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BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 680

Study of Competition in the Freight Railroad Industry

COMMENTS

of

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

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The National Industrial Transportation League ("League") respectfully submits its comments in this proceeding, in which the Surface Transportation Board ("STB" or "Board") is seeking comments on the *Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition*, dated November 2008, by Laurits R. Christensen Associates of Madison, Wisconsin ("Christensen Study" or "Study""). The Christensen Study was commissioned by the Board, following the recommendations of an earlier study by the U.S. Government Accountability Office ("GAO"), in which the GAO recommended that the STB conduct an analysis of the state of U.S. railroad competition.[1]

The League commends the Board for commissioning the Christensen Study, and in seeking comments on the results of the Study. The League is the nation's oldest and largest association of companies interested in transportation. Its 600-plus members range from some of

[1] GAO, *Freight Railroads: Industry Health Has Improved, But Concerns About Competition and Capacity Should Be Addressed*, GAO-07-94, October 6, 2006 ("GAO Study").

the largest companies in the nation to much smaller enterprises. Many members of the League ship via rail, and are vitally interested in the capacity, service, and competitiveness of the nation's rail industry. League members also substantially ship via other modes, both domestically and internationally. Shipments over these other modes frequently connect with rail service to provide origin-to-destination through transportation. Thus, all League members have an interest in the state of competition in the U.S. rail industry.

I. The Christensen Study Confirms That a Significant Group of Rail Shippers Are Captive and Need Regulatory Protection

At the outset, the Christensen Study notes that "relative captivity" arises for shippers whose next best alternatives do not effectively constrain railroad rates. Study, ES-12. The Study notes that the effects of captivity may be continuous, that is, they may bear no relation to markup thresholds such as R/VC ratios. In fact, the Study concludes that a shipper may pay a rail rate below 180 percent R/VC and yet experience captivity relative to other shippers with similar cost characteristics, because those other shippers may have better access to intramodal or intermodal competition that results in lower rail rates. *Id.* Significantly, the Study considers truck competition to be "ubiquitous," but "generally a high-cost alternative," and that "for long-distance bulk commodity hauls, we would not expect trucks to be a constraining mode for railroad pricing." Study, pp. 11-9 to 11-10.

Indeed, the Study indicates that shippers in the continental United States are subject to "regional duopolies." The Study notes:

> [Figures 9-2, 9-3, 9-4 and 9-5] reinforce what already has been revealed in the cost analysis. Namely, the western railroads (BNSF and UP) have similar cost structures to each other, the eastern railroads (CSX and NS) have similar cost structures to each other, but the cost structures differ somewhat between the eastern and western railroads.

> The similarity of cost structures can have implications for the competitive behavior of the railroad industry. BNSF and UP are about equally-sized railroads and dominate the industry in the western U.S. Likewise, CSX and NS are about the same size and dominate the eastern corridor freight traffic. Theories of oligopoly suggest that parallel behavior (whether coordinated or not) is more likely in situations where the industry has only a few firms, each offering a fairly standard product and facing a similar cost structure. Our cost analysis indicates that BNSF and UP face similar cost structures, and the same is true for CSX and NS. In particular, the similarities in marginal cost, because of its fundamental relationship to price, suggest conditions favorable to parallelism. [footnote omitted]

Study, p. 9-29. The Study indicates, as a "basic finding," that "the exercise of market power appears to have increased in the freight railroad industry over the last twenty years." Study, p. 10-11.

Across a variety of commodities, the Study finds that increasing distance from water competition and competition from other rail carriers at origin and destination leads to significant rail rate increases. In coal shipments, for example, the presence of a second railroad in the terminating county alone reduces rates by nearly twenty-five percent. Study, p. 12-9. In the case of chemicals, the presence of a second railroad in the destination county alone reduces rail rates by nearly fifteen percent. Study, pp. 14-7 to 14-8. The Study concludes generally that relatively captive shippers, that is, those shippers with less access to railroad or water competition, tend to pay higher rates than otherwise similar shippers with access to more rail and/or water competition. Study, p. ES-5, ES-25, and 11-30.

It would appear that the Study's general conclusions regarding captivity could well be understated. The Study notes that the average county in the 48 contiguous states is approximately 1000 square miles. Study, p. 11-14. The Study relied on county-level data to determine captivity. However, the presence of two railroads in a county does not mean that two railroads effectively compete or that the service from both of them are practicably available to shippers in that county. For many shippers, because of the very high cost of new rail construction and the significant regulatory hurdles that must be overcome, unless a second railroad actually serves their plant or is very close by, such barriers practicably eliminate that second railroad as an effective competitor.

In view of these and other factors, the Study indicates that regulatory oversight is clearly needed. Study, ES-6. The League agrees with that conclusion. The Study also concludes that recent Board actions to make its regulatory processes more accessible are useful. Study, ES-41. Again, the League supports that conclusion, and believes that the Board should make its regulatory processes even more accessible and available.

II. The Christensen Study Indicates that Significantly More Shippers than Previously Thought Pay Very High Rail Rates.

One of the most significant findings of the Christensen Study concerns the presence of very high (over 300% R/VC ratio) rail rates. One of the main issues for concern in the GAO Study was the fact that the amount of traffic traveling at rates over 300% R/VC ratio increased from 4 percent in 1985 to 6 percent in 2004. See Study, p. ES-11. The Christensen study's findings on this point confirm the direction of the GAO analysis, but point to a much more severe situation both with respect to the time frame involved and the percentage of shippers whose rates are subject to these very high rail rates.

Specifically, the Christensen Study found that, on a tonnage basis, in 2005-2006 the percent of tons being transported at rates exceeding 300% of variable cost was nearly one-fifth (17%) of all traffic. Study, p. ES-11. Even more significantly, the percentage had increased from 12% in just the five years from 2000-2001 to the 2005-2006 period, rather than over the 20-year period noted by GAO. On a ton-miles basis, the percentage of traffic with very high (+300% R/VC) ratios nearly doubled over the same period, from 5% to 9%. *Id.*

These facts suggests that the Board cannot be complacent. The Christensen Study looked at "averages" with respect to shippers, and its analysis of those averages led it to conclude that there is no "overall" railroad pricing abuse. Study, p. ES-38. But the Study also concludes that the averages are composed of very wide R/VC ratio ranges. (Study, ES-11). Indeed, the Study notes that county-level R/VC ratios for wheat shipments range from 43% to 757%. The League believes that such wide ranges in R/VC ratios are not an anomaly.[2] Moreover, the Study's focus on "median" rates could hide substantial rate increases in rates above the median, if the number of rates below the median does not change. The statute requires the Board to determine whether individual rates are "reasonable," 49 U.S.C. 10701, and therefore, even assuming arguendo the correctness of the Study's conclusion regarding overall abuse, the Board must be sensitive to the needs of shippers paying very high rail rates.

In this connection, the League must note that it strongly disagrees with the Study's conclusion that reducing rail rates for some shippers means increasing rates for others. Study, ES-39. Under the Study's own reliance on the railroad industry's drive to "profit maximization" and general economic theory, railroads are presumed to have maximized profits on all of their traffic, whether captive or not. Thus, reducing rates for one shipper will not lead to an increase in the rates for another.

III. The Christensen Study Indicates a Recent Trend toward Significantly Higher Rail Rates

In general, the Study period began with the year 1980, the year of the passage of the Staggers Act, and ended with the year 2006, the last full year for which data was available. The

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[2] See, *e.g.*, R/VC ratios calculated in STB Docket No. 42112, *E.I. DuPont de Nemours and Company v. CSX Transportation Inc.*, amended Complaint filed December 16, 2008 (R/VC ratios on URCS Phase III basis range from 185 percent to 1085 percent).

League notes with concern that the analysis of recent data (2004 to 2006) suggests a significant discontinuity in the data trend with respect to rates. Specifically, an analysis of the recent data indicates that rates have increased significantly between 2004 and 2006, breaking with an apparent long-term trend in which rates for many commodities were in general either stable or falling. The Study notes, for example, that Class I railroads' rates (real revenue per ton mile) "rose substantially above short-run marginal cost in 2006." Study, ES-5. "While overall railroad prices were fairly stable-to-declining for a long period of time in the post-Staggers Act period, rates have increased substantially in the last few years." Study, ES-15. The Study notes that Class I freight revenue grew an annual average of 7.2% from 2000 to 2006, and published indexes analyzed in the Study showed substantial average rate increases from 2004 to the most current period studied. See, Study, p. 2-11, 8-7, 8-13. The index developed by the Study showed rates and miscellaneous revenue increasing at an average rate of over eight percent (8%) a year between 2004 and 2006. An analysis of the yearly change in the Christensen Index between 1988 and 2006 shows that, in the sixteen years between 1988 and 2003, rates and miscellaneous revenue increased, on average, well less than one-half percent a year over that entire period. Between 2004 and 2006, on the other hand, rates and miscellaneous revenue increased on average 8.8% a year, or over sixteen times the average annual rate increases experienced in the 1988 to 2003 period. Study, pp. 8-13 to 15, 8-53 to 54. The Study noted that in 2006, industry revenue "noticeably exceeded industry cost." Study, p. 10-12. Again, just the bare figures mean that rate increases to some shippers were significantly above the average in the 2004 to 2006 time period.

More importantly, the recent data trend shows a significant discontinuity compared to the previous study years, and the League believes that the Study must be treated with great care in drawing conclusions on the basis of the data over the entire study period. If the data trend from 2004 to 2006 continues through 2007 and 2008, it would appear that current market and railroad financial conditions may be quite different than those in the Study years prior to 2004 or over the entire Study period.

IV. The Christensen Study Confirms That the Rail Industry Is Currently in Sound Financial Shape. The Study Indicates That the Board's Measures of Rail Financial Health Likely Understate the Financial Health of the Industry

The Study confirms that the rail industry is in sound financial shape. The Study notes that the rail industry has been close to being revenue adequate for most years of the study (1987-2006), and recently has achieved revenue adequacy. Study, p. ES-20 to 21. Indeed, the Study concludes that, using the current STB measure, rail returns have been in excess of the cost of equity from 2000 through 2005 (Study, p. ES-26), and that rail earning per share have exceeded the S&P 500 in five out of the six years since 2001 (Study, p. ES-27). Rail financial trends, especially recently, have been very strong. Between 1997 and 2006, the average annual growth in earnings before interest and taxes (EBIT) and in net profit have been 8.8% and 9.9% respectively. Study, p. 8-32. Between 2004 and 2006, those critical revenue measures increased even faster. Indeed, the Study notes that the EBIT "profit margin" – the EBIT to revenue ratio – was fairly flat from 1997 to 2004. However, the EBIT margin increased at a very, very substantial annual average rate of 16.2 percent between 2004 and 2006. Study, p. 8-32 to 8-34.

The Study notes that the Class I rail industry had revenues over 4% above the level needed for revenue sufficiency in 2006, Study p. ES-21. Again, the lack of 2007 and 2008 data and recent reported financial trends suggest that the rail industry is even in sounder financial shape now than it was at the end of the Study period.

Other information provided by the Study confirms that the industry is sound. Rail market share measured by ton-miles has increased substantially since 1990, after being static in the decade after passage of the Staggers Act. Study, p. ES-6 to 7, 2-2. The Study notes that the rate of growth of rail freight has been more than double the rate of growth of total freight (2.5 percent/year vs. 1.2 percent/year). Study, p. 2-1 to 2-2. Railroads have experienced increasing density and lower per-unit costs. Study, p. ES-9 to 10.

The Study suggests that the Board's measures of financial health have been, and are still, understating the carriers' financial health. For example, while the agency has ruled that the industry was "revenue inadequate" in 2006, with five out of the seven Class I carriers failing to achieve "revenue adequacy," the Study, as noted above, found that the industry had in fact achieved "revenue sufficiency" in 2006 by a significant margin. In light of the Study's findings, the League believes that, in developing policy, the Board should not be nearly as concerned with rail revenue adequacy as it has been in the 28 years since the passage of the Staggers Act.

V. The Study Clearly Confirms the Need for More and Better Data Regarding Rail Service Quality

The Study finds that data on service is far too general, and that better data exists but is not public. Study, pp. ES-35, ES-42. The League believes that the Board should carefully examine whether better data on service quality might be made available without compromising competitively-sensitive matters.

VI. The Study's Conclusions Regarding Capacity Should Be Studied Carefully

The Study indicates that there are no global capacity constraints in the industry and capacity is constrained only at certain terminals. Study, pp. ES-5, ES-28 to 29. The Study also indicates that projections of large capacity shortages in coming years should be treated with caution. Study, p. ES-30.

These findings appear to call into question the need for substantially increasing rail rates to justify large increases in capacity. This is particularly true since the Study finds that railroad capital spending has been unaffected by recent increasing earnings. Study, pp. ES-32, 8-37 to 40, 8-50. The League believes that this matter should be carefully studied, especially in light of recent trends of decreasing rail volumes in response to the current economic slowdown, accompanied by increasing rail revenues.

Respectfully submitted,

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