224251

BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 680

STUDY OF COMPETITION IN THE FREIGHT RAIL INDUSTRY

COMMENTS OF MONTANA SHIPPER INTERESTS AND ALLIANCE FOR RAIL COMPETITION

Terry Whiteside
Whiteside & Associates
3203 Third Avenue North
Suite 301
Billings, MT 59101
(406) 245-5132

Registered Practitioner for
Montana Interests and ARC

John M. Cutler, Jr.
Andrew P. Goldstein
McCarthy, Sweeney & Harkaway, P.C.
2175 K Street, N.W., Suite 600
Washington, DC 20037
(202) 775-5560

Attorneys for
Montana Interests and ARC

Dated: December 22, 2008

I. INTRODUCTION

These comments are being filed on behalf of Montana shippers of grain and other agricultural and related commodities by Montana Wheat & Barley Committee and its members. Also joining in the comments is the Alliance for Rail Competition, which includes among its members shippers of agricultural and other commodities. We welcome the opportunity to file these comments concerning "A Study of Competition in the Railroad Industry and Analysis of Proposals that Might Enhance Competition," issued November 2008 by Christensen Associates (hereafter, "Christensen Report").

These comments will focus on three aspects of the Christensen Report. First, we will comment on and expand upon the Report's finding that grain shippers in general, and Montana wheat shippers in particular, have in the past and continue today to pay exceptionally high rail rates.

Second, these comments will discuss and expand on the Christensen Report's qualified support for arbitration, and will update the STB on recent developments concerning arbitration in Montana. Third, these comments will address shortcomings in the Christensen Report. While parts of the Report appear sound, other parts appear to reflect questionable analytical methods and/or reluctance on the part of the authors to grapple with key issues.

II. THE CHRISTENSEN REPORT CONFIRMS THE HIGH RAIL RATES PAID BY MONTANA WHEAT SHIPPERS

Montana is the fourth largest state in the U.S. by land area, and ranks third among all states in wheat production, and second in production of durum. It is in the top three in production of barley, lentils and other agricultural commodities, and also ships and/or receives other goods by rail. Agriculture accounts for more than one-third of Montana's economy.

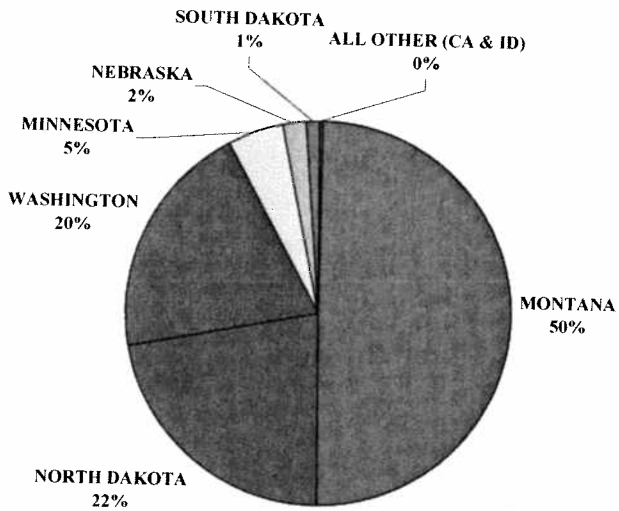
Montana is the most captive State in the U.S., with one railroad, BNSF, controlling some 95% of rail freight. Moreover, because of Montana's location distant from the largest ports and population centers, and the bulk nature of many commodities requiring transportation, the movement of that freight by truck provides only a limited competitive alternative to rail service provided or controlled by BNSF. [1] Much of the trucking that takes place is from farms to the elevators at which grain is loaded onto rail cars.

Most Montana grain is shipped west to the Pacific Northwest ("PNW") for export. Some moves to domestic mills at Chicago, Los Angeles, Spokane and other destinations. Of total BNSF wheat movements to the PNW, Montana wheat shipments are by far the most important, accounting for roughly 50% of total BNSF originated carloads (North Dakota is a distant second with 22%). The largest wheat producing area in Montana is the "Triangle" in north central Montana, with a secondary concentration of production in the area around the northeastern corner of Montana.

---

[1] See Christensen Report at 11-9 to 11-10: "For long-distance bulk commodity hauls, we would not expect trucks to be a constraining mode for railroad pricing."

TOTAL BNSF ORIGINATED WHEAT CARLOADS (81,806)
MOVING TO PNW EXPORT TERMINALS



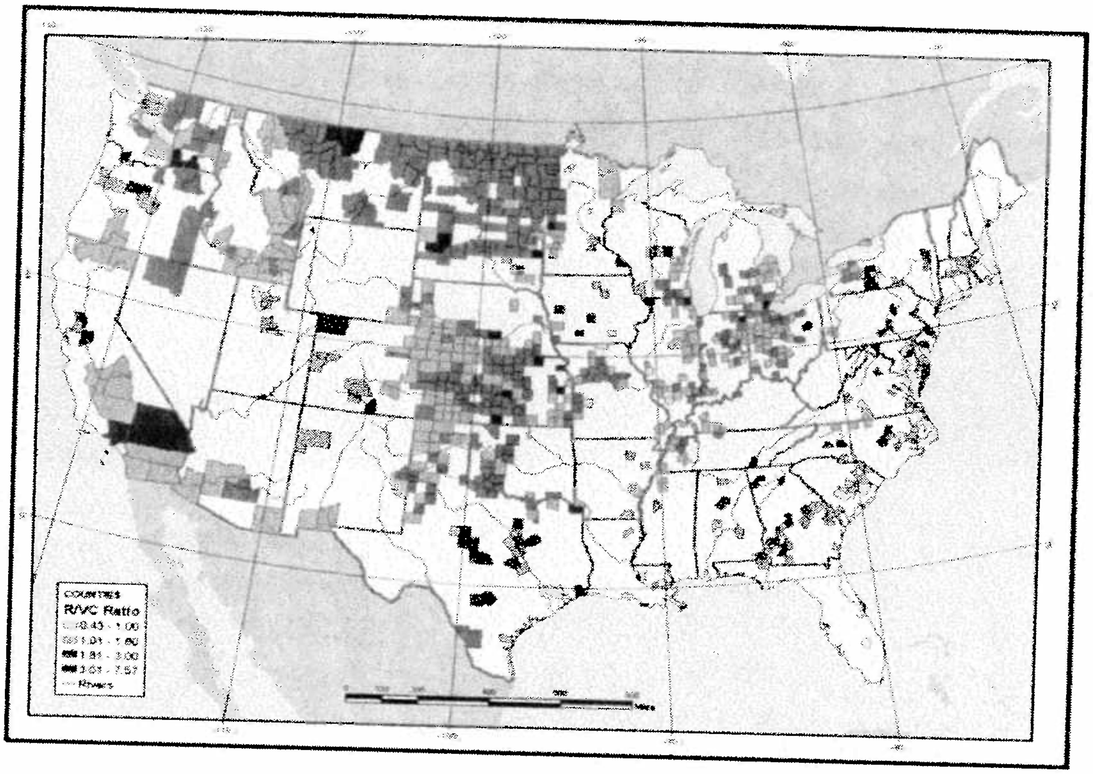
Montana producers transport their grain to grain elevators. While the elevators are billed for and pay BNSF's rail rates and charges, the elevator that can do so deducts freight from the amounts paid to producers, who effectively bear the transportation costs. Because grain producers do not deal directly with grain buyers (other than the local elevators) there is no one to whom producers can pass on increases in rail rates. While these facts are not unique to Montana producers, the impact is unusually severe because BNSF rates and charges in Montana are unusually high. Rail transportation costs have risen from 15% of the price of wheat 30 years ago to around double that percentage today, as grain growing areas become more captive.

The Christensen Report is not the first report to document high rates on grain shipments in the Upper Great Plains States. The Government Accountability Office ("GAO") has also studied U.S. rail rates and substantiated that rail rates on grain in general, and on Montana grain shipments in particular, exceed rates on other commodities and in other regions.

In Report GAO-07-94, Freight Railroads, issued in October 2006 with the subtitle "Industry Health has Improved, but Concerns about Competition and Capacity Should be Addressed," GAO noted the increasingly strong financial condition of the major railroads. However, at pages 34-38 of its report, GAO found that the routes from Billings, MT and Minot, ND to the PNW "had the highest percentage of traffic traveling at rates over 300% R/VC for 2004" of all routes examined. GAO also found that "increases in R/VC from 1985 through 2004 "were driven more by increases in revenue [i.e., rates] than by changes in variable cost." GAO went on to note the difficulty of reaching definitive conclusions given data limitations, but concluded that "the results of our analysis suggest that shippers in selected markets may be paying excessive rates, meriting further inquiry and analysis."

The GAO report led the STB to engage Christensen Associates to inquire further into railroad pricing and competition. The Christensen Final Report, issued in November 2008, confirmed the GAO Report's findings as to Montana. See, e.g., Figure ES-3 from that Report, showing county-by-county R/VC averages:

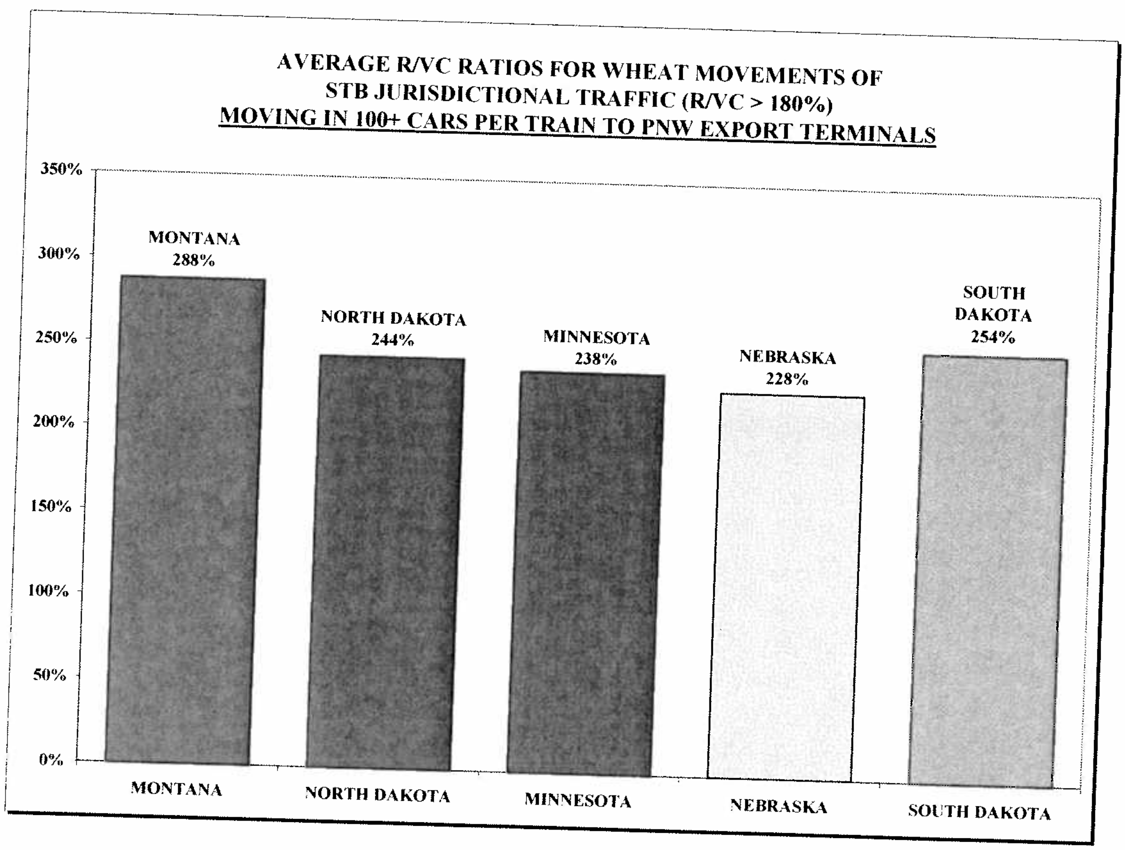
FIGURE ES-3
R/VC AVERAGES BY ORIGIN COUNTY FOR WHEAT SHIPMENTS
2001-2006 CARLOAD WAYBILL SAMPLE



The Christensen Report also found that rail "rates have increased substantially in the last few years," to the point that rail industry revenues exceed what the Report calls "revenue sufficiency." And the Report states (at page 11-22) "Our results suggest that grain shippers are not unjustified in viewing themselves as paying relatively high mark-ups." Montana has the highest R/VC percentages on wheat movements of any of the five States with the largest volume of rail originations of wheat. Montana's average R/VC for all wheat shipments is well above the five State average.

State	Average R/VC All Railroads
Montana	195.44%
South Dakota	170.50%
North Dakota	187.27%
Nebraska	150.33%
Kansas	182.48%

Of particular concern are high-rated Montana shipments – those moving to the PNW at rates producing R/VCs in excess of 180%. Analysis of the average R/VC levels for movements above the 180% threshold of STB jurisdiction for Montana and five other nearby states with major Ag production moving to the PNW showed that Montana's average R/VCs are the highest.



III. ARBITRATION AS CALLED FOR IN BILLS IN CONGRESS COULD HELP, BUT BNSF'S MEDIATION/ARBITRATION PROPOSAL FALLS SHORT OF SOLVING HIGH MONTANA FREIGHT RATE ISSUES

The high wheat rates discussed above could be challenged as unlawful in one or more rate cases filed with the STB. One of the defects of the Christensen Report is that, while the authors describe various regulatory remedies, they do not assess the effectiveness of regulation in deterring or remedying excessive rail rates. This may be because the Report avoids assessing abuses of market power, or because the focus is competition, not regulation.

The Christensen Report does provide the authors' views on legislation designed to enhance competition and to improve the effectiveness of alternative remedies where competition is unlikely to constrain rail rates, as in Montana. In analyzing the Rail Competition and Service Improvement Act, the Christensen Report discusses Final Offer Arbitration in Chapter 22, at pages 22-17 to 22-18.

The Report cites the ease and speed of dispute resolution using Final Offer Arbitration as practiced in Canada. The report goes on to state that, if the prospect of Final Offer arbitration produces more negotiations and settlements, the public interest could be served. This is what has happened in Canada. Virtually all disputes are resolved informally, but the possibility of Final Offer Arbitration means that shippers have bargaining leverage in negotiations with railroads that too many shippers in this country do not have.

The Christensen Report raises concerns about the actual implementation of Final Offer Arbitration, in the event that negotiations do not produce an agreement. However, these are expressed as "concerns" and do not constitute legitimate criticisms of Final Offer Arbitration as provided for in the Rail Competition and Service Improvement Act.

First, the Report expresses concern about "whether the process will produce outcomes consistent with competitive market outcomes." This concern does not appear to be well-founded, if it is read as meaning resulting rates might be excessively low. Final Offer Arbitration as proposed in legislation before Congress, unlike the Canadian version, is subject to a floor of 180% of variable cost. In any event, shippers would be likely to accept, as one of the standards to be applied by arbitrators, that the decision be "consistent with competitive market outcomes." As the Christensen Report shows, competitive markets produce lower rates than captive markets.

Such a standard based on competitive markets may also address another concern expressed in the Christensen Report, about lack of standards. And the use of knowledgeable arbitrators is not objectionable, though they should be familiar not just with railroad economics but also with shipper economics. What makes no sense, however, is to turn fast, simple, inexpensive arbitrations into stand-alone cost cases.

BNSF has expressed interest in a version of arbitration. Unfortunately, the mediation/arbitration process being promoted by BNSF in Montana is tilted in favor of the railroad and differs in significant ways from the approach that has proved successful in Canada. BNSF's approach to arbitration appears to exclude the grain elevators and other Montana shippers who actually receive BNSF's invoices and directly pay excessive freight rates and charges. Under BNSF's proposal, only producers of agricultural commodities are allowed to seek arbitration, and even they could not invoke arbitration without the approval of a producer organization that has signed on with BNSF. The arbitrators under the proposed rules are instructed to weigh such factors as BNSF's investment in rail infrastructure versus the farmer's cost of seed and fertilizer, a comparison inherently weighted in favor of BNSF.

Moreover, a controlling issue in such a mediation/arbitration proceeding appears to be whether the rate affecting the arbitrating producer is disproportionately high as compared with the rates affecting another producer, after taking into consideration BNSF's capital investments in relevant rail facilities and BNSF costs of service. And rail rates could not be challenged at all if equal to or lower than truck rates.

BNSF rates sought to be challenged through the proposed process are not reasonable under any standard in the case law merely because truck service would cost even more. The Christensen Report discounted trucking as a competitive constraint on rail rates for long-haul bulk commodities like grain. If trucks can haul grain but their rates would be equivalent to rail rates producing R/VCs of 500% or more, those rates, under the BNSF mediation/arbitration approach, could not be challenged.

The biggest problem with BNSF rail rates is that they put Montana shippers, including elevators, at a competitive disadvantage as compared with lower rates paid by shippers in other states. The proposed BNSF mediation/arbitration shifts the focus from BNSF rail rates statewide to individual producer receipts from elevators.

The proposed mediation/arbitration process does not allow a challenge to the full rates borne by farm producers. Fuel surcharge levels cannot be challenged, even though the true price of shipping grain includes both tariff rates and fuel surcharges. If relief were to be awarded, it would last only one year. While the BNSF mediation/arbitration proposal's shortcomings are clear, any benefits are difficult to identify.

BNSF is embracing its process as a way of resolving excessive freight rate issues, but mediation/arbitration only covers base tariff rates and has a built-in bias in favor of BNSF. This proposal can be considered one tool out of many needed for some captive traffic, but it does not effectively address the competition and rate problems in Montana as outlined in the Christensen and GAO studies.

IV. OTHER FEATURES OF THE CHRISTENSEN REPORT DEMONSTRATE FLAWS

The Christensen Report contains some useful data. However, taken as a whole, the Report is flawed. Too many issues of importance to shippers were ignored, including the effectiveness of current rail regulation as implemented by the STB. The Christensen Report analyzes captive shipper legislation designed to address regulatory shortcomings, but the Report is silent on whether those shortcomings are real, and whether there are steps the Board could take to improve its effectiveness.[2]

It must be remembered that the STB commissioned the Christensen Report because of the GAO study and the need to address concerns in that study about competition, capacity and high rate levels. Yet the Christensen study shies away from developing or recommending measures that would strengthen STB regulation or remedy shortcomings in regions identified by GAO as particularly captive, like Montana. Simply stated, possible changes in the regulatory status quo are analyzed for weaknesses, but the status quo itself is not.

Not only does the Report contain errors of omission, it also reflects errors of commission. Most of these are addressed in other shipper comments being filed in this

[2] Section B of Appendix 20 of the Report describes the functions the STB performs, but there is little or no assessment of how those functions are performed, or whether other approaches might work better.

proceeding, so this discussion will be brief. However, the Report's criticism of R/VC percentages as an indicator of market power and its preference for analyzing market power based on qualitative market dominance characteristics, are neither sound nor practical.

The Report's misgivings about R/VCs appear to be a function of the authors' decision to rely on the Lerner Index to judge market power. However, as the Report concedes at page 10-8, there are "both theoretical and practical difficulties in using the Lerner Index to measure market power" (quoting from the FTC).

Two examples of anomalous results from use of the Lerner Index can be described briefly. First, the Report says market power peaked in the 1980s. The reason for this reading is that the Index looks only at cost and revenue impacts of the fact that during the 1980s, the railroads (1) cut their labor force in half, and (2) took virtually no rate increases other than those provided by the RCAF-U, which were extremely generous.[3]

The railroads' power over captive shippers did not peak during that decade. The Index (or the authors) mistakenly regard the railroads' newfound power to cut labor costs and to take quarterly rate increases immunized from shipper challenge as indicators of exceptional pricing power over shippers. Similarly, the Report says the railroads "ceded some of that market power during the periods of cost increases associated with the large mergers." Report at ES-19. The period of mergers may have raised railroads' costs but the result of the mergers was <u>more</u> market power, not less.

In any event, even if R/VCs may not be the ultimate indicator of where competition is absent, the Christensen Report cites no better indicator of where competition is not <u>effective</u>. It is the absence of effective competition that triggers regulatory scrutiny.

---

[3] During that decade, the ICC was resisting adoption of a productivity adjustment to the RCAF.

Moreover, the maps at pp. ES-13 and ES-14 of the Report show a strong correlation between high R/VCs and rail market power in Montana.

Another flaw in the Report is the authors' presumption that their finding of significant traffic transported by railroads at less than 100% of variable cost can only mean data errors. It is remarkable that the authors would fail to consider the possibility of cross-subsidization of low rated freight by captive shippers, or the need to exclude such traffic from RSAM calculations, or even to try to confirm whether the data they question could be improved or is accurate.

There are other flaws in the Report, as comments being filed by other shippers and shipper groups demonstrate. These flaws are regrettable.

V. CONCLUSION

Despite too many flaws in analysis, the Christensen Report does confirm, once again, the high rail rates on Montana wheat shipments.

Respectfully submitted,

Terry Whiteside
Whiteside & Associates
3203 Third Avenue North
Suite 301
Billings, MT 59101
(406) 245-5132

Registered Practitioner for
Montana Interests and ARC

John M. Cutler, Jr.
Andrew P. Goldstein
McCarthy, Sweeney & Harkaway, P.C.
2175 K Street, N.W., Suite 600
Washington, DC 20037
(202) 775-5560

Attorneys for
Montana Interests and ARC

Dated: December 22, 2008