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STB Ex Parte No. 665 (Sub-No. 1)

Rail Transportation of Grain, Rate Regulation Review

Reply Comments of the

U.S. Department of Agriculture

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Under Secretary

Marketing and Regulatory Programs

U.S. Department of Agriculture

Washington, D.C. 20250

Date: August 25, 2014

Authority and Interest

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

Introduction

The U.S. Department of Agriculture (USDA) appreciates the opportunity to offer reply comments in this important proceeding impacting grain shippers and producers. USDA finds the record for this proceeding highlights the need and desire for a more accessible rail rate challenge process for grain shippers and producers. USDA believes the proceeding record has presented the Board with several workable concepts and hopes the Board is able to find a meaningful resolution on behalf of agricultural shippers and producers.

It seems clear from both the record and the perspective of agricultural interests that the Board's current rail rate challenge procedures do not provide effective protection against unreasonable rail transportation rates for grain because the nature and needs of this important sector do not lend themselves to the existing processes. Instead, new rate relief methodologies have been suggested in the record that are tailored specifically for agricultural commodities—mediation and arbitration, the Ag Commodity Maximum Rate Methodology, and a Two-Benchmark test. USDA believes these concepts show promise towards achieving the Board's stated goal of ensuring accessible and effective rate challenge procedures for grain shippers and producers and therefore should be examined and seriously considered by the Board.

The Extent of Competition

Railroads are natural monopolies.¹ Though they generally operate in competitive grain transportation markets, they are not wholly competitive participants, nor in competition for every movement. As such, there is a history of rail regulation in this country. USDA acknowledges that the partial deregulation of the rail industry under the Staggers Act brought many innovations and efficiency gains to carriers and shippers alike. Many of these innovations have benefitted agricultural shippers, such as auctions for allocating grain cars, shuttle trains, and larger railcars.

Within the agricultural sector, grain producers and shippers in regions with more transportation competition have benefited the most from rail deregulation.² Yet, railroads are still natural

¹ Characteristics of a natural monopoly are such that its costs are lower if it consists as the single supplier to a market, rather than two or more competing firms. The importance of the service and consequent elasticity of demand create the need for regulation to protect the consumer. This concept is described more fully in: Kahn, Alfred E. *The Economics of Regulation: Principles and Institutions*, MIT Press, 1988.

² Bitzan, John, Kimberly Vachal, Tamara VanWechel, and Dan Vinge, *The Differential Effects of Rail Rate Deregulation: U.S. Corn, Wheat, and Soybean Markets*, Upper Great Plains Transportation Institute, June 2003.

monopolies, and the Rail Transportation Policy³ requires the Board to maintain reasonable rates where there is an absence of effective competition. Producers with few transportation options, such as wheat farmers in remote areas, have the highest rates and bear the brunt of any rail service disruptions.

Previous studies have concluded that many agricultural shippers have a range of transportation alternatives, that grain transportation markets are largely competitive, and that different modes of transportation often compete head-to-head to move grain. Yet, no findings claim *all* agricultural shippers have competitive transportation options or that grain transportation markets are *always* competitive. As such, this characteristic of grain transportation markets underlies the impetus behind this proceeding. This proceeding is being held to address the concerns of those grain shippers without competitive transportation options who wish to have some means for challenging rail rates they believe are unreasonable.

One need look no further than the current, ongoing rail service problems for clear examples of where grain shippers lack competitive transportation options. Many grain shippers were left with severely reduced transportation options, leading to skyrocketing premiums paid in the primary and secondary railcar markets which widened the grain basis and depressed the net prices that farmers received. A North Dakota State University study estimated a \$67 million loss in North Dakota farm level revenue for crops that were sold from January through April. In addition, the study estimated another potential \$95 million loss in farm revenue if crop basis levels did not improve.⁴ Another study estimated that delays in railroad shipping have cost Minnesota corn, soybean, and wheat farmers nearly \$100 million and has cut deeply into the value of grain still in storage.⁵ Were competitive options available, either through other rail carriers or other modes such as truck or barge, these shippers and producers would most likely have availed themselves of these alternatives to avoid sustaining such significant losses.

The losses occurred because of unexpected increases in transportation costs, such as skyrocketing costs of grain cars on the secondary railcar market that peaked at \$6,000 per grain car, and other transportation related costs associated with the rail service crisis. Early on, some of these additional costs were likely borne by the exporter through reduced margins, but as the situation progressed, were more likely reflected in the prices paid to producers for their crops.

Because there are many agricultural producers with operations that are relatively small in size, and their products are homogeneous, individual agricultural producers of grain and oilseed crops are considered “price-takers.” That is, they have little or no ability to influence the price received for their products, and therefore, are unable to pass cost increases forward to buyers. Instead, these producers tend to absorb cost increases, especially in the short-run. Consequently, these increases in transportation costs resulted in decreased producer prices and, ultimately,

³ ICC Termination Act of 1995, §10101.

⁴ Olson, Frayne, *Effects of 2013/14 Rail Transportation Problems on North Dakota Farm Income*, Executive Summary to Senator Heidi Heitkamp, North Dakota State University, May 2014.

⁵ Usset, Edward, University of Minnesota, presentation at *Envisioning the Future of Agricultural Freight in Minnesota*, Alexandria, Minnesota, July 10, 2014.

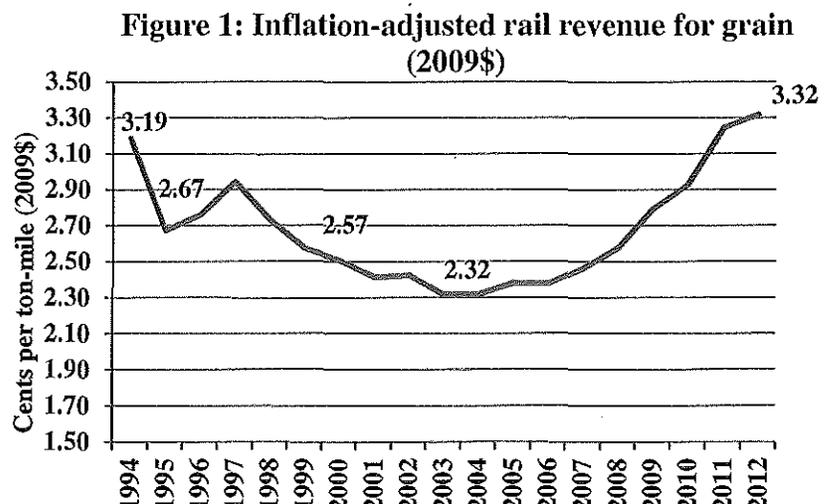
lower incomes as producers absorbed much of the increased transportation cost. In turn, lower producer incomes adversely affect the ability of individual producers to borrow funds and reduce economic prosperity in rural areas.

An analogous example is the record high premiums being paid in the primary railcar market to secure guaranteed service due to substandard service, which have reached unprecedented levels in excess of \$3,000 per car. In this case, substandard service has translated into additional rail revenue. Where competitive alternatives are prevalent, rail carriers would be unable to command these premiums. This is not to say that rail carriers necessarily charge uncompetitive rates over these segments when their service is functioning optimally. Rather, this illustrates the ability to do so. It is this ability that warrants careful consideration of prescriptions by the Board because markets are not driven by the benevolence of its participants but ultimately by their profit maximizing motivations. It is for this reason why the Rail Transportation Policy requires the Board to maintain reasonable rates where there is an absence of effective competition and why developing a workable rate complaint process for grain shippers is so important.

Rail Profitability

In comments provided to the Board in this proceeding, various rail interests have asserted that shippers have no incentive to challenge rail rates where the rates are reasonable, and implied this is the major reason behind the lack of rate challenges from grain shippers. Yet, this is certainly not true for all grain shippers. The record in this proceeding and many other past proceedings is replete with testimony that contradicts this argument. Even in an environment where rates are generally reasonable, there are likely to be at least some grain shippers who could be disadvantaged and deserve a fair process to seek relief. USDA believes they deserve a process that is not only fair, but one that is inexpensive and doesn't require a battery of lawyers and economists to prove the case. If what the rail interests claim is true, then designing a more accessible rail rate challenge procedure for grain shippers would not lead to any new rail rate challenges. However, if the rail interests are wrong and a more accessible rate challenge procedure is not implemented as a result of this proceeding, then at least some grain shippers would continue to be left without access to a useable rail rate challenge process—a hard pill to swallow in light of continued record-breaking railroad profitability.

The fact that inflation-adjusted rail rates have increased faster than the rail cost adjustment factor is at least an anecdotal indication of the market power of Class I railroads. Since 2003, inflation-adjusted rail rates for grain have increased 43 percent, from 2.32 cents per ton-mile to 3.32 cents per ton-mile (figure 1). In contrast, the rail cost adjustment factor, adjusted for



Source: USDA analysis of Surface Transportation Board Confidential Waybill

productivity, increased only 28 percent (table 1). Very few industries in this country, in a down economy, could similarly raise their prices well above costs, boost their profits, and continue to maintain their customers. We raise this point to suggest that railroads can and sometimes do use market power in their pricing and, therefore, there is a legitimate need to find a way for grain shippers without competitive transportation options to challenge rail rates they believe are unreasonable with a process that is simple, cost effective, and fair.

Table 1: Annual rail cost adjustment factor (Adjusted for productivity) (4Q 2012 = 100 for unadjusted RCAF)	
Year	RCAF (adjusted)
2003	0.334
2004	0.341
2005	0.360
2006	0.369
2007	0.365
2008	0.426
2009	0.358
2010	0.396
2011	0.430
2012	0.429

Source: Association of American Railroads, *Railroad Cost Indexes*

A Need for an Accessible Rail Rate Challenge for Grain Shippers

Effective regulatory mechanisms are critical to rounding out the Rail Transportation Policy’s complementary directive of allowing competition to establish reasonable rates. USDA had previously found that States lacking rail-to-rail competition do not necessarily pay higher rates than States with more transportation competition.⁶ Some of the possible reasons behind this included individual railroads being sensitive to shippers’ needs and greater engagement at the State government level. However, another reason discussed by rail carriers during the course of this proceeding is the presence of rate reasonableness remedies through the Board. Said another way, where competition does not exist, some rail carriers are likely to temper rates in the face of possible litigation. As such, rail carriers often choose to preserve customer relations and avoid litigation.

Thus, the mere possibility of litigation serves as a check on the rail industry, disciplining markets that might not otherwise produce a competitive rate. The possibility of litigation is only effective if it is credible. This underscores the importance of designing an effective rail rate challenge procedure through this proceeding that is accessible to grain shippers and producers, thereby ensuring its credibility as a check against rail rates for this class of shippers.

⁶ USDA, Agricultural Marketing Service, *Study of Rural Transportation Issues* at 231 (April 2010).

USDA realizes that some railroads are more active in responding to and working to address their customers' needs and commends these efforts. However, other railroads are less proactive in this regard. And, just because some rail carriers are currently active in working with their customers to identify markets and provide competitive rates, does not ensure this will always be the case. Effective regulatory policy ensures markets will continue to function properly through socially optimal incentives regardless of how future circumstances and opportunities change.

Railroad Revenue Adequacy

USDA established in its opening comments the pertinence of linking the rail rate challenge process with railroad revenue adequacy. When the railroads were in poor financial health, it was arguably appropriate that shippers seeking regulatory redress for high rates faced a heavy burden. However, as a result of decades of efficiency improvements and recent but consistent rate increases, the railroads are now earning approximately their cost of capital.⁷ There can be no doubt that the rail industry is in far better financial health today than it was in the immediate post-deregulation period.

It is in everyone's interest for the railroads to earn sufficient returns on their investments to be able to maintain, improve, expand, and safely operate their extensive and expensive infrastructure and rolling stock. As rail revenues become persistently adequate, the tradeoff between the short-run interests of shippers (in lower rates) and the long-run interests of shippers (in rail revenues that are high enough to ensure adequate investment) begins to shift in favor of lower rates. In particular, though the high rates paid by captive shippers may be considered "reasonable" so long as a railroad is earning less overall than the cost of maintaining and improving the railroad network, as discussed below, even current policy recognizes that the same rates may be judged "unreasonable" when the railroad is earning more overall than this cost.

There is general agreement that, in order for the railroads to efficiently recover high fixed costs, it is necessary and appropriate that shippers without competitive options pay a higher share of these fixed costs than other shippers.⁸ However, it is neither appropriate nor the law that the degree to which these captive shippers are discriminated against be unlimited.⁹ Under Constrained Market Pricing precedent, a captive shipper is not to be "required to continue to pay differentially higher rates than other shippers when some, or all, of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs."¹⁰ This principle is called the "revenue adequacy constraint" on differential pricing to captive shippers.

⁷ Laurits R. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition*, November 2008 ("Christensen Report"). Also, USDA Opening Comments at pg. 3.

⁸ This approach is known as Ramsey pricing or 3rd degree price discrimination. *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985).

⁹ *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985).

¹⁰ *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1), October 30, 2006, at 7.

USDA Recommendations

USDA asserted in its opening comments the most accessible rail rate challenge procedure for grain shippers would be characterized by: (1) significantly lower costs than the Board's three current procedures, (2) a predictable set of outcomes through a simple to use and easy to understand process, and (3) a preferably formula-based process using data that is easy to obtain and deterministic in nature.

Mediation and Arbitration

Based on these criteria, USDA recommended in its opening comments and would again like to lend support for private-sector mediation and arbitration for grain, such as the system operated by the National Grain and Feed Association (NGFA), which is fair, easily understood, accessible, and affordable. However, USDA postulates the use, expansion, and success of these procedures is contingent upon the Board encouraging railroads to participate in rate disputes through these types of systems and assisting in facilitating their expansion or creation.

Additional Procedures for Consideration

USDA also believes the Ag Commodity Maximum Rate Methodology (ACMRM) proposed by the NGFA and the Two-Benchmark test proposed by the Alliance for Rail Competition in the opening round of this proceeding adhere to the criteria of simplicity, practicality, and predictability, and could also be promising new approaches. Their inclusion and treatment of railroad revenue adequacy make them especially strong candidates for challenging rail rates moving forward as the regulatory environment increasingly incorporates this concept.

While one of the many benefits offered by mediation and arbitration is the opportunity to address rate related issues through a more informal process, USDA considers the ACMRM and the Two-Benchmark test could be viable alternatives for grain shippers unwilling to challenge rail rates through the Board's three established procedures but who still require a formal rate challenge process. Both approaches represent a significant improvement from the status quo. Their straightforward, formulaic designs are appropriate for the unique characteristics of the agricultural sector. They rely upon readily available data, which bypasses much of the unpredictability and costs that surround grain rail shippers' hesitation from using the Board's current procedures. Furthermore, they offer reasonable approaches that build upon the sound framework underpinning the Board's three-benchmark procedure.

In fact, because of the agricultural sector's unique needs, USDA believes it could be quite useful to have two processes available, such as mediation and arbitration to address problems more informally, and another formal process such as ACMRM or a two-benchmark procedure. Having both informal and formal processes that are specifically designed for the needs of agriculture would provide the mechanisms to tackle the wide range of problems that can arise.

Conclusion

As the Board has discovered, there is not a single rail rate challenge process that works best for all shippers under all circumstances. Similarly, it would seem that having a choice of rate

challenge options may be optimal for grain shippers. Mediation and arbitration would most likely be the preferred solution from the perspectives of shippers, producers, and rail carriers as this would preserve business relationships and avoid the costs of litigation. Conceptually, however, having a more formal process at shippers' disposal would serve in instances where mediation and arbitration are impractical, may encourage railroads to pursue mediation and arbitration who might not otherwise, and may act to discipline uncompetitive markets, helping avoid the need for any rate challenge in the first place.

For these reasons, USDA encourages the Board to consider: (1) USDA's recommendations on mediation and arbitration, (2) the ACMRM proposed by NGFA, and (3) the Two-Benchmark test proposed by ARC, et al. as workable concepts to ensure rail rate challenge procedures are accessible and effective for grain shippers and producers. These proposed concepts address cost, timeliness, and predictability, which USDA identified as the major impediments to the Board's established procedures. Furthermore, the rail revenue adequacy component of the ACMRM and Two-Benchmark test address an important and emerging issue, making them relevant potential solutions for future rate challenges.

Respectfully submitted,

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

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Under Secretary

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CERTIFICATE OF SERVICE

I, Bruce Blanton, certify that on this 25th day of August, 2014, caused a copy of the foregoing document to be served by first-class mail, postage prepaid, on all parties of record in STB Docket Number EP 665 (Sub-No. 1).

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

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