoly" rate.

Overall, the adverse impacts of rail market power on innovation and costs are detrimental to the long-term financial health and economic soundness of the industry and should cause the Board to avoid, rather than encourage, the undue reliance on market power advocated by the big

[6] See Docket No. EP 290 (Sub-No. 4), Railroad Cost Recovery Procedures—Productivity Adjustment, decisions released February 18, 1997, January 25, 2001, January 26, 2006 and February 7, 2011.

railroads. Competition by railroads may be chaotic and challenging, but it promotes long-term financial and economic fitness in ways that excessive reliance on market power does not.

The Big Railroads' Own Evidence Substantiates the Public Interest Problems of the Board's "Competitive Abuse" Standard

In my opening verified statement, I pointed out the public interest problems associated with the Board's applications of its "competitive abuse" standard that has prevented the application of access remedies.[7] I highlighted the role of resource allocation considerations in establishing both a public interest foundation for differential pricing and a public interest need for the Board to apply appropriate competitive access remedies when a carrier's exercise of market power leads to tangible misallocation of resources in the form of circuitous routes and/or inadequate service.

The evidence submitted by the big railroads corroborates the observations presented in my opening verified statement, and provides no foundation whatsoever for the Board to disregard the inefficiencies that result from the exercise of market power by the big railroads. AAR witness Willig confirms that "...the public's interest in the efficient allocation of an economy's scarce resources is best served by reliance on well-functioning market forces".[8] The statutes do not provide for the Board to administer any type of "differential service" or "differential efficiency" standards that would permit defined distortions in resource allocation to occur (analogous to those established for differential pricing), and the underlying economic theory treats as a resource misallocation any deviations from the competitive norm for service and/or efficiency. There simply is no public interest foundation for the Board to apply any

[7] VS Nelson at 17-18.

[8] "Initial Comments of the Association of American Railroads" (April 12, 2011) ("AAR Comments"), VS Willig at 2.

definition of "competitive abuse" that overlooks resource misallocations stemming from carrier exercises of market power (i.e., other than the limited distortions that result from permitted levels of differential pricing).

Competitive Access Does Not Unduly Sacrifice Differential Pricing

The big railroads imply that the Board's mandate to support carrier achievement of adequate revenues through differential pricing conflicts with, and should take precedence over, its mandate to remedy inefficient and/or inadequate service through introduction of competitive access. No such conflict exists, for the following reasons.

First, from a public interest perspective, resource allocation issues generally trump distribution issues,[9] so providing an effective remedy for inefficient and/or inadequate service should take precedence over any transfer payment provided by differential pricing.

Second, as discussed in greater detail in my opening verified statement, the attainment of revenue sufficiency curtails the justifiable level of differential pricing. As stated succinctly by DOT/DOJ: "Shippers should not be required to pay more than necessary for carriers to earn adequate revenues."[10] The railroads have basically disregarded this limitation, and have

[9] For example, in a merger case cost savings generally are counted as public benefits, while the transfer payments associated with differential pricing are not.

[10] "Initial Comments of the United States Department of Transportation and the United States Department of Justice" (April 12, 2011) at 4. As major statutory objectives are achieved, the need for rebalancing regulatory priorities to assist in the achievement of other objectives is unavoidable. On its face, the Staggers Act and the NTP were not and have never been perfectly ordered on the achievement only of ever-improving financial health by railroads.

presented no credible evidence or credible argument for the proposition that differential pricing should extend above this level.[11]

Third, AAR witness Willig offers a series of observations that collectively suggest that application of a competitive access remedy would be justified by rates above the SAC level.[12] If the big railroads' own witness provides a foundation for using competitive access to curtail differential pricing above the level contemplated in the statutes and theory, the Board should relax whatever concerns it may have about collateral impacts on differential pricing caused by other prospective applications of competitive access that are consistent with the statutes and theory.

Fourth, as a practical matter, if the Board became serious about applying competitive access remedies to address inefficient and/or inadequate service, excessive differential pricing, or any other carrier conduct that is deemed in the statutes or the Board's judgment to be contrary to the public interest, it would not take long for rail carriers to reform their conduct to avoid facing competitive access remedies. If carriers provided efficient routes, adequate service, rates within permissible limits, etc., to captive shippers, they would ensure that differential pricing within

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[11] The railroads do argue that the Board should permit the railroads to attain high earnings to maximize their role in meeting environmental and resource needs (such as reduced pollution, lower fuel use, and less highway congestion). Congress explicitly defined and limited the criteria that establish revenue sufficiency, and provided the Board with absolutely no authority or mandate to place a valuation on such externalities and intangibles in the revenue sufficiency context.

[12] Witness Willig observes that "(w)here the concern is that a railroad has abused its market power with anticompetitive behavior, then regulatory intervention is available through access remedies". AAR Comments, VS Willig at 4-5. The Board, as described in its recent decision in Docket No. 42104, determines whether a railroad is abusing its market power in part on the basis of the rate level. Witness Willig advises that "regulators should attempt to provide market participants with the same signals that a well-functioning market would provide" (AAR Comments, VS Willig at 5) and observes that in such markets, "(c)harges above SAC would lose the shipper's business to competitive entry…" (AAR Comments, VS Willig at 5, n.2). Taken together, these comments support the proposition that the Board should consider the application of competitive access remedies where a railroad charges rates above the SAC level.

permissible limits would not be jeopardized. The competitive access remedies provide a powerful tool with which the Board can motivate conduct by the major railroads towards captive shippers that is consistent with applicable statutes and supportive of the public interest without unduly sacrificing the ability of the industry to engage in permissible differential pricing.

<u>The Adverse Impacts of the Major Mergers Heighten the Needs for Competitive Access Relief</u>

The big railroads make various erroneous claims regarding the competitive benefits of the major mergers.[13] As originally proposed, the major mergers were expected to produce such benefits as reductions in the cost of moving traffic and improvement of service levels through expanded single-line service, and reductions of fixed costs through elimination of duplicative parallel facilities. These changes were supposed to enhance the competitive capabilities of the railroads, and offered shippers the prospect of improved price/service options. At a minimum, even if shippers never realized such improvements, the big railroads argue that the conditions imposed on the mergers prevented the occurrence of anti-competitive degradations of price/service options.

While all of this sounds good, it does not comport with the available evidence regarding the actual impacts of the major mergers. As discussed in detail in my initial verified statement in this proceeding, Christensen's findings indicated that both the marginal costs of moving traffic and average fixed costs <u>increased</u> as a direct result of the major mergers (in combination with the Bottleneck Rule). Indeed, consistent with these findings, Christensen also found that the major mergers had basically exhausted economies of density, and that the merged carriers had begun to

[13] See, for example, UP Comments at 8-10.

exhibit diseconomies of density.[14] While the conventional wisdom at the time of the major mergers was that "bigger is always better", the evidence provided by the Board's contractor indicates that this is not – and was not - the case.

Likewise, the evidence indicates that that the increased costs were accompanied and facilitated by reduced competitive pressure, as the conditions imposed in the major mergers did not fully protect shippers against anti-competitive degradations of price/service options. In particular (as discussed in my initial verified statement in this proceeding) written testimony I submitted in STB Ex Parte No. 658, The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead, identified and described several ways in which unapproved losses of competition occurred during the wave of rail mergers.[15] These include, but are not limited to, losses associated with "3-to-2" reductions in the number of serving carriers, reductions in source competition, and reductions in shipper leverage. My initial verified statement in this proceeding already discussed the demonstration by Christensen that "3-to-2" reductions in the number of serving carriers that resulted from some past mergers had tangible anti-competitive effects on shipper price-service options. Similarly, the opening statements of several shippers corroborate the losses of source competition and shipper leverage that I discussed.[16]

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[14] As summarized by Christensen, "(e)arly in the sample period, railroads appear to have experienced fairly strong economies of density, but those economies have been diminishing since around 1995." While Christensen neglected to mention that this corresponds to the initiation of the major mergers, Christensen's data further show the post-merger development of diseconomies of density associated with lengthened hauls on the western railroads, and diseconomies of density associated with increased revenue tons on the eastern railroads. See "An Update to the Study of Competition in the U.S. Freight Railroad Industry" (January 2010) at 3-5 to 3-8.

[15] For convenience, the referenced portion of that testimony is attached as Exhibit 1.

[16] See, for example, "Comments of E.I. du Pont de Nemours and Company" (April 12, 2011) at 3-4; "Comments of The Fertilizer Institute" (April 12, 2011) at 7.

As a result of these considerations, the Board should recognize that the competitive environment shippers now face is not the one that was described in the carriers' merger applications and anticipated by the Board and shippers. Indeed, by the carriers' own descriptions, the merged systems have become so unwieldy that they cannot respond promptly to even routine perturbations of traffic.[17]

Service Arguments of the Railroads Corroborate the Absence of Effective Competition

Railroad arguments regarding the service impacts of competitive access, particularly as discussed in the evidence submitted by UP, demonstrate the inadequacy of current competitive pressures. Subsequent to the UP/SP merger, the merged UP system subjected coal shippers to not one, but two lengthy periods of substantial service inadequacy (along with assorted lesser service disruptions). The "meltdown" following consummation of the UP/SP merger and UP's PRB throughput problems that began in May 2005 by any measure were two episodes of very substantial service problems.[18]

In a competitive environment, carriers may gain or lose traffic based on the competitiveness of their price/service options. Firms that offer poor or unreliable service, or that

[17] See, for example, "Initial Comments of Norfolk Southern Railway Company" (April 12, 2011) ("NS Comments"), VS Manion at 1-2, which emphasizes the scarcity of available network resources, and expresses horror at the prospect that more than one shipper at a time might exercise a right to use a joint line route in lieu of a single line route. Similarly, UP witness Fritz expresses concern that "(f)orcing new access and changing interchange points would add work events to busy rail lines with heavy through train density, thus slowing down the overall network, and reducing throughput capacity." UP Comments, VS Fritz at 7. Having spent most of the 1980's and 1990's creating "new access" to new markets and building traffic density all over its network, as described in UP Comments, VS Young at 7-8, UP apparently now does not want the traffic its efficient routes might enable it to gain through competitive access.

[18] The incidence of these problems on captive vs. non-captive shippers is an open question in AECC's petition for reconsideration of the Board's March 15, 2011 decision in STB Docket No. 42104, Entergy Arkansas, Inc. and Entergy Services, Inc. v. Union Pacific Railroad Company and Missouri & Northern Arkansas Railroad Company, Inc., and therefore is not discussed here. Whether or not the STB accepts AECC's specific arguments in Docket No. 42104, it is undisputed that these severe problems did occur following the UP-SP merger.

expand beyond an optimal size (as discussed above), naturally tend to lose traffic to more nimble and efficient competitors. However, that hasn't happened to UP. Indeed, in the current transportation environment, the threat that UP will lose (or gain) traffic is so remote that, by UP's own evidence,[19] it maintains little capability to accommodate such volume fluctuations. Having experienced 2 major service disasters and various smaller disruptions over a period of less than 15 years, UP incredibly now comes to the Board not only indicating that it has elected not to manage its railroad in a way that protects against service issues that may arise from routine volume fluctuations in a competitive marketplace, but also specifically threatening the Board that forcing it to face actual competition could trigger another service disaster.[20]

<u>The Traffic "Fiefdoms" of the Duopolies Do Not Provide Needed Competition</u>

The big railroads basically argue that their systems have been designed to accommodate the traffic they are planning to handle,[21] and that they should be insulated from the possibility that another carrier might offer better price/service options (or that they might succeed in attracting traffic from another carrier), thereby changing the distribution of traffic between carriers. There are no allegations of ruinous competition or stories of bare-knuckle brawls between carriers over major flows. Indeed, the shipper statements indicate that the major railroads do not effectively challenge each other even for ostensibly "competitive" flows. Traffic

[19] UP indicates that "(c)hanging the patterns of traffic flows" on an "inadequate network" was the root cause of the UP/SP meltdown, but then describes how UP still can "reach a tipping point quickly" because "problems on one part of the railroad network quickly spread to the rest of the network". In a span of 3 sentences, UP indicates that it hasn't materially improved its ability to withstand volume fluctuations. See UP Comments, VS Fritz at 18.

[20] UP Comments, VS Fritz at 7.

[21] NS Comments, VS Manion at 3 references the "delicate operational balance" of NS; UP talks about improving "efficiency" by coordinating "investment and transportation plans" and having "operations become more consistent, predictable and repeatable". UP Comments, VS Fritz at 4. Unfortunately, there is stochasticity in transportation demand, and the conditions described by these carriers represent management decisions to operate their networks with minimal provision for the unplanned, unprogrammed events that characterize the actual marketplace.

apparently is no longer viewed by the carriers as something to be sought or served; rather it is a controlled input used to optimize their financial performance.

This is not the environment of healthy competition that the Board/ICC thought it was fostering when it approved the mega-mergers. Rather, it indicates that rail traffic handled by the major carriers is moving not in competitive markets, but in traffic "fiefdoms" that are governed more by boardroom forces than by market forces.

Once upon a time, railroad competition lived up to the role envisioned for it in the Staggers Act. Rail carriers were not bashful about soliciting traffic, *including traffic being handled by other rail carriers*. Where a carrier did not serve a given facility or source of supply, it promoted aggressively the facilities and sources it did serve. In the west, for example, SP did not serve the Powder River Basin, but promoted aggressively the eastward movement of western bituminous (Colorado/Utah) coal in the years following its merger with DRGW and preceding its acquisition by UP. When a carrier found that its competitive offerings were ineffective, it sought innovation and change to improve its capabilities and performance, and thereby gain volume and contribution.

In this light, it can be seen that the diminution of efforts by the major railroads to compete with each other for traffic undermines the long-term benefits for the financial health of the industry that stem naturally from the innovation that results from such competition. The mega-railroads' claims regarding the effects of changes on the stability of their operations[22] manifest the type of resistance to change that inhibits innovation in some large organizations. If the big railroads genuinely fear the disruptions that may accompany routine volume fluctuations,

[22] See, for example, UP Comments, VS Fritz at 6-7.

the Board surely cannot count on them to invest in disruptive innovations to the extent that a more nimble firm would. This provides a fundamental public interest justification for the Board to take whatever actions may be required to move away from the homeostasis sought by the carriers in favor of an environment of more vigorous competition.

Market Forces Promote Operating Efficiency and Investment

Several big railroads claim that the competitive changes contemplated by the Board in this proceeding threaten their operating efficiency and future infrastructure investments.[23] However, these claims are erroneous in at least three fundamental respects. First, as discussed in the "Horizontal Merger Guidelines" adopted by the U.S. Department of Justice and the Federal Trade Commission, efficiencies generally are of minimal significance from a public interest perspective if, as is the case here, they are achieved at the expense of a loss of competition in a concentrated market.[24] Especially in light of the robust financial condition achieved by the Class I railroad industry, there would be no credible public interest basis for the Board to give preference to those efficiencies over the tangible and demonstrated harms associated with lost competition.

Second, the carriers overstate dramatically the magnitude of future investment requirements and related issues. Specifically, the railroads reference repeatedly the study performed by Cambridge Systematics, Inc., which presents estimates of large future capital

[23] See, for example, UP Comments, VS Young at 12-13.

[24] See http://www.justice.gov/atr/public/guidelines/hmg.htm#4 (Section 4).

needs. However, the conclusions of that study have been refuted by Christensen[25] as well as a past AECC filing.[26]

Third, and perhaps most importantly, the big railroads' claims ignore the adverse impacts that carrier market power (as well as the Bottleneck Rule) can have on efficiency and investment, and the ways market forces can mitigate those impacts. For example, under the statute and the Board's rules, Section 10705 provides a specific remedy for situations where a carrier has relied on its market power to foreclose a more efficient through route in order to take its long haul. Especially for heavy-haul trainload/unit train operations, use of a more efficient route can materially reduce the resource costs of transportation. If a carrier is short-hauled by a Board-ordered through route under these circumstances, it is because another carrier can provide more efficient service for the given portion of the route (i.e., the short-hauled carrier's costs go down faster than the competing carrier's costs go up). Moreover, diversion of the movement over a given segment to a more efficient carrier sends the proper investment signals to both carriers. The original carrier must decide whether to increase the efficiency of its route that serves the given segment, and the investments made ultimately focus on creating or expanding the capacity of the most efficient route. These factors improve industry efficiency and productivity in both the short- and long-term.

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[25] Christensen's "Supplemental Report to the U.S. Surface Transportation Board on Capacity and Infrastructure Investment" (March 2009) highlighted a number of the exaggerations and inconsistencies embodied in the traffic volume projections relied upon in the Cambridge Systematics study.

[26] See STB Ex Parte No. 664, Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, "Reply Comments of Arkansas Electric Cooperative Corporation" (October 29, 2007) at pages 4-6. As described in these comments, the Cambridge Systematics study not only does not support the railroads' argument, it actually refutes it. The study highlights the way an expanded traffic base would support increased infrastructure investment at current rates, and the way ongoing and future productivity improvements will increase the throughput capacity of the existing network without major additional investment.

Analogous considerations arise in the context of the Bottleneck Rule, as described in greater detail in Appendix A of my statement accompanying AECC's comments in Ex Parte No. 680.[27] Specifically, that analysis estimates that the Bottleneck Rule as of 2006 caused traffic to move over circuitous routes that generated $1.32 billion of unnecessary operating costs annually. This represents wasted crew time, fuel, locomotive time, track maintenance, etc. associated with unnecessary ton-miles. The wasted fuel alone amounted to an estimated 103.4 million gallons annually, along with corresponding adverse impacts on carbon emissions and other environmental, national energy policy and security goals.

The same source documents three specific adverse impacts of the Bottleneck Rule on the economic efficiency of infrastructure investments.[28] These include wasteful investments in the development and implementation of duplicative plant access facilities that are not needed for capacity, efficiency or other freestanding reasons; disproportionately large infrastructure investments in the least efficient portions of a carrier's long-haul route;[29] and foreclosure of potential ("toll road") investments by third parties.[30] In short, the big railroads' arguments on efficiency and infrastructure ignore the well-known benefits of competition in promoting efficient operation and investment.

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[27] STB Ex Parte No. 680, <u>Study of Competition in the Freight Railroad Industry</u>, "Comments of Arkansas Electric Cooperative Corporation Regarding Study of Competition in the U.S. Freight Railroad Industry Conducted by Christensen Associates" (December 22, 2008). Appendix A of my statement in that document (hereafter, "Nelson Bottleneck Study") incorporates content from the study of the public interest impacts of the Bottleneck Rule I performed for CURE, which was cited favorably in the joint study of rail issues prepared by the Departments of Agriculture and Transportation.

[28] In addition, it documents the adverse impacts of the Bottleneck Rule on rail system reliability and other considerations.

[29] Discussed further on page 10 of Nelson Bottleneck Study.

[30] Discussed further on pages 10-11 of Nelson Bottleneck Study.

More generally, it should be noted that the big railroads' arguments regarding infrastructure investment implicitly assume that competitive access would be imposed so frequently that it would eliminate differential pricing entirely and thereby undermine achievement of the revenue level specified in Section 10704(a)(2). However, under the approach to liberalizing competitive access that AECC is recommending, the railroads would have an opportunity to show cogent reasons why competitive access should not be ordered in particular cases, and the Board would have authority to determine the extent to which competitive access would be ordered. Furthermore, as discussed previously, substantial public interest benefits would result from increasing competitive access even if access were not pervasive, and even if differential pricing were not eliminated. As discussed in my initial verified statement, the Christensen study found that the industry by the mid-1990's had achieved revenue levels sufficient to attract all of the capital it needed.[31] Given the improvements in industry financial performance that have occurred since that time, the industry's assertions that even limited application of competitive access tools would jeopardize investment simply lack credibility.

The Decline in the "Captive" Percentage of Rail Traffic is a 2-Edged Sword

Several big railroads note that the percentage of rail traffic that is captive has declined over time.[32] The intended implication of this appears to be that the volume of traffic to which competitive access relief would apply is smaller than it used to be, so it would not be that harmful if competitive access relief remained scarce.

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[31] AAR asserts that the Christensen analysis of revenue sufficiency had a number of shortcomings, including issues related to replacement costs and the treatment of taxes. AAR Comments at 18. These criticisms are not persuasive, however, as AAR's past efforts to introduce a replacement cost methodology have not been accepted, and Christensen's general findings regarding revenue sufficiency are evident in different analyses using different methods, whether or not there is an issue with the treatment of taxes in one of Christensen's analyses (which, in any event, AAR has not demonstrated).

[32] See, for example, "Initial Comments of Canadian Pacific Railway Company" (April 12, 2011) at 12.

Obviously, over time, individual facilities have pursued competitive access through the planning, development and, if needed, construction of new plant access trackage. Likewise, new facilities may have been sited to obtain competitive access. Also, in the Conrail transaction, the "Shared Asset Areas" received additional competitive options. Where such actions have occurred, they have reduced or eliminated the relevance of regulatory options for providing competitive access.

What the railroad parties ignore is the extent to which the percentage decline in captive rail traffic results from a disproportionately high incidence of closure or diminished output among captive facilities vs. competitively-served ones (as reported in the opening comments of several shipper parties).[33] The reluctance of shippers to locate new facilities at locations that are not competitively served would also cause a decline in the captive traffic percentage. In this situation, the decline in the percentage of captive traffic does not mean that competition has increased; it means that customers have been forced to make decisions that result in substantial resource misallocations in response to carrier exercise of market power at exclusively-served points. Such misallocations are inconsistent with the public interest and the competition elements of the NTP, and should therefore be viewed by the Board as a cause for remedial action rather than reassurance.

Indeed, even where competition has been added, the Board should consider carefully the efficiency of the underlying resource allocation. If a shipper or competing rail carrier has to construct a duplicative rail access that is not needed for capacity, efficiency, or other

[33] See, for example, "Comments of PPG Industries" (April 12, 2011) at 6.

freestanding purpose, such construction would also represent a resource misallocation that is inconsistent with the public interest and the competition elements of the NTP.

Small Railroad Issues

The opening evidence submitted by ASLRRA and others details important distinctions between the big and small railroads in issues related to competitive access. In general, I agree with the assessments offered by the small railroad interests on the subjects that they cover, particularly the testimony of Carl Martland, whom I take seriously even before reading what he says. However, I believe those assessments have omitted some relevant considerations that should be taken into account by the Board as it reviews competitive access issues in the context of the current transportation marketplace.

The specific considerations I would add to those discussed by the small railroad interests are as follows:

- because of interchange commitments/paper barriers, distinguishing the actions of a big railroad from the actions of a small one is not always straightforward, and goes beyond the name on the letterhead or the color scheme of the locomotives. Interchange commitments/paper barriers may contain terms that impose financial penalties on the shortline for interchanging traffic with carriers other than the parent. This effectively can force the shortline to quote rates that embody substantial differential pricing, and mimic or exceed the rates the parent Class I would have quoted on its own;
- to the extent that interchange commitments reflect market power the parent would exercise over the shortline's traffic absent the shortline spin-off, it would be difficult or impossible for the Board to exempt shortlines from competitive access orders without

simultaneously insulating the parent's exercise of market power from competitive access remedies. Put another way, the Class I's should not be able to hide their exercise of market power behind a "human shield" of shortlines and the terms of associated interchange commitments;

- contractual arrangements between a shortline and its parent Class I may provide opportunities for the Class I to undermine the effectiveness of Board-ordered competitive access involving the shortline that the Class I views as contrary to its interests. In the limit, the continued ability of the shortline to provide service to specific facilities – or to provide service at all – may be jeopardized in this manner;
- on the other hand, all else equal, the shortline portion of movements to/from a carrier other than the parent likely tends to be longer than it is on movements involving the parent. This was illustrated in Docket No. 42104, where the spin-off of MNA from UP created a short (less than 10 mile) movement of loaded PRB coal trains on MNA between Newport, AR and a nearby powerplant served by MNA, but the movement for MNA would be much longer (approximately 280 miles) if the loads were being received from BNSF (via Lamar, MO). Shortlines typically aren't spun off to handle substantial volumes over long distances, but that may be the result if the connecting carrier is changed (e.g., as a result of Board-ordered competitive access). It therefore can be anticipated that Board-ordered competitive access may frequently produce beneficial traffic changes for the smaller railroads;
- while shortlines have a well-deserved reputation for efficiently providing quality service, the Board's procedures need to be able to address the exceptions as well as the general rules. In the "Pyco" case, for example, disputes arose between a shipper and a shortline

regarding the adequacy of the "last mile" service provided by the shortline.[34] In that case, the shipper ultimately acquired the line under the feeder line development statute. It likely would not happen often, but it cannot be ruled out that analogous future situations could arise in which the availability of Board-ordered competitive access would be needed to address, for example, a shortline's service inadequacies.

In light of these considerations, I believe it would be best from a public interest perspective to ensure that shortlines remain subject to competitive access orders. However, it would be reasonable and appropriate for the burden of proof in such unusual circumstances to rest with the complaining shipper. In any competitive access request that involves a shortline, the Board likely will need to devote careful attention to the contractual arrangements between the shortline and the parent Class I - including any interchange commitments - that could undermine the effectiveness of the relief provided.

Further Implications of Opening Evidence

The opening evidence submitted by other parties suggests the following additional considerations that supplement issues discussed in AECC's opening comments related to prospective application of competitive access by the Board:

- Increasing private car ownership has given shippers a stake in routing decisions that they didn't have before. If, as the Board asserted in Docket No. 42104, differences between routes may affect rolling stock costs, it is both equitable and efficient for those who increasingly bear such costs to have an expanded say in their incurrence;

[34] See Docket No. FD 34890, Pyco Industries, Inc.—Feeder Line Application—Lines of South Plains Switching, Ltd. Co. and related proceedings, as summarized in the decision served June 11, 2010.

- Where competition is to be added, consideration should be given to the feasibility and effectiveness of adding such competition via a "third" carrier other than one of the duopolists;
- The Board may wish to consider awarding competitive access for any captive rail-served plant that closes if, for example, pre-closure R/VC ratios are above a threshold level;
- The Board may wish to consider awarding competitive access for any captive rail-served plant for which the carrier charges a tariff rate above the SAC level; and,
- Many of the claims made in various "form letter" statements submitted in this proceeding are patently false. For example, rail rates above the level needed for revenue sufficiency almost certainly hinder, rather than facilitate, recovery from the recession, and tend to push down investment and employment. Indeed, the opening evidence indicates that the adverse effects of the mega-mergers on source competition have been substantial, and now are acting to favor export of U.S. jobs.

Exhibit 1

Excerpt from

STB Ex Parte No. 658

The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead

Written Testimony of Michael A. Nelson

on Behalf of Arkansas Electric Cooperative Corporation

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 658

THE 25TH ANNIVERSARY OF THE STAGGERS RAIL ACT OF 1980: A REVIEW AND LOOK AHEAD

WRITTEN TESTIMONY OF
MICHAEL A. NELSON

ON BEHALF OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION

131 North Street
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October 12, 2005

4. Mergers and Competitive Issues

The current rail environment results in large part from the handling by the Board and its predecessor of numerous mergers and acquisitions that have been proposed since the Staggers Act. These transactions in many cases have eliminated redundancy, reduced costs, extended single-line services and produced other benefits. However, within the "big picture" of beneficial changes described in Section 3 (above), there are aspects of the ICC/STB's handling of merger applications under the Staggers Act that may have hindered the full realization of the benefits of market forces.

Each application for a merger or acquisition normally has triggered a detailed consideration of competitive issues. When competitive problems have been identified, remedial conditions have frequently been imposed. Few if any merger approvals have been granted in which substantial unremediated competitive problems were believed (by the ICC/STB) to exist. Moreover, several of the more recent mergers have been followed by formal oversight proceedings (typically 5 years) during which competitive problems that materialized could be brought forward.

Despite these procedural safeguards, there are several avenues through which meaningful competition may have inadvertently been lost in the merger process. This section identifies and discusses four such avenues.

a. "<u>3-to-2</u>". Competitive issues in early mergers were typically assessed based on increases in market concentration that would ensue. However, some of the later mergers were assessed primarily on the basis of the (more permissive) standard of avoiding the elimination of all rail competition options for individual shippers. As an example, a merger that combined two carriers which each held 40 percent shares of a given regional commodity flow might raise competitive concerns under the early criteria, but would not under the later criteria as long as individual shippers did not lose all competing rail options. The changed criteria facilitated a "3-to-2" reduction in the number of serving rail carriers (but prevented "2-to-1" reductions), thereby enabling the creation of the current duopolies of the principal railroads in the East and West.

To date, I know of no conclusive evidence as to whether or not this change of criteria, viewed in isolation, produced measurable competitive harm for specific commodity flows. However, there are several reasons for the Board, in hindsight, to give careful consideration to this issue:

- with rail volumes now pushing capacity limits in many lanes, the elimination of redundant facilities in past "3-to-2" mergers may no longer be viewable as a benefit (i.e., those facilities may now be needed for capacity reasons);
- subsequent events have shown that the large duopolies that were created through approval of "3-to-2" mergers lack redundancy, and tend to be susceptible to serious service degradations as result of unplanned events;
- from the outset, the shift in criteria rested in large part on a presumed strength of truck competition that was inconsistent with ICC precedent.[1] The ineffectiveness of truck competition for long haul rail traffic has subsequently been corroborated by the explosive growth in rail intermodal volume and profitability; and,

[1] In its landmark decision denying the proposed merger of Southern Pacific and ATSF (Finance Docket No. 30400), the ICC rejected the proposition that truck competition would protect transcontinental rail traffic from competitive harm.

- the computation of compensation for trackage rights implemented to protect shippers from complete loss of competitive rail alternatives apparently has not accounted for differences in contribution between captive and competitive traffic. This omission makes it difficult or impossible for a tenant to replicate the price/service options for competitive traffic that the trackage rights were implemented to serve.

b. "Learning Curve". As greater experience was gained in processing mergers under the Staggers Act, merger analysis criteria in some instances were changed so that certain types of lost competition could be better identified and remediated. These types of lost competition include the following:

- "Cross-over" effects – Due to merger sequencing and the time lags associated with the availability of the Rail Waybill Sample data used in merger analyses, a proposed transaction sometimes required evaluation before the effects of a predecessor transaction could be observed in the data. While methods for addressing this issue were eventually developed, early transactions may have overlooked some significant cross-over effects.
- Source Competition. As the scope of mergers became larger, the potential for losses of "source competition" increased.[2] While the importance of source competition was eventually embraced by the Board in its merger rules, several large transactions had occurred in which no source competition issues were acknowledged or addressed.
- "Bottleneck" Segments. From the outset, mergers carried the potential to eliminate the ability of captive shippers to separately contest the reasonableness of rates on the "bottleneck" portion of specific movements. While the importance of this consideration has

[2] "Source competition" refers to a shipper's ability to sell products through alternative outlets or obtain inputs from alternative sources that are independent of a given railroad, limiting the differential pricing opportunities for that railroad in serving a given movement.

been accepted by the Board and incorporated in recent merger decisions, many earlier cases did not provide such protection.

c. Shipper "Leverage". It is sometimes thought that large companies have the ability to resist anti-competitive conduct by railroads simply by virtue of their size. To the extent that that is true, it may result from the "leverage" a large shipper may wield as a result of operating multiple plants at multiple locations. In this circumstance, the ability to shift output among plants served by different railroads may constrain differential pricing by the individual railroads. As mergers became larger in scope, they had an increasing tendency to reduce or eliminate this leverage (i.e., by decreasing the number of different rail carriers serving a large shipper's plants). As a result of the loss in leverage, those shippers were exposed to potential degradations in their price/service options for rail transportation.

d. System Breakdowns. There are several avenues through which "breakdowns" of the system in individual cases are believed to have caused competitive problems to avoid scrutiny:

- A responsive carrier fails to pursue relief for a competitive problem in merger X, because it plans to engage in a subsequent merger with the merged "X" system, or fears adverse commercial consequences ("retribution");
- A responsive carrier fails to pursue relief for a competitive problem due to misimpressions regarding the (new) markets it would become able to serve;
- A responsive carrier fails to pursue relief for a specific competitive problem in merger X, because it wishes to negotiate a settlement and cannot obtain concurrence from applicant(s);
- A responsive carrier's counsel directs the filing of competitive analyses at an improper stage of the case, resulting in a successful motion by applicants to strike evidence of demonstrable competitive problems;

- A party advances a meritorious argument in an oversight proceeding, but doesn't develop corresponding traffic analyses to demonstrate the problem, so no action is taken;
- The Board identifies a problem and imposes remedial conditions, but the conditions do not function as planned and go essentially unused.

In general, in the early years after the Staggers Act the self-interest of non-merging railroads led to aggressive pursuit of competitive issues in merger cases. However, the analytical process was somewhat myopic, so the treatment of competitive issues may have been incomplete. As merger analysis processes were refined, industry concentration was increasing, and the ardor of other carriers to pursue competitive conditions diminished. As a result, there have been ways from the outset for competitive problems to avoid detection and remediation in the merger process.

VERIFICATION

I, Michael A. Nelson, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.

Michael A. Nelson

Michael A. Nelson

Executed on May 24, 2011