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BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 680

STUDY OF COMPETITION IN THE FREIGHT RAIL INDUSTRY

COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS

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The Association of American Railroads ("AAR") is pleased to have the opportunity to submit comments on the recently released study requested by the STB and conducted by Christensen Associates entitled "A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition" ("Christensen Study" or "Study"), which was the subject of a Board hearing on November 6, 2008. Since 1934, the AAR, a non-profit trade association, has represented the interests of major freight railroads in North America. All of its members have a keen interest in the issues examined in the Study.

I. <u>Background</u>

The Christensen Study is the result of a recommendation made by the General Accounting Office ("GAO") in its 2006 report entitled "Freight Railroads: Industry Health Has Improved But Concerns About Competition And Capacity Should Be Addressed." Specifically, the GAO recommended at pages 3-4 that "the STB conduct a rigorous analysis of the state of competition nationwide and, where appropriate, consider the range of actions available to address problems associated with the potential abuse of market power." The STB released a

Request for Proposal and ultimately awarded a contract to a team put together by Christensen Associates.

In compiling the Study, Christensen Associates conducted qualitative and quantitative research. The qualitative research consisted of gathering input from stakeholders on issues relating to competition, rates, capacity and service. The quantitative research focused on an examination of data relating to the structure of the industry, the operation of the marketplace, costs, revenue levels, pricing, capacity availability and capital investment. In addition, the Study includes an assessment of various proposed policy changes intended to address potential market power abuse in the areas of reciprocal switching, bottleneck rates, terminal agreements, and trackage rights.

In this submission, the AAR offers comments on quantitative and qualitative findings of the Study in the following areas: the economics of the railroad marketplace; the assessment of railroad capacity; service quality issues; and the analysis of proposed policy changes. In these areas, the AAR also offers thoughts on possible refinements to the analyses and findings.

II. Framework For The AAR Comments

The comments the AAR offers in this submission reflect the themes that have formed the basis of the industry's comments in other STB proceedings. They are as follows:

1. The Staggers Act has been a success in bringing about a more efficient, cost-effective, and financially viable industry that is better equipped to respond to the needs of its customers. Its basic regulatory framework of balanced regulation remains valid today.

2. A key to the Staggers Act framework is differential pricing, which continues to be essential to the financial viability of the industry and its ability to serve its customers. It must be preserved in any regulatory framework.

3. Another important element of the Staggers Act framework is the provision for rate review where there is no effective competition. In determining the methodology for reviewing rates, the industry has continued to stress that the Board must take into account all forms of competition and ensure the accuracy of the costs being used to assess the reasonableness of a rate.

4. The ability to differentially price and the economic integrity of the STB rate review process are determinative of the railroads' ability to invest in the infrastructure essential to meeting the needs of the customers. This ability to invest is also important to the national interest in energy efficiency and the promotion of environmentally cleaner transportation.

5. Pursuing certain regulatory policy changes will significantly erode the financial viability of the industry, impede network efficiency, and create disincentives for needed capital investment. Such results would not be in the best interest of shippers or the country as a whole.

The Christensen Study examines various issues addressed by these themes. The AAR comments highlight Study findings related to these issues.

III. <u>The Economics Of The Railroad Marketplace</u>

The Study examined the current state of competition in the U.S. freight rail industry. As part of this analysis, the Study addressed five issues: the comparison of tons carried to miles of track; the relationship between average revenue per ton mile and average costs; the comparison of rate trends to trends in input prices and productivity; the relationship between pricing power and revenue sufficiency; and the various market conditions affecting pricing.

In reviewing these five issues, the Study found that, while total Class I track miles have declined, usage of that track has intensified as Class I revenue ton-miles have grown continuously over the period of the Study (ES-9) – a reflection of economies of density. (ES-10). The Study further noted that, when economies of density are present, marginal cost pricing does not produce enough revenue to cover a firm's total cost, and differential pricing (i.e., charging different price markups over marginal costs to different customers or customer classes based on market conditions) is needed to cover total costs and achieve revenue sufficiency. (ES-22).

In its examination of pricing, the Study reviewed the extent to which the industry has priced, or marked up, above marginal cost. The Study characterized any pricing above marginal costs as an exercise of market power, making it clear that the exercise of market power does not necessarily mean the presence of market abuse.

The Study determined that, while the industry had exercised its market power in a theoretical sense as defined in the Study, there was no trend of abuse. The Study emphasized that markups are anticipated when economies of density exist. The fact that shippers with fewer transportation alternatives were found to pay higher rates is not unexpected. (ES-25). Furthermore, increased prices coincided with increased marginal costs (ES-22), as well as with increased input prices and lower productivity (ES-17). Increased prices also coincided with the industry's efforts to move closer to revenue sufficiency, which the Study found it achieved in only 2 out of the last 20 years of the Study period. (ES-21).

The Study complemented its assessment of the exercise of market power with an examination of industry earnings and found them not to be out of the ordinary. "Although the railroad industry's earnings have increased in recent years, they do not appear to be excessive from a financial market perspective." (ES-26). The Study examined the earnings per share (EPS) metric and found over the Study period many similarities among the railroad industry, the electric utilities industry and the S&P 500 composite. (ES-27).

The Study also discussed various marketplace conditions that affect pricing. In examining the effect of competitive alternatives on pricing, the Study mentioned the existence of truck competition, although it dismissed it as a significant factor. This is particularly noteworthy given its finding of no trend of abuse of market power. The railroads clearly continue to face vigorous competition from trucks, and if the effect of truck competition on pricing had been more fully considered, the Study's finding of no trend of market abuse would have been even stronger.

IV. <u>Assessment Of Railroad Capacity</u>

The Study examined current and near term rail capacity constraints. As part of this analysis, the Study assessed the elements of capacity, influences on capacity, capacity utilization, investment levels, future capacity needs, and the competitive effect of capacity constraints.

In reviewing this issue, the Study found evidence of congestion at various points or along certain corridors, as reinforced by terminal dwell data particularly in recent years. (ES 28-29). The Study also suggests that, with the recent increases in capital spending, while it is possible that near term system-wide capacity constraints will not be an issue, localized congestion is likely to continue. (ES-30).

Turning to the question of investment levels, the Study indicates that over time the rail industry has consistently maintained the highest share of revenues devoted to capital spending by comparison to other industries. In this regard, the Study does point out that the capital spending gap between the railroad and utilities industries has narrowed over time. (ES-31). The utilities are expected to continue to be heavy investors in capital in the near future as the country addresses constraints on generation and distribution of power. This capital infusion is not dissimilar from the significant investments made by the railroads after the passage of the Staggers Act and continued through this year.

The Study reinforces the importance of ensuring that the industry continues to have the ability to invest in its infrastructure to minimize congestion throughout the network and provide the kind of responsive and reliable service that the customers seek. While the Study questions some of the projections about the extent of future growth and additional demand for rail service, it does not disagree that there will be growth, especially given the nation's interest in the fuel savings that would result from taking traffic off the highways and putting more cargo on the railroads. Particularly in view of the need for the industry to invest in large increments as the Study notes (ES-29), its ability to invest must be maintained over time in order for the industry to be adequately prepared for the future.[1]

V. Service Quality Issues

The Study examined service quality, using anecdotal information gathered from stakeholders and performing a quantitative analysis by examining average train speed data and variability. In this regard, the Study suggested that more route-specific data would be helpful in identifying and rectifying service problems. (ES-36).

The industry certainly views as a top priority customer interest in more reliable and less variable service. While metrics are important, service reliability can best be enhanced if all the participants in the supply chain – shippers, receivers, railroads, ports and river terminals – work together to improve the efficiency of all components in the supply chain. In addition, ensuring that the industry continues to have the ability to make the necessary capital investments to address choke points in the network clearly enhances efforts to improve reliability.

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[1] The economic downturn has recently reduced traffic levels for the railroads. But customers' transportation needs will change in terms of volume and the markets in which they buy or sell. It is important to have in place policies that do not erode the industry's ability to sustain and align investment over time consistent with these needs.

VI. Assessment Of Proposed Policy Changes

The Christensen Study examined the four open access proposals discussed in the 2006 GAO report relating to reciprocal switching, bottleneck rates, terminal agreements, and trackage rights. In evaluating each of these proposals, the Study focused on the extent of shipper gain, the effect on railroad profitability and investments, and the impact on costs and efficiency. As a backdrop for its analysis, the Study found that its "assessment that, overall, the railroad industry is pricing at levels generating earnings that maintain or slightly exceed those necessary to ensure financial viability implies that there is little room to provide significant 'rate relief' to certain groups of shippers without requiring increases in rates for other shippers or threatening the railroads' financial viability." (ES-39). In other words, no policy change should be adopted that would cause harm to certain shippers in order to create benefit for others, or undermine the industry's financial ability to meet the needs of its customers.

While the Study does not advocate the adoption of any policy changes, it found that, if changes were to be pursued, what it terms as the more "incremental" policies (reciprocal switching and terminal agreements) would result in the most shipper benefit and the least adversity in terms of costs and efficiency. By contrast, changes in bottleneck rate or trackage rights policy would result in more coordination issues and significant inefficiencies by creating shorter hauls to interchange points that are a greater distance from the endpoint of a movement, and thus would be less likely to create the competitive response that the customers are seeking. (ES-40).

The industry calls into serious question the Study's assessment of certain access proposals as merely "incremental." The Study did not even analyze the effect of these proposals on revenue levels and pricing, and in fact itself calls attention to this disconnect in the analysis.

It emphasized that the details of access terms and pricing must be more fully examined before any final conclusions can be reached. The Study notes in particular that "[t]o the extent that the terms of access are set according to some legislative or regulatory formula that differs from the outcome of voluntary negotiations, the economic effects of these open-access proposals become less predictable." (ES-39). The Study further notes the importance of working out the details "in a way that enhances, not diminishes, economic efficiency." (ES-41). The Study goes on to say that "[n]ot only can the terms of access have an effect on the degree to which open access occurs, but it can have important effects on incumbents' investment behaviors." (ES-41). The Study concludes by stating that "[n]one of the current policy proposals address these details and, therefore, the risks entailed in implementing these policies as written carry the very real possibility of unintended and economically harmful outcomes." (ES-41).

The Study looked at key considerations in determining the appropriateness of access policy changes: whether shippers will benefit in reality, and if so, whether some will benefit to the detriment of others; whether costs will be increased and efficiencies diminished; and whether investment incentives will be reduced. It also pointed out that the important details of access and pricing have yet to be fully examined. No access proposal should be adopted without a full examination of its effect on revenues and investment, which cannot be conducted without understanding the details. The risk of "unintended and economically harmful outcomes" from more open access is significant and cannot be ignored.

VII. **Summary Comments**

The Christensen Study found no trend of abuse of market power, and increased prices that coincided with marginal cost and input price increases and a decrease in productivity. It also found that the exercise of market power has been consistent with the need for the industry to differentially price, and necessary to bring the industry closer to revenue sufficiency. The Study highlights the fact that revenue sufficiency is key to the industry's ability to continue to invest to address capacity constraints and respond to customer interest in service reliability, as well as to promote the national interest in conserving energy. Accordingly, as the Study suggests, any access policy changes must be carefully examined to ensure that the industry's financial viability can be sustained, that benefits to shippers from any changes would be real, and that all the details of proposed access changes are fully understood before adoption.

Respectfully submitted,

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December 22, 2008

CERTIFICATE OF SERVICE

I, Linda J. Morgan, certify that, on this 22nd day of December, 2008, I caused a copy of the foregoing document to be served by first-class mail, postage prepaid, on all parties of record in STB Ex Parte No. 680.

Linda J. Morgan

Linda J. Morgan