

December 22, 2008

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To: ATTN: STB Ex Parte No. 680

Surface Transportation Board  
395 E. Street, S.W.  
Washington, D.C. 20423-0001

Re: Christensen Associates Study: *"A Study of the Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition"*

Submitted Jointly by the Following Organizations:

American Farm Bureau Federation  
American Soybean Association  
National Association of Wheat Growers  
National Chicken Council  
National Council of Farmer Cooperatives  
National Corn Growers Association  
National Grain and Feed Association  
National Oilseed Processors Association  
National Sorghum Producers  
North American Millers Association  
USA Rice Federation

We thank the Surface Transportation Board (STB) for sponsoring the Christensen Associates (Christensen) study of the U.S. rail system, its current financial situation, economic performance, logistical performance, and competitive nature of the sector. Throughout many parts of the study, it appears Christensen made a good faith effort to review data and apply statistical analysis to gain a deeper understanding of the rail freight marketplace. However, the analysis clearly falls short in some key areas, and the conclusions offered by the authors do not always seem closely linked to the supportive analytics presented. Furthermore, there are some aspects of the study that are even contradictory. Below, we offer our specific comments about the study.

Status of the U.S. Rail Freight Industry. In the Executive Summary, page ES-6 and ES-7, the authors state, "Since 1980, railroads have been gaining an increasing share of U.S. freight shipments." The study goes on to cite US Department of Transportation (US DOT) data indicating that across all types of freight, rail shipments (on a ton-mile basis) have grown from 27 percent in 1980 to 38 percent in 2005. Such data would seem to reflect a rail industry that has aggressively expanded its service in an effort to compete across all sectors. In the agricultural industry, however, rail tonnage may have grown, but modal market share has declined sharply. For example, the rail modal share of commercial shipments in grain and grain products has shrunk from approximately 50

percent in 1980 to about 32 percent in 2007. The closing of rural branch lines, often unreliable service, and a reduction in service to those shippers that have not made investments to meet unit train or shuttle loading capacity requirements, have all contributed to a declining market share for railroads. The business strategies of railroads in de-marketing some of their services to agricultural production areas have forced much more traffic on highways, creating an increasing burden on the U.S. taxpayer to finance the highway system. Agriculture remains a fairly significant part of the rail customer base, yet it is clearly declining in importance. This is not because the agricultural sector is failing to grow. U.S. agricultural production and markets are growing. The railroads simply have chosen to emphasize other areas of their business (even though on page 11-31 the study notes “highest estimated markups” on rail rates are for grains). The study fails to mention this aspect of the railroad marketplace in light the 2006 Government Accountability Office (GAO) study, which found that agricultural rail rates are increasing while all other rates declined. We contend that the Christensen study failed to provide adequate follow-up analysis clearly intended by the STB in commissioning this study.

Why railroads have been able to increase rates. The Christensen study demonstrates some weak economic reasoning on why rail rates have increased in the last several years. On page ES-38, the study states, “...recent increases in revenue per ton-mile appear to be largely the result of increases in variable, fixed and marginal costs related to increases in the railroad industry’s input prices and diminishing productivity growth – and not due to the increased exercise of market power.” While we agree railroad costs related to rolling stock, steel, human resources and some other items have been rising, the elevated prices for one of the major cost items – fuel – has been completely offset by the fuel surcharges passed back to customers. It is difficult to accept the authors’ conclusion that rail rate increases are mostly related to cost increases or declining productivity. Correlations in data are not necessarily reflective of causative relationships. We acknowledge, however, the conclusion that productivity has not been improving may be a difficult point to demonstrate convincingly; a matter we address in a subsequent section discussing railroad productivity trends.

For the last 5 years, virtually any Wall Street analyst’s quarterly report on a railroad company’s financial performance cites the significance of rail pricing power in a capacity-constrained marketplace and its significance in predicting future company stock price performance. It is obvious railroads are “testing the market” in pricing rail services as to what the market will bear competitively. The tightness in truck freight and relatively higher fuel costs for trucks has resulted in declining competition, which has only encouraged railroads to be more aggressive on pricing. If the authors of the Christensen study believe most of the rail freight rate increases have been cost-related and not market/profit-driven in a constrained environment, how do they explain the rapidly increasing profits in the same period? Clearly, the railroads have been able to raise rail rates at a faster rate than the increasing costs they confront, otherwise profitability would have declined. The railroads are simply pricing at what the market will bear. With fewer railroads, less truck competition, and a gradually tightening capacity, the marketplace provides more than ample evidence of the exercise of market

power by railroads. In some cases, railroads are using their pricing power to raise rates to levels that will stop traffic, thus de-marketing rail services through pricing strategies.

Increasing rail-to-rail competition through mandated reciprocal switching. The conclusions of the study that compelled switching and terminal agreements “are more likely to create favorable economic benefit/cost conditions than more sweeping access reforms” (such as bottleneck rate solutions) is worthy of consideration. Our Coalition is aware of several carriers that are currently increasing switch rates into the \$500 per car range, and possibly higher. We consider such switch rates to be overly excessive compared to the costs of providing service and a transparent effort to further block competition. We also fear that competing carriers may take similar action to retaliate against those carriers that already have raised switch rates. If the authors of the Christensen study think that the market power of the railroads is not making a difference in their pricing behavior, why are the railroads taking such actions to excessively raise switching charges in an attempt to enhance their market power? We believe the study correctly concludes that further regulation of switching charges and preserving physical access to competitive alternatives through terminal agreements may have substantial merit, particularly in future years if continued actions by carriers block even more competitive alternatives.

Railroad investment in expanding capacity. The Christensen study takes a fairly detailed look at the investment trends of carriers in sections 8 and 10. The study finds that the railroads have maintained capital investments at a relatively constant level of total revenues and have not increased the rate of investment, even when profitability has grown rapidly. This finding is a concern of railroad customers as constrained transport capacity across all modes is a potential constraint on national economic growth. In trying to explain railroad infrastructure investment behavior, the Christensen study states, “...the aggregate value of investments in railroad infrastructure is less than the current price....(thus) there do not appear to be strong economic incentives for railroads (to invest).” The same comment could be applicable to many industries that must invest heavily in infrastructure, especially in an economy where inflation has been running between 2 and 5 percent for the last 25 years. Other industries make investments on the basis of projected revenues, knowing it may be cheaper to invest with today’s construction costs, and not wait for inflation to drive up the price of raw materials and labor. There also is the realization in many industries that nominal dollar revenues are likely to grow on a per unit basis. Many other types of businesses invest at times to grow market share, knowing if competitors invest first, the potential for their own company growth will be less. With rare exceptions, railroads do not seem to exhibit these market behaviors. We did not see any comments in the study pertaining to this point.

Also, with respect to the needed expansion in rail capacity, the STB has stated on numerous occasions its policies toward rail rates are guided by the belief that greater margins are necessary for railroads to make the investments that were predicted to be necessary to meet the huge growth in demand expected in the next two decades. As a matter of public policy (as opposed to anyone's particular economic principles), it makes

less sense to take a hands-off position on railroad regulation if infrastructure is not going to be added to meet the growth for which higher rates are tolerated.

Railroad productivity trends. The Christensen study comments that railroad productivity growth has slowed in recent years, causing a need for raising more revenue through rate increases. In section 8, page 8-52, however, the study states, "This (no mergers since the STB blocked the BNSF-CN merger) forced the rails to focus on improving their own networks and improving service, growing internally rather than by acquisition. This has led to higher velocity and better service and reliability." How does "higher velocity and better service and reliability" relate to the described "slowing productivity?" The statements appear contradictory. In our view, the productivity of railroads has continued to improve, at least for agricultural movements. We have experienced consistent productivity gains in asset utilization, railcars, locomotives and crews as well as gains in fuel efficiency. To use the lack of productivity gains as an "excuse" for raising rates (at least in agricultural rates) is not justifiable by the analytical results from this study.

Cost structures of railroads. Section 9 of the Christensen study offers an analysis of railroad cost structures and makes note that the primary western U.S. carriers (UP and BNSF) have comparable cost structures, and the primary eastern U.S. carriers (CSX and NS) also have comparable cost structures. According to the study, economic theory suggests "conditions favorable for parallelism (similar market behavior)." Thus, the study concludes that just because railroads raise rates at the same time, it does not necessarily mean there is active collusion between competitors. Economic theory also suggests duopolies that are competing in the same marketplace could also logically behave very differently, depending on long-term goals of the company. For example, if a particular company wanted to grow market share over the long-term, a firm might choose to emphasize investment and service. These behavioral characteristics are not being borne out in the rail marketplace. The study seems to explain away the "parallel" behavior of railroads pricing and service as being related to similar cost structure. In our view, that conclusion on parallel behavior and linkage to a single causal factor is much too simplistic, and is not credible on its own.

Rail rate increases. Section 10, page 10-11, of the study comments, "The largest increases in market power appear to occur in periods when marginal cost was declining. In these periods, the average revenue per ton-mile did not decline proportionately with marginal cost." We are unsure of the relationship between marginal cost and market power. Railroads have displayed a pattern of not "giving back" to customers 100 percent of the savings in marginal costs in such periods, and this is not unlike the behavior of some other industries where there can be a "stickiness" to price reductions. This explanation seems to be an illogical way of establishing a relationship between marginal cost and market power. In contrast to the authors of the study, we believe market power is much more related to relative rail capacity utilization than marginal cost changes. If the rail sector operates like virtually all other economic sectors, pricing power emerges from strains on capacity. When an item becomes more dear, it is priced as such. Trying to tie pricing power to marginal cost is difficult to defend at best. The study fails to adequately document its conclusions on this point.

Analysis of transportation competition in grain markets. In section 13 of the study, some analysis is presented to assess how responsive wheat and corn rail rates are to competition of various forms. In general, the study finds wheat rates tend to be more responsive to competitive alternatives, with corn rates being less so. Previous studies have indicated a much higher level of responsiveness of rail rates to competition – whether that competition is coming from other railroads nearby, waterway transport alternatives, or other factors. Most of these previous studies have used crop reporting districts as the basis for rail rate data, rather than the county-based approach used in this study. By using county level data, the Christensen study is essentially assuming farmers will not truck to another county if they can find more favorable pricing, which may be driven by more attractive transportation alternatives. In the agricultural marketplace, longer distance trucking of grain by farmers to seek the best price is commonplace today. Moving grain from farm to market over distances of 50 to 100 miles is not uncommon. Thus, the assumptions made by the Christensen study in the structure of agricultural markets may lead to erroneous conclusions. We recommend that the STB conduct a comparison of the research approach and conclusions from this and previous studies, and if the methodology used by Christensen is flawed, it should be corrected.