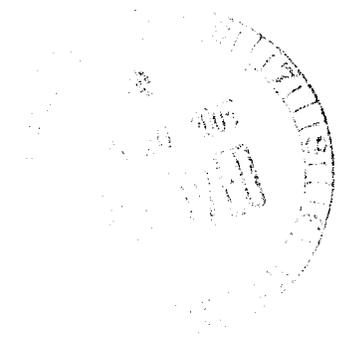


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UNITED STATES OF AMERICA
SURFACE TRANSPORTATION BOARD



EX PARTE NO. 657

RAIL RATE CHALLENGES UNDER THE
STAND-ALONE COST METHODOLOGY

COMMENTS OF
EDISON ELECTRIC INSTITUTE

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Due Date: April 20, 2005
Dated: April 20, 2005

COMMENTS OF EDISON ELECTRIC INSTITUTE

Interest of EEI

The Edison Electric Institute and its Alliance of Energy Suppliers (together, "EEI") are submitting these Comments pursuant to the Notice herein served by the Surface Transportation Board ("STB" or "Board") on February 16, 2005 in the above-captioned proceeding. The Edison Electric Institute is the association of U.S. shareholder-owned electric companies and international affiliates and industry associates worldwide. The Alliance of Energy Suppliers represents investor-owned electric energy suppliers and marketers nationwide, including affiliate and independent power producers who also own generation facilities that provide electricity to wholesale markets regulated by the Commission.

Together EEI's U.S. members serve almost 95 percent of the ultimate customers in the shareholder-owned segment of the industry, and nearly 70 percent of all electric utility ultimate customers in the nation. They generate over 70 percent of the electricity generated by U.S. electric utilities. EEI's members include electricity generation, transmission, distribution, and service companies that operate in wholesale and retail markets throughout the country.

EEI's members are some of the largest customers of the Nation's railroads, and ship hundreds of millions of tons of coal, as well as other materials, by rail. EEI's members require safe, secure, reliable and timely rail transportation at reasonable cost to provide electric service to the nation. EEI's members may also, on occasion, be shippers of small amounts of other materials, such as when they have shipped radioactive materials (a task now largely the duty of the Department of Energy), or chemicals for use in the pollution-control equipment in their powerplants. As such, EEI and its members also have an interest in the STB Ex Parte No. 646

proceeding, Rail Rate Challenges in Small Cases. That proceeding is largely not the subject of these Comments.

Argument

I.

PRELIMINARY OBSERVATIONS.

EEI is joining in a separate submission with numerous other shipper associations and shippers ("Subscribing Shippers") stating certain principles with respect to rate regulation at the STB, and with respect to the undesirability of "stand-alone cost" ("SAC") rulemaking proceedings.

This proceeding involves certain general issues arising with respect to rail rate regulation in proceedings involving the SAC methodology, which are addressed in the joint submission of "Subscribing Shippers," so that EEI will not address them at length here. EEI understands that it is not to comment on pending rate-reasonableness proceedings.

Accordingly, these Comments focus on general issues, and on the overall rate regulatory process at the Board, in the hopes that the STB will find these additional thoughts helpful to it from the perspective of the entities – EEI's members – who most frequently have availed themselves of the STB's rate-regulatory process in the past 25 years, but who are for the most part no longer inclined to do so. EEI is making this submission to be constructive, and to provide a perspective on how the process could be improved.

EEI addresses the alleged "revenue inadequacy" of the Class I railroads because the Staggers Rail Act of 1980 requires that railroad revenue adequacy be considered in rate reasonable proceedings, and because that factor clearly has greatly influenced the ratemaking process since 1980. EEI presents evidence and argument that at least some of the Class I

railroads are revenue-adequate, because they rank highly, relative to other industries, in the returns on stockholder equity and have no difficulty paying debt and attracting capital (the statutory definition of revenue adequacy).

As the Board knows, its rail rate-regulation authority only applies to proceedings in which the shipper has been found to be captive (or "market-dominant," to use the technical term) for the transportation to which the rate applies. (Market-dominance standards have been extensively litigated in other lengthy Ex Parte proceedings, such as Ex Parte Nos. 320 and 627, and EEI does not intend to address here the issues addressed in those proceedings.) Accordingly, these Comments will assume that the affected shipper is captive to the railroad.

II.

THE RATE REGULATORY PROCESS IS UNAVAILING FOR MOST SHIPPERS.

The rate regulatory process appears to be unavailing for captive shippers, even for most large, unit-train coal shippers, although a few such complaints are still pending before the Board.

Chairman Nober forthrightly told Congress in the past that only about 75 shippers (many of them EEI members) could avail themselves of the SAC process. That number is now significantly less as a result of Board decisions since that testimony was given. EEI is not certain of the exact number of shippers who might still even be able to file a rate complaint, relying on SAC, with any prospect for success, but is certain that the number is now lower than 75. Indeed, as a result of the way in which the SAC process is now being implemented, EEI believes that there will be few, if any, SAC complaints filed with the STB in the future.

Moreover, as a result of the FMC proceeding¹, the only shippers for whom the SAC process has any chance of being useful, as a practical matter, are large, unit-train shippers of coal. Therefore, the SAC process no longer works for nearly all captive shippers.

The reasons that the process is unavailing for nearly all, or all, captive shippers, include: the unsuitability of the SAC methodology unless the transportation at issue involves unit-train shipments from one (or, at most, a few) origin(s) to one (or, at most, a few) destination(s), as the ICC found in the "spent nuclear fuel" cases²; the cost (estimated to be \$3-5 million, as a result of changes to the SAC methodology, with a filing fee that now alone exceeds \$100,000); the fact that electricity generation is an increasingly competitive business (thus precluding the ability to compete effectively without knowing one's costs); and the perception that shippers cannot obtain any relief, or at least enough relief, to make the SAC process worthwhile.

III.

EEI AND ITS MEMBERS DO NOT SUPPORT NEW RULEMAKING PROCEEDINGS TO "FIX" THE RATE-REGULATORY PROCESS.

EEI's members and other large coal shippers have given serious consideration to the Board's suggestions that additional rulemaking proceedings be conducted on generic SAC issues. They do not now support rulemaking proceedings to address technical issues (or any other issues) affecting the SAC methodology.

There are several reasons that EEI does not advocate rulemaking proceedings involving SAC issues. Those reasons are addressed in the separate, joint statement of "Subscribing Shippers." Briefly, they are likely to be time-consuming, costly, and therefore delay the resolution of rate challenges now pending before the Board. Moreover, the Board can resolve

¹ FMC Wyoming Corp. v. Union Pacific R.R., 4 S.T.B. 699 (2000).

² Commonwealth Edison Co. v. Aberdeen & Rockfish R.R., 2 I.C.C.2d 642 (1986), remanded, Union Pacific R.R. v. ICC, 867 F.2d 646 (D.C. Cir. 1989).

generic issues by rulemaking or adjudication, at its discretion. The Board has made numerous changes to its SAC methodology in the individual SAC cases over the last few years, proving that rulemakings are not needed. But that also proves that rulemaking proceedings do not actually ensure a process that is sufficiently stable to preclude the possibility of further methodological changes in individual rate proceedings, so rulemakings offer the illusion of certainty.

Experience has discouraged shippers from supporting rulemaking proceedings, which are also quite expensive. Moreover, shippers are not inclined to believe that the outcome of such proceedings will be helpful, if railroad revenue adequacy is the uppermost objective, and if the Board adheres to what EEI regards as an erroneous revenue-adequacy standard, ROI. The reason is that, under the ROI standard, most railroads have been deemed revenue-inadequate, even if revenue-adequate under the ROE standard.

The Board might respond "but shippers have had success in the past under the SAC standards, so why not believe that they can do so again?" Indeed, Coal Rate Guidelines – Nationwide, Ex Parte No. 347 (Sub-No. 1), 1 I.C.C.2d 520 (1985), aff'd sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3rd Cir. 1987), produced standards that worked well for a time, until the FMC, PPL Montana, LLC v. Burlington Northern and Santa Fe Ry., __ S.T.B. __, STB Docket No. 42054, et al. (served Nov. 27, 2001), and other, more recent rate-reasonableness decisions by the Board demonstrated that (a) non-coal shippers, almost without exception, cannot avail themselves of the SAC methodology, and (b) much of the SAC methodology is subject to change in SAC cases themselves, so that further rulemakings will not finally resolve many of the key issues. So, shippers do not believe that rulemaking proceedings involving SAC technical issues will be useful, and such rulemakings may only cause harm to

shippers because of the inevitable delay that they cause in promptly deciding pending rate-reasonableness proceedings.

IV.

THE CIRCUMSTANCES SUPPORTING THE USE OF SAC AS THE ONLY METHODOLOGY FOR RAILROAD RATEMAKING HAVE CHANGED.

EEI and its members have not challenged, and do not challenge, the so-called "jurisdictional threshold" in the statute (49 U.S.C. § 10707(d)(1)(A)). Any proposed legislation of which EEI is aware would not amend or eliminate the jurisdictional threshold, so differential pricing would still be permissible.

That having been said, there is no magic to the SAC methodology for setting maximum reasonable rates. SAC can be made to work, as it has in the past, for some shippers, for whom the cost of such proceedings is a reasonable fraction of the amount in dispute. But other methodologies also can, by definition, produce rates that ensure that railroads are "revenue-adequate."³ If, for example, all shippers are captive, setting all rates at fully allocated costs (about 140-160 percent of variable costs, historically) would, by definition, do so. Moreover, because the Board may not set rates below 180 percent of variable costs, a fully allocated-cost approach would, where all shippers are captive, lead to recovery of revenues above a revenue-adequate level under those circumstances. While railroads may say "but all shippers are not captive," railroads have been raising most rates substantially in recent years and little traffic has left their systems. In fact, railroad volumes just keep increasing.

³ The use of SAC is not required under the Interstate Commerce Act ("ICA"), as supplemented by the Staggers Rail Act. The statute, like the 1977 version of the ICA applicable to oil pipelines, merely requires the agency to apply a "reasonable" rate standard. When the FERC regulates rates on oil pipelines, it uses a rate methodology based on actual costs. See BP West Coast Products v. FERC, 374 F.3d 1263 (D.C. Cir. 2004), and cases therein cited.

EEI is not here advocating a fully-allocated cost method, or any other method, for setting rail rates. Its point is simply to explain that the use of the SAC methodology is not necessarily the only method that would make railroads revenue-adequate.

Economists contend that a "long-run incremental cost" ("LRIC") standard may be appropriate where there are capacity constraints such as those the railroads are now encountering.⁴ For that and other reasons, EEI supports rate regulation based on the railroads' actual costs, in addition to the continued availability of the SAC methodology. EEI in particular supports an effort by the railroads, encouraged by the Board, to raise rates on lower-rated traffic so as to more rationally price the railroads' effective capacity, rather than to continue to raise rates on high-rated traffic such as coal. EEI notes that such is required by the "Long-Cannon amendment" to the Staggers Act, 49 U.S.C. § 10701(d)(2). If railroads rationally priced their scarce capacity so that higher-rated traffic were ensured access to it, they would be conducting their business following rate-regulatory principles that FERC applies under the Interstate Commerce Act to regulate oil pipelines and which FERC and other agencies apply under other analogous statutes.

What has changed to justify use of another rate methodology, as a supplement to SAC? Three things, at least. One, SAC is not workable, for most shippers, so to rely on it exclusively is to fail to satisfy the statutory obligation "to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital" (49 U.S.C. § 10101(6)), and "to

⁴ See discussion of the testimony of Dr. Frederic C. Dunbar for National Coal Association in Coal Rate Guidelines, 1 I.C.C.2d at 529-33; see also Exhibit A, prepared by Dr. William B. Tye and presented at "The Transportation Forum," sponsored by the Association for Transportation Law, Logistics and Policy in October 2004 at the Board, entitled "Economic Issues in Costing and Pricing Railroad Services: How to Run a Shipper-Owned Railroad." Dr. Tye explained that SAC may be appropriate for circumstances in which excess capacity exists, but that LRIC is appropriate where there are capacity constraints. EEI offers the Tye paper to demonstrate that economic theory does not require use of SAC under today's circumstances in the railroad industry.

provide for the expeditious handling and resolution of all proceedings required or permitted to be brought under this part" (*id.*, § 10101(15)).⁵

Two, railroads (or at least most of them, most of the time) are earning demonstrably adequate revenues. They have no difficulty attracting capital, and railroad analysts typically rate them as a "strong buy," "over-perform," or the like. The railroads themselves use other standards, such as return on equity or earnings performance, to determine executive bonuses or other compensation. See, e.g., Testimony of Dr. Harvey A. Levine (formerly the Vice President-Economics and Finance, Association of American Railroads, before the United States Senate, Committee on Commerce, Science and Transportation, Subcommittee on Surface Transportation & Merchant Marine, on Issues Relating to the Freight Railroad Industry, May 9, 2001 (Exhibit B). The ICC itself said, when it established Coal Rate Guidelines - Nationwide, that if railroads were revenue-adequate, a standard lower than SAC would be appropriate. 1 I.C.C.2d at 534-37.

Three, as every railroad has been saying for a few years now, there are capacity constraints throughout the U.S. rail network. SAC was a methodology adopted at a time in which there was excess capacity in the U.S. rail network. See, e.g., Coal Rate Guidelines - Nationwide, 1 I.C.C.2d at 524, 526. In such circumstances, it may have made sense to carry traffic that barely covered the variable costs of carrying it and made only a tiny contribution to fixed costs. Today, however, carrying such traffic often means that other, higher-rated traffic

⁵ The ICC attempted to use a standard other than SAC to set rates in the McCarty Farms case. 4 I.C.C.2d 262 (1988); see also, 7 I.C.C.2d 1026 (1991). The D.C. Circuit rejected that, because the ICC had until that case said that SAC was the only reliable economic methodology. Burlington Northern, Inc. v. ICC, 985 F.2d 589 (D.Cir. 1993). However, it is black-letter administrative law that an agency may change its policies, provided that it gives an adequate explanation for the change. The circumstances addressed in text would provide more than an adequate basis for adopting a cost-based rail rate methodology.

will not be carried, due to congestion.⁶ That makes no sense. Therefore, other rate-reasonableness methodologies are now appropriate, separately or in conjunction with SAC, given the changed circumstances now prevalent, because railroads do not need to recover nearly all of their fixed costs from their high-rated traffic.

V.

A MAJOR PROBLEM IS THE ERRORS IN THE ANALYSIS OF
RAILROAD REVENUE ADEQUACY; RAILROADS ARE EARNING
ADEQUATE REVENUES.

One of the major problems that, from the shippers' perspective, prevents the rail rate-regulatory process from being useful to shippers, is the erroneous standard used to measure revenue adequacy. The Board uses a standard of "return on investment," i.e., net income (with some adjustments) divided by a complex, controversial measure of "investment." The "investment" analysis is so flawed as to be considered meaningless by Professor Alfred E. Kahn, the author of The Economics of Regulation.

For example, "investment" includes the entire "acquisition premium" a railroad paid for assets in a merger or acquisition. This would include the enormous premium paid by Norfolk Southern Railway Company and CSX Transportation, Inc. for Conrail, even though the Board never allowed this entire premium in its original approval of the Conrail transaction. Instead, the Board only recently approved of the restructuring of the relationship between NS (and CSX) and Conrail, are now considered the "owner" of Conrail tracks it formerly "leased." In reality, CSX and NS has owned them (or at least "invested" in them) all along, but the fiction that they largely did not allowed the Board, in the Conrail acquisition proceeding, to find that the acquisition

⁶ Several EEI members report that they have been having significant difficulty getting adequate amounts of coal delivered to their generating facilities for quite some time. The Wall Street Journal and the trade press have carried similar stories about many shippers having such problems.

premiums paid by NS and CSX were relatively insignificant (less than 10 percent). Partly on that basis, the Board rejected the shippers' concerns about such adjustments to "investment" base.

However, the Board, in 2004, approved a change, so as to treat NS as the "owner" of its portion of Conrail, effectively reversing its earlier decision that the acquisition premium was small (less than 10 percent). NS apparently intends to add over \$8 billion to its Property account, which will be offset by about \$3 billion in deferred taxes, for a net adjustment of NS's "investment" base of over \$5 billion. That change (which has no relationship to economic reality, of course, since NS bought Conrail in 1997, not 2004) will apparently reduce NS's return on "investment" substantially, to about 5-6% (exclusive of any increase in return from 2003 to 2004).⁷ This shows that the shippers' concerns in the Conrail acquisition were correct, and that the premium as of 1997 was, effectively, much larger than the Board said that it was in the Conrail acquisition decision.

On the other hand, NS reported to investors that it earned record earnings in 2004, so its "return on investment" should rise. But the increase in NS's return (the numerator in the "ROI" calculation) will not rise enough even to offset the increase in the "investment" denominator in 2004, so NS's ROI will decrease in 2004 as compared to 2003. This, in the year in which NS's stock price rose substantially. Clearly, NS can attract capital, and has record earnings, so it is "revenue-adequate in fact." Wall Street certainly agrees.

Wall Street relies on ROE, not ROI. (Some on Wall Street may also rely on average earnings growth.) ROE is what determines whether the railroads can "attract capital," in the words of the statute. That is what the Board ought to use, as well. If it were to do so, BNSF, CSX, and NS would all appear to be "revenue-adequate" in 2004, and BNSF, CSX, and perhaps

⁷ These are estimates, based on information publicly available.

UP would appear to be revenue-adequate over the period 2000-04. See returns published in The Wall Street Journal, February 28, 2005 (at R6):

Railroads

Company Name	Stock Symbol	One-Year Return (%)	Surplus/Deficit Relative to Industry (pct. pts.)	Three-Year Average Return (%)	Surplus/Deficit Relative to Industry (pct. pts.)	Five-Year Average Return (%)	Surplus/Deficit Relative to Industry (pct. pts.)	10-Year Average Return (%)	Surplus/Deficit Relative to Industry (pct. pts.)
Burlington Northern Santa Fe	BNI	48.8	19.9	20.5	5.3	16.4	4.2	13.3	4.3
Norfolk Southern	NSC	55.1	26.2	27.2	11.9	14.4	2.1	8.6	-0.4
Union Pacific	UNP	-1.3	-30.2	7.4	-7.8	10.9	-1.4	10.4	1.4
CSX	CSX	12.9	-16.0	5.9	-9.4	7.4	-4.9	3.8	-5.2
Industry Group Average		26.9	0.0	15.3	0.0	12.3	0.0	9.0	0.0

Source: WSJ.com – 2005 Shareholder Scoreboard;

<http://online.wsj.com/public/resources/documents/scoreboard2005-railroads.htm>

These ROE figures, not the Board's ROI determinations, are the types of indicators used by railroad executives themselves, as disclosed in their SEC proxy statements and other filings, to determine whether their railroads are earning sufficient revenues to award themselves bonuses or other compensation. Exhibit B. They are, therefore, what the Board should use to determine revenue adequacy or inadequacy, because they are one of the measures of whether railroads can attract capital, and are sufficiently reliable to be relied on by the railroads themselves to measure whether their returns are adequate. Financial institutions are certainly willing to invest in the railroads.

To the best of EEI's knowledge, no investment advisor of the railroads relies on the Board's "revenue adequacy" findings to determine whether investors should invest in the railroads. Wall Street railroad investment analysts look at railroad earnings, and base their ratings on earnings expectations. Obviously, an improving ROE results from improved earnings.

The perception that railroads are "revenue-inadequate" apparently has influenced many actions of the Board because the statute requires the Board to consider "revenue adequacy" or "inadequacy" in setting rates. But given that history and the statute, it is important that the Board should use a reliable, "real world" methodology to determine whether railroads can "attract

capital." Given the problems with the methodology used to determine "revenue adequacy," the tilt in favor of the railroad revenue adequacy represented by ROI is quite problematic, and makes the rate-regulatory process at the Board seem impossible for many shippers, when coupled with the technical complexity of the SAC methodology and cost of a SAC proceeding.

In any event, the railroads are increasing their investments in their systems, which is additional evidence that the Class I railroads are earning adequate revenues. For example, NS announced an increase in investment earlier in 2005, and Rail Business reported in its March 14, 2005 edition (at 1) that BNSF and UP will together invest \$3.6 billion in 2005 in their systems.

The ICC itself said that, if the railroads achieved revenue adequacy, a rate standard other than SAC would be appropriate. Coal Rate Guidelines – Nationwide, 1 I.C.C.2d at 534-37. EEI submits that the time has long since arrived to treat railroads as they treat themselves, and as Wall Street treats them – as revenue-adequate (except, perhaps, where huge acquisition premiums have been paid over shipper objections, or where mismanagement may occur, circumstances that should not be the responsibility of the shippers under the required "honest, economical, and efficient management" standard applicable to railroads in 49 U.S.C. § 10704(a)(2)). If (a) railroads were treated as if they were revenue-adequate, which EEI believes at least some of them are, (b) the Board were to expect the railroads to get as much revenue as possible from their lower-rated traffic, instead of from their higher-rated traffic, as the statute requires, and (c) the Board were to regulate rail rates on the basis of the railroads' actual costs, rail rate regulation might well be practical and therefore useful for many shippers. At the present time, however, rail rate regulation is not practical or useful for nearly all shippers, for the reasons stated herein.

Conclusion

For all the foregoing reasons, EEI does not support rulemaking proceedings to address technical issues with the Board's SAC methodology, but instead urges the Board to consider such issues in the SAC proceedings themselves, as has been done previously.

EEI does urge the Board to recognize that circumstances have changed, in that at least some railroads are "revenue-adequate," using the standards Wall Street applies to them, and that they apply to themselves.

Respectfully submitted,

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**ECONOMIC ISSUES IN
COSTING AND PRICING
RAILROAD SERVICES:
HOW TO RUN A
SHIPPER-OWNED RAILROAD**

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INTRODUCTION

A few years ago I was asked to propose economic principles of pricing, costing, and finance to a recently privatized railroad that was owned by its major shippers. This paper incorporates the results. I have intentionally deleted any reference to the subject railroad and to irrelevant considerations or to matters so basic to the situation of U.S. railroads that they would be of little interest to the present audience. For the record, the railroad in question was undercapitalized as a result of years of government ownership and consequently was severely capacity constrained. This paper, then, might be considered the result of a thought-experiment: How should shippers run our railroads if they owned them, and how does this differ from present policy? I have not edited these recommendations to discuss their implications to our current circumstances, an exercise I leave to the reader.

I. AGREEMENT ON OVERALL OBJECTIVES OF THE ENTERPRISE

- A. Improve economic efficiency of the enterprise, improve service to shippers, and make decisions in long-run best interest of the enterprise.
- B. Achieve revenue adequacy and achieve a financially stable enterprise.
- C. Avoid cross subsidy — individual shippers and groups of shippers should pay their own way.
- D. The tariff should be fair — put another way, shippers' competitive relationships should not be artificially distorted; the structure of tariffs should achieve:
 - 1. "Competitive neutrality"
 - 2. There should be no discrimination.

II. SUMMARY OF CONCLUSIONS: HOW TO ACHIEVE THE GOALS OF THE FIRM

A. The Appropriate Cost Standard for Setting Rates over the Duration of the Concession Is Long-Run Incremental Cost (LRIC)

1. Short-Run Incremental Cost (SRIC) considers only costs that are “traffic sensitive” over a relatively short time horizon (shorter than the life of rail assets) — tends to set the floor to rates too low and encourages development of business that does not recover all costs incurred as a consequence of the traffic of a shipper or group of shippers.
2. LRIC gives the right incentives to carrier and shipper — promotes long run financial viability and prevents cross subsidy.
3. The “relevant increment” for the traffic size for measuring cost responsibility is large — all of the traffic of a shipper or group of similar shippers over a long period of time.
4. Therefore LRIC includes “specific fixed costs” — costs that are incurred to serve a shipper or group of shippers but don’t vary with traffic in the short run.
5. LRIC includes not just “out-of-pocket” or costs incurred directly as a consequence of the traffic — includes also “indirectly variable” costs, such as supervisors, general and administrative, *etc.*, that vary with directly variable costs.
6. For many assets acquired with the lease, such as wagons and locomotives, LRIC includes profit and depreciation of current market values of rolling stock (depreciated replacement or reproduction costs).

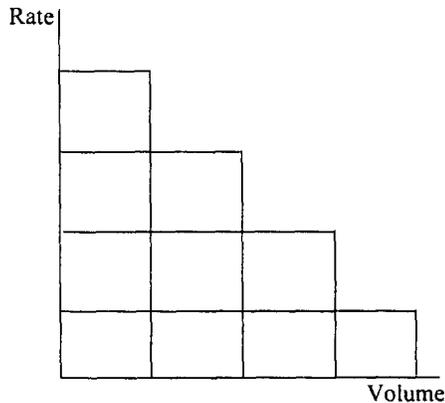
7. If properly implemented, the LRIC methodology will adequately distribute variable costs and fixed costs.
8. "Fixed costs" are those costs which are part of the total revenue requirement but cannot be recovered from shippers based on principles of "cost causation." They are not necessarily equal to "rent" or some fixed obligation. By definition, assignment of these costs to individual shippers cannot rely on analysis of costs alone.
9. If new investments are incurred to benefit a shipper, that shipper's rates should recover the cost of that investment. Other shippers that are enjoying equivalent service from existing assets should pay equivalent rates even if there was no explicit price in the franchise fee or rental payments for those specific assets.

B. The "Starting Point" for Recovery of Fixed Costs Is Rates Based on a Constant Proportional Markup over Variable Costs

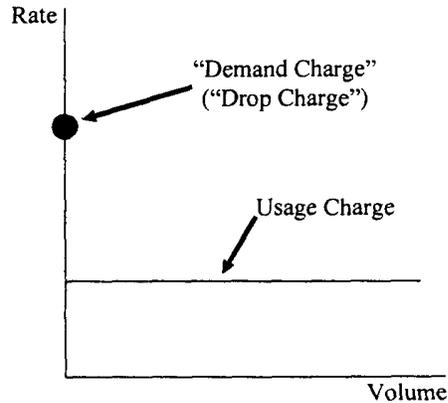
1. There are fairness reasons for such a standard — in many cases such rates meet a definition of no discrimination — the same price for the same thing — a unit of service.
2. Possible exception # 1 — if there is excess capacity, it may be necessary in *the short run* to use SRIC as floor to rates.
3. Possible exception # 2 — if there is excess capacity, it may be desirable to use "value of service" or "differential pricing" for marketing reasons.
4. Possible exception # 3 — it may be necessary to use differential markups to prevent shipper "bypass" (*i.e.*, shippers may supply their own wagons).

C. Use Block Rates to Encourage Shipper Volume, Appropriately Assign Risk, and Create Incentives for Efficient Use of the Rail System

1. Examples:



EXAMPLE #1



EXAMPLE #1

2. Block rates affect allocation of risk between carrier and shipper.
3. The first block would include all "specific fixed costs" of the customer.
4. Rate differentials on subsequent blocks would be justified by either differences in incremental costs or demand — but would seek to be remunerative ($\Delta R > \Delta C$).
5. Despite high first block, shippers may find that lower "tail block" can encourage efficient use of service and benefit shippers.

D. Use Contracts to Reduce Carrier and Shipper Uncertainty and Encourage Proper Incentives

1. Commercialize and de-politicize relationships — just as with other long run vertical relationships in private sector.
2. Make contracts long-term — allow shipper and carrier capital commitments based on stable relationships — reduce risk and “gaming” (“opportunistic” behavior).
3. Therefore it is very important to get it right the first time (hard to make changes).
4. Impossible to forecast all contingencies — provide for automatic adjustments (inflation, *etc.*) and arbitration/court enforcement.

E. Productivity and Shipper “Work Sharing”

1. Rail car supply is most promising initial area.
2. The carrier should not implement general indexing of tariffs for overall productivity changes at the present time — no automatic “flow through”.
3. Shipper tariff savings should occur at time and amount of cost savings — they should at least achieve “revenue neutrality.”
4. Assure recovery of markup over variable costs for shipper savings by recovering lost margin elsewhere.

F. Cost of Capital: The Enterprise Must Know Its Cost of Capital

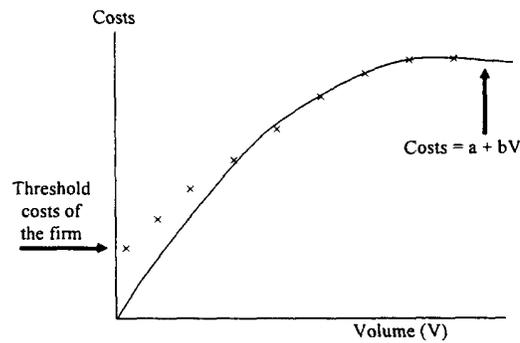
1. Highly leveraged capital structure.
2. No tariffs to offset risk to shippers — no “hedge” of risk.
3. Low diversification of industry base.
4. Need to justify the required return for shareholders, shippers, and government.
5. Need for capital budgeting.

III. DEFINING AND MEASURING FIXED AND VARIABLE COSTS

A. There are Three Separate Concepts of Fixed Costs that Must Be Distinguished

1. “Sunk costs” — these are costs that cannot be recovered if the firm exits the market — these are “traffic sensitive” costs in the long run but not the short run. Example: many track-related costs.
 - a) Since they are causally related to a shipper’s traffic they should go into the cost floor (LRIC) and are not part of the remaining pool of costs that must be recovered based on principles other than cost causation.
2. “Specific fixed” costs — these are non-traffic sensitive costs that are incurred only to serve an individual shipper. They too should go into the LRIC floor to rates. Example: all the costs incurred to provide a branch line to serve a customer or group of customers.

3. “Threshold costs” of the entire enterprise — these are the fixed costs which must be recovered by charging rates in excess of LRIC because they cannot be causally related to service to a customer or size of the customer’s traffic.



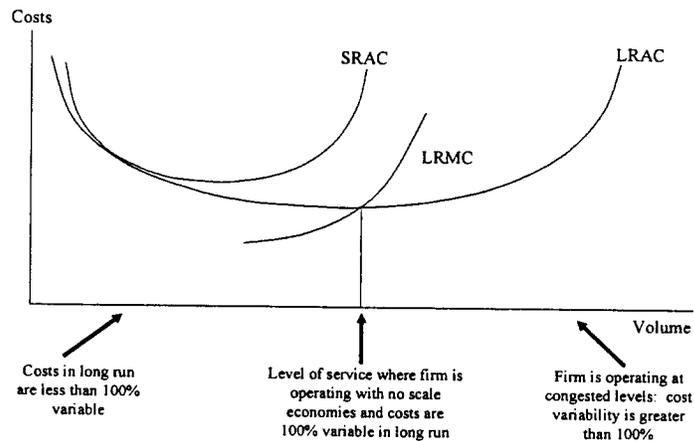
Note: Threshold costs may not actually be incurred as a result of operating at low levels of output. They may be the costs incurred to allow the firm to achieve the scale necessary to operate efficiently.

4. “Threshold costs” are the pool of costs left over after the principle of long-run cost causation has been exhausted. All variable costs must then be “marked up” above variable costs to achieve revenues necessary to recover the enterprise’s total revenue requirement.

Note: Whether the firm has fixed costs in the long run (threshold costs for the entire firm) depends on whether the firm is operating at:

- a) Less than minimum efficient scale (“excess capacity”): less than 100% cost variability in the long run.
- b) At efficient scale (no “excess capacity”): 100% cost variability in the long run.

- c) Greater than efficient scale (capacity overuse or congestion): greater than 100% cost variability in the long run.



B. Issues in Implementing the Long-Run Incremental Cost Concept

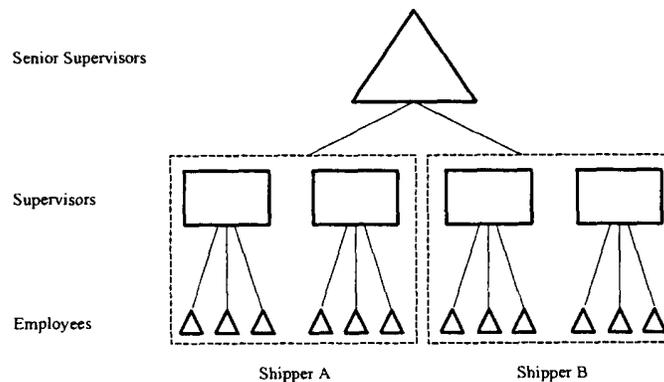
1. Terminology: "Fixed costs" are costs that cannot be related to individual shippers or to traffic even in the long run. "Variable costs" are all costs causally related to service to a shipper or group of shippers: We are treating this as LRIC.

Note: "Variable costs" will include costs which are fixed in the short run, such as sunk costs or "specific fixed" costs.

Therefore it may be useful to develop a new terminology that better expresses the notion of cost causation and suggests a break from the past use of a more limited concept of cost variability. (LRIC might be "attributable" and everything else might be "residual.")

2. "The relevant increment": the size of the traffic used for measuring variability is very large — all of the traffic of an individual shipper or group of shippers that are similarly situated over a very long period of time.
3. Appropriate time horizon: the length of time for measuring variability is long, certainly no less than the length of the concession or length of time service is expected to continue for a shipper.
4. Indirectly variable costs: certain costs such as supervisory, general and administrative, employee benefits, *etc.* vary indirectly with traffic because their magnitude depends on the level of directly variable costs (labor, rolling stock, *etc.*). These too should be included within the category of variable costs.

Simple Example: Employees, supervisors, and senior supervisors (employees are traffic sensitive).

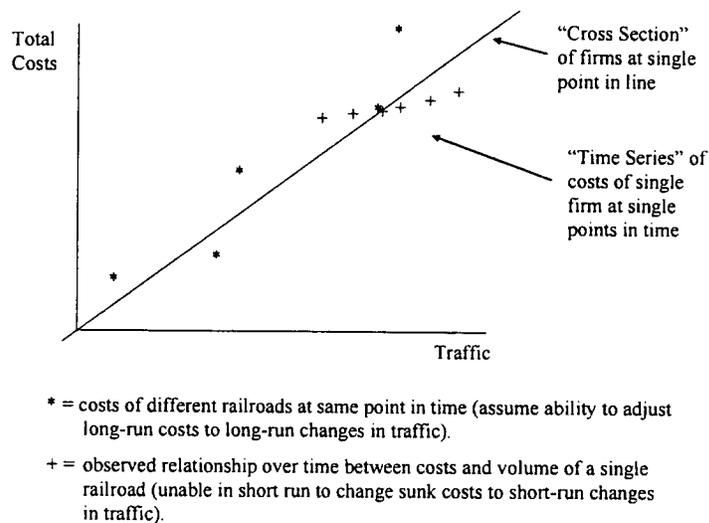


Note: Although not shown, the senior supervisor's cost also will likely be variable, because greater supervisory responsibility required more and higher paid senior supervisors.

5. "Cross section" vs. "time series": cost variability is not measured by observing actual changes in costs and volume over short periods of time (the changes in traffic are too small, the time period too short, and sunk costs

cannot be readily adjusted for temporary ups and downs in traffic). Thus a "time series" of a single firm's volume and costs tends to measure SRIC.

A "cross section" looks at many firms at the same time and looks at the relationship between costs and traffic. This "cross section" more accurately measures the results of hypothetically asking what would happen in the long run if all of a shipper's traffic went away, or groups of shippers provided no traffic (the purpose of measuring LRIC).



IV. ANALYSIS OF VARIOUS PROPOSED METHODS FOR RECOVERING FIXED (RESIDUAL) COSTS

A. Meaning of "Fixed Costs"

1. "Fixed Costs" are those remaining parts of the total revenue requirement that cannot be recovered as part of the variable cost floor to rates.

2. By definition, therefore, allocation to customers of responsibility for recovery of fixed costs in rates cannot rely upon arguments about what caused the costs to be incurred. Recovery of these costs must rely upon considerations such as fairness (no discrimination), demand (marketing), *etc.*

B. Stand Alone Cost (SAC)

1. The stand-alone cost (SAC) test has been proposed as a means of recovering the fixed costs in different rates for different shippers.
2. The SAC test asks what rate would the shipper pay to use a hypothetical new railroad built only to serve that shipper's needs.
3. As a practical matter, the method involves endless arguments over what the SAC railroad would look like and can involve numerous expensive engineering studies involving complex hypothetical alternatives.
4. Despite these difficulties, the SAC test could be used to justify the reasonableness of rates to a shipper who claims that a rate is unreasonably high.
5. If one were to calculate the SAC of all the shippers, and charge each shipper its SAC, the total revenue produced would likely exceed considerably the total revenue requirements of the enterprise. SAC would therefore not permit the enterprise to decide the appropriate markup over LRIC for each of the classes of traffic to recover the total revenue requirement. It would however provide a maximum theoretical ceiling to rates.
6. The SAC method also encounters "the spaghetti problem": to give the SAC railroad the benefits of scale & scope of the enterprise, we have to add more shippers and services to share in the recovery of the fixed costs. But this

means that we face the same problem: deciding how the shippers on the SAC railroad will pay the fixed costs. The SAC methodology does not make the problem of fixed cost recovery go away.

C. Tons, Ton-Kilometers, or Other “Distribution Keys”

1. If approaches to assignment of fixed cost such as tons, ton-kilometers, *etc.* indeed are the “cost drivers” for cost causation, then the costs in question have already been treated as variable — for example, costs that might otherwise appear to be fixed are really indirectly variable and change in proportion to the distribution key. If so, this use of a distribution key to allocate variable costs is reasonable.
2. However, real fixed costs are truly fixed — have no causal connection with traffic even in the long run. Applying such distribution keys to truly fixed costs could give the false impression of causation in this case and ought to be avoided.
3. Such distribution keys might coincidentally result in rate differentials that account for differences in demand — value of service. However, this is not a necessary result and ought to follow only after a study of the real determinants of demand.

D. “Value of Service” or “Ramsey Pricing”

1. “Value of Service” or “Ramsey Pricing” seeks to make the markup over variable cost depend on the willingness or ability to pay.

Example: airlines charge a business customer who does not stay over the weekend a higher fare than a vacation (discretionary) traveler.

2. Such pricing makes no effort to avoid discrimination — indeed it seeks to maximize a special concept of economic efficiency by whatever forms of discrimination are available to it.
3. As a formal mathematical model, “Ramsey Pricing” sets the markup over incremental cost based on demand elasticity.
 - a) high demand elasticity = low “value of service”: low markup over variable cost.
 - b) low demand elasticity = high “value of service”: high markup over variable cost.

4. “Demand Elasticity”: is an index of value of service:

$$E = \frac{\% \text{ change in traffic}}{\% \text{ change in rate}}$$

Example: $E = -1.0$ if a 1% increase in the rate causes a 1% reduction in the traffic.

5. Apart from the problem of discrimination, the problem with Ramsey Pricing is the measurement of the elasticities — even under the best of circumstances there is considerable uncertainty and error in measurement of the elasticity.
 - a) Unfortunately, small errors in measurement of elasticity in the model often result in big changes in the rates.
 - b) Even worse, these large changes in rates produce relatively small changes in the measure of benefits used by the model: “consumers’ surplus.”

6. However, if it can be shown that the traffic still recovers its incremental costs, it may make sense to reduce rates below the constant markup level if certain low value traffic would not move at all. In this special case, the higher rated traffic would benefit from the lower rate, as compared with a loss of business at the higher rate.
7. However, even in these cases, Ramsey pricing may not be as attractive as a two-part tariff. It may be possible to create low prices to attract additional traffic without having to accept the lower contribution to non-attributed costs.

E. Rate Differences Based on Differences in Shipper Costs of Production

1. One of the determinants of differences of value of service among shippers is their costs of production. Shippers with lower costs have higher value of service and can afford to pay higher rates without losing their ability to compete. Put another way, shippers with high costs may have low value of service and be unable to move the traffic except at a lower rate.
2. However, explicitly basing the tariff structure on shipper cost differences might be viewed as discriminatory and counter to certain definitions of "competitive neutrality." This is especially true if "competitive neutrality" is defined as a tariff structure that permits shippers to capture any efficiency gains they may realize — it leaves undisturbed any competitive advantages or disadvantages that otherwise would prevail.
3. There are numerous ratemaking practices that would fall into the category of accounting for differences in shipper costs, *e.g.*, different rates for different grades of product, different rates based on location, *etc.*

4. Another example would be similar or identical rates to shippers despite differences in the cost of rail transportation. For example, "group rates" charge all shippers in a region or all shippers with the same destination the same rate despite differences in rail costs. Charging the same rate might not be justified on the basis of costs, but might be justified on the basis of differences in value of service.

F. Indexing Rates to Shipper Prices, Profits, *etc.*

1. Making the rail rate fluctuate with the price of the product could be a form of value-of-service pricing.
2. Whether such rates create a permanent difference in rates depends on the expected cycle in rail rates over the cycle of prices in an industry with substantial price uncertainty. Comparisons of rates among shippers for the purpose of evaluating claims of discrimination must forecast the future cycle of the prices over the lifetime of the franchise and the contract.
3. Prices indexed to products in \$US can help hedge the risk of currency changes.
4. However, without any fixed charges to shippers in the tariff and any volume guarantees, these tariffs expose the railroad to the risks of both price changes and volume changes on the railroad.
5. Given these increased risks of rates indexed to commodity prices, the enterprise should measure these risks and ensure that shippers are explicitly charged for the cost of assuming these risks. In the alternative, the shipper might be required to make assurances of fixed payments, minimum tonnage requirements, or higher "markups" in future periods to compensate for rate reductions during periods of low prices.

G. Allocation of Fixed Costs Based on "Production Factors"

1. The "production factor" method seeks to allocate certain fixed costs on the basis of only some of the variable costs, such as capital employed. In effect, fixed costs are treated as a "burden" on some other category of costs that can be related to the traffic of shippers.
2. If fixed-cost allocations truly reflect cost responsibility, the exercise would be an example of calculating "indirectly variable costs" and be entirely appropriate.
3. However, the costs would then be called variable and would not be fixed.
4. Fixed costs are indeed fixed. Therefore, there is no principled method for allocating fixed costs to tariffs using "production factor" procedures based on principles of cost causation.
5. Such methods could also motivate the search for essentially arbitrary "distribution keys" that produce result-oriented rate structures, but provide no standards for selecting among them.
6. In other words, the "production factor" method could produce the incorrect impression that the assignment of fixed costs was based on principles of cost causation, when it is not.
7. The "production factor" method is sometimes called "fully allocated costs," but this should not be confused with the fully allocated cost interpretation of the "constant proportional markup" concept (discussed below).
8. In summary, "production factor" method of allocating fixed costs involves a contradiction:

- a) If the method truly conforms to the concept of cost causation, the method is allocating variable costs, not fixed costs.
- b) If the method is used to allocate truly fixed costs, then it creates the false impression of precision, when in fact it may be entirely arbitrary — it may have no logical connection to either cost causation or value of service.

H. The “Constant Proportional Markup” Over Variable Cost Method

1. The constant proportional markup method computes rates by causing the ratio of rates to variable cost to be the same for all shippers.
2. This ratio is set at a level so that it recovers the entire revenue requirements of the firm. Put another way, all of the enterprise’s revenue requirements are classified as either fixed or variable. The ratio of the total revenue requirements to the total variable costs is the “system-wide” revenue to variable cost ratio. This is the same ratio as the ratio to variable cost of each of the shippers and classes of traffic.
3. The method is often criticized because it fails to take into account differences in demand. For example it could set the rate for some classes of traffic at too high a level, creating a situation where the traffic does not move at all, or considerable traffic is priced out of the market, even though it would move at a lower rate.
4. The first important exception to ratemaking under the revenue to variable cost method is excess capacity in the short run, where it may be necessary *in the short run* to accept traffic that is priced below LRIC but priced above short-run (directly) variable costs. However, this approach should only be used temporarily, inasmuch as the use of this method over the long run will

cross subsidize the traffic receiving the favorable rate treatment because it does not recover all costs incurred as a consequence of the traffic.

5. A second possible exception is that if there is excess capacity in the long run it may be necessary to charge lower than the system wide revenue to variable cost ratio for traffic that would otherwise not move at higher rates. If commitments are made to serve such traffic over the long run (such as by signing contracts), the rates must be in excess of long-run incremental costs to ensure that the traffic is compensatory, *i.e.*, recovers all the costs incurred as a consequence of the favorable treated traffic.
6. A third possible exception is that it may be necessary to charge a lower markup of above incremental costs to prevent "shipper bypass," *i.e.*, at higher rates a shipper may be motivated to avoid the recovery of the fixed cost because it can provide the service itself cheaper at the level of the carrier's long-run incremental cost. An example might be car hire, where the shipper can provide locomotive and wagon services at costs equal to or lower than the carrier's long-run incremental costs.
7. For every case where the carrier is required to charge a markup over incremental cost at a level lower than the system wide average, the revenue deficiency must be made up by charging other shippers' rates where the revenue to variable cost ratio is higher than the system wide average.
8. In the case of car hire, if possible the revenue to variable cost ratio for other services to that shipper should be raised to make up the lower revenue to variable cost for care services so that the total revenue to variable cost of the shipper returns to the system average.
9. There are many economically sound reasons why the constant proportional markup method is a useful starting point for the rate structure. One of the

most important is that it provides useful discipline to the pricing structure — rates tend to be established so that the total revenue requirements of the enterprise are recovered. Otherwise there may be a tendency for rates to move down to long-run incremental cost or, even worse, short-run incremental cost, thereby threatening the firm's financial viability. If implemented successfully, the constant proportional markup method will make sure that the firm recovers all of its costs in the long run, including an appropriate rate of return on invested capital.

10. Under many circumstances, the constant proportional markup method also satisfies various standards for “competitive neutrality” or nondiscrimination:
 - a) A given shipper's or group of shippers' share of the fixed cost burden is the same as its share of the variable cost;
 - b) Where it is meaningful to speak of a unit of service, say for locomotive or wagon usage, the method is nondiscriminatory in the sense that all shippers will pay the same price per unit of service;
 - c) The ratio of prices paid by customers is the same as the ratio of variable costs (a standard for economic efficiency sometimes endorsed by theoretical academic economists when variable cost ratios approximate marginal cost ratios.)
 - d) Revenues will be in excess of the incremental costs for each shipper and groups of shippers, thereby preventing cross subsidy and ensuring that all shippers pay their own way.

I. "Replacement Costs," "Reproduction Costs," or "Virtual Fixed Cost"

1. This method is not an approach to allocating fixed cost as such; rather it should be viewed as a method of establishing variable cost in an economically appropriate way that has the consequence of reducing the size of the markup necessary to recover the total revenue requirement.
2. The approach starts with the idea that prices in a competitive market result in customers paying the same price for the same service, regardless of the age of the assets that provide the service. For example, the price of tomatoes does not depend on the age of the farmer's tractor.
3. To illustrate, supposed the railroad acquires a rail wagon and dedicates that wagon to the service of a single shipper over the life of the asset. Under the principle of long-run incremental cost, the shipper's rates should recover the additional costs incurred on behalf of that shipper over the life of that asset.
4. Assume that another shipper receives an equivalent service from another asset that was received as part of the franchise and has no explicit purchase price. The shipper's rates should also include an equivalent charge for the service based on the rates charged the first shipper.
5. This approach to pricing has been variously called "replacement costs," "reproduction costs," or "mark to market."
6. This approach prevents discrimination because all shippers pay the same price for the same service. There is no difference in price to customers based on arbitrary differences in when the asset was purchased and how much it cost or how old the asset is (unless there is a difference in service for assets with different ages — such as if newer cars are bigger or provide a higher quality service).

7. This approach to pricing helps cover the “fixed cost” of the lease payment because in effect it determines what part of the total purchase price represents the cost of different assets, even though from a strict accounting sense those assets do not have an explicit acquisition cost.
8. This approach also ensures the long-run viability of the firm, because it ensures that adequate revenues are being generated to pay for the replacement of depreciating assets.
9. It also prevents discrimination and prevents cross subsidy among shippers because all shippers pay the same price for the same service despite arbitrary differences in the valuation of assets on the books for accounting purposes — it thereby achieves competitive neutrality.
10. The method also provides incentives for optimum investments in assets by carrier and shippers — new assets are neither overpriced nor underpriced relative to old assets:
 - a) if new assets are overpriced relative to old assets, there is an incentive to use obsolete old assets rather than acquire new ones;
 - b) with replacement cost valuation and pricing of all assets, there is an incentive to make correct decisions about acquiring new assets;
 - c) if old assets are over-priced relative to new assets, there is an incentive to acquire new assets even when old assets are perfectly serviceable.
11. In many cases, such as rolling stock, current market prices can be taken from market prices elsewhere. In other cases an engineering study can calculate the depreciated replacement cost of the asset.

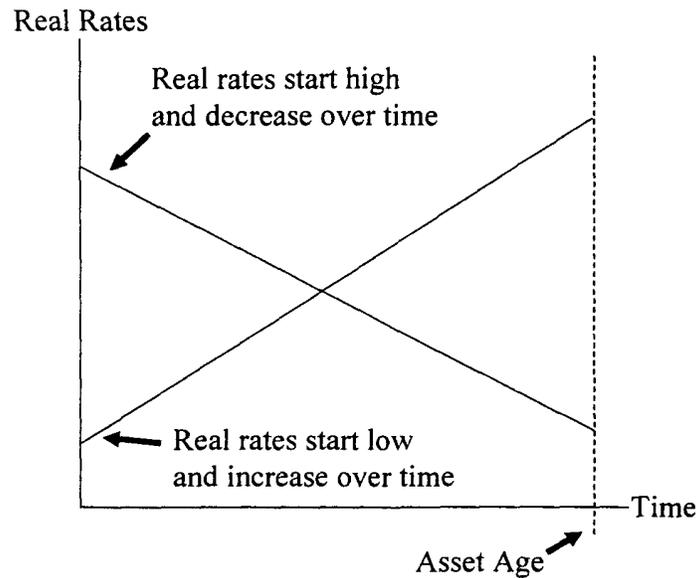
12. For example, suppose that a new rail car costs R \$60,000 and lasts 20 years. Suppose that a 10 year old car costs R \$30,000 or has a remaining undepreciated value (using economically appropriate standards) of R \$30,000, even though it has no explicit value on the accounting books because it was included with the lease.
- a) The \$60,000 must be recovered in rates over a 20-year period.
 - b) The \$30,000 must be recovered in rates over a 10-year period.
 - c) If done correctly and if both cars provide the same service, the rental rate on both cars will be the same.
 - d) The recovery of the replacement cost of the 10-year-old car will help pay the fixed cost and ensure adequate pricing to achieve the overall revenue requirements in the long run.
13. By the same token inventory is an asset; even if it came with the franchise at no explicit cost it should be valued and costed at replacement value. If it is consumed or depreciates, this should be treated as a cost. The value of inventories should be included in the asset base for establishing the necessary revenue requirements for return on capital invested.

V. ISSUES RELATED TO THE TIME STRUCTURE OF RATES

A. Basic Issues

1. The time structure issue relates to the pattern of rates over time. The basic idea is that the same overall rate of profit on an asset and the same asset

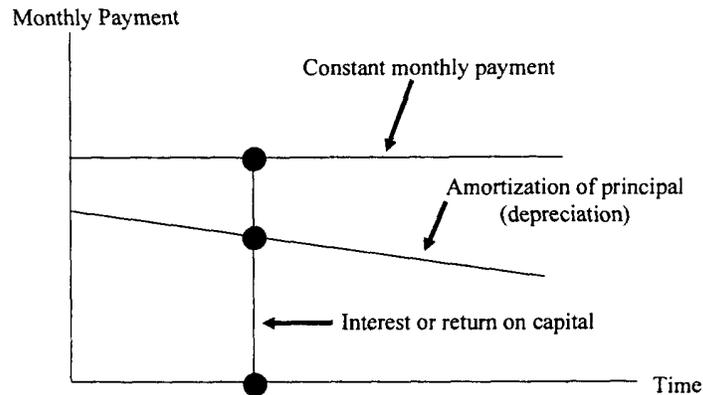
value can correspond to different patterns of rate changes over time. For example:



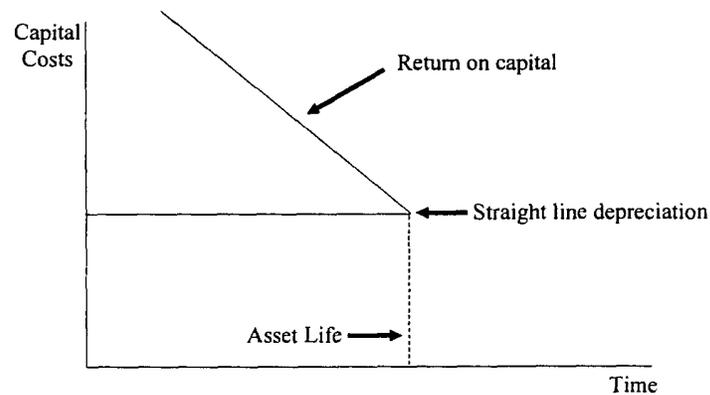
2. The appropriate choice of time structure depends on issues such as risk and technological change:
 - a) In the computer industry rates decline over time because of the fast pace of technological change.
 - b) Wine usually becomes more valuable with age, so real prices increase over time.

B. The Starting Point for Setting Rates is Constant Real Rates

1. Assume a mortgage payment of a fixed amount monthly in a zero inflation economy:



2. Of course, in an inflationary economy, the payments would have to be adjusted for expected inflation.
3. The mortgage example illustrates that the time structure of rates is intimately connected with the choice of depreciation schedule. Straight time depreciation in fact incorporates an automatic “front end load”:



4. Because different shippers may have different schedules of shipments over time, they may be in disagreement with the appropriate schedule of rates over time.

VI. SHIPPER "WORK SHARING" / "BYPASS"

A. Basic Issues

1. Shipper "work sharing" occurs when shippers incur additional costs to save the carrier money.
2. The most promising initial areas seems to be rail car supply (who owns the cars) and car utilization (the shipper can spend money to accelerate loading and unloading and increase the carrier's efficiency in locomotive and wagon turnaround).

B. Ratemaking Principles

1. To create incentives for shippers to engage in costly activities to save money for the enterprise, rate concessions (credits) should be based on the time, place, and amount of verifiable cost savings. The revenue reductions should at least be "revenue neutral," *i.e.*, the revenue credits should be no greater than the cost savings. Hopefully cost savings greater than the revenue losses should allow the enterprise to share in the productivity savings.
2. Conversely the enterprise may wish to impose rate premiums where shippers cause extra costs to be incurred — these premiums should be equal to or greater than the costs incurred.
3. To achieve revenue neutrality with shipper work sharing/bypass, the enterprise must ensure that any markup over avoided (variable) costs must be recovered through other charges to that same shipper. If efficiency gains can be achieved by shipper work sharing/bypass, then the "Coase theorem" says there should always be a means of renegotiating the contract to leave both parties better off.

4. "Bypass" is generally regarded as a situation where the customer avoids some or all of the service without making the carrier whole (revenue neutral). Given the overall current situation, the enterprise should endeavor to ensure that shippers do not have the unilateral right to bypass without negotiating with the enterprise to leave it revenue neutral.
5. Similarly, the enterprise should not employ "automatic flow through" of productivity savings to customers, independent of the efforts of individual shippers. These overall productivity gains arising from the efforts of rail management should instead be used to build equity in the carrier (contribute to retained earnings).

VII. ROLES OF SHIPPERS, INVESTORS (SHAREHOLDERS), AND MANAGERS

A. Basic Principles

1. The enterprise should be operated as a stand-alone independent company on the basis of decisions in the long-run best interest of the enterprise.
2. This means that shippers who are owners should find ownership to be neither a competitive advantage nor a competitive disadvantage in their roles as competitors.
3. This concept is perhaps best captured in the notion of "competitive neutrality": if rates are competitively neutral, shippers are able to capture 100% of productivity gains they achieve in their own businesses.
4. It is also captured in the notion of nondiscrimination in rates.
 - a) All owners should be treated the same.

- b) Non-owners should be treated the same as owners.

B. Shipper/Owner Measures of Success

1. Despite the principle of independence, owners should look at the success of their investment in terms of the total returns they receive — profits as a shareholder, rates as a shipper, and service as a shipper.
2. This may require some traffic managers to change their thinking, if previously they viewed their measure of performance success in terms of negotiating the lowest possible rate. Instead, higher rates may be necessary to improve service and permit the carrier the opportunity to earn a competitive rate of profit.
3. This means that shippers will need to think of their percentage share of ownership in the railroad as a corporate affiliate and measure the success in terms of profits at both the railroad level and the level of the shipper business.
4. If shippers' share of the railroad ownership was the same as their share of traffic, the level of rates might be viewed as a 'transfer price' among corporate affiliates, and what each shipper lost as a result of higher rail rates would be offset by their higher profits as an owner of the railroad.
5. However, traffic shares do not equal ownership shares. Owners/shippers may therefore favor a carrier or shipper position depending on the relative balance of shares. Also
 - a) tax considerations may affect shippers' interest in where profits are realized;

- b) corporate performance measures may affect interest in sharing profits at level of shipper and at level of carrier.

[The remainder of the original document consists of issues in the application of these principles that are either idiosyncratic to the subject enterprise or not novel to those knowledgeable about the U.S. rail industry.]

EXHIBIT B

Testimony of
DR. HARVEY A. LEVINE

Before the United States Senate,
Committee on Commerce, Science and Transportation,
Subcommittee on Surface
Transportation & Merchant Marine

On Issues Relating to
the Freight Railroad Industry

May 9, 2001

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present my perspective on issues concerning the freight railroad industry relative to the industry's financial performance, current posture, and future needs. My experience spans over 35 years in the field of transportation in general and railroad economics in particular, including employment with: railroad customers (shippers), the New York Central Railroad, the U.S. Department of Transportation (DOT), several transportation consulting companies, the Interstate Commerce Commission (ICC), and the railroad industry's major trade association, where for 18 years, I was the Vice President of the Economics & Finance Department. I also have taught transportation economics and other business subjects at several universities, written a book on national transportation policy, and co-authored a book on local and regional railroads. Over the past four years, I have provided consultation to a multitude of railroad, shipper, and other organizations involved in, or affected by, freight railroads. As an independent transportation economist and consultant, the views that I present in this testimony are strictly my own, based on what I believe to be the public interest.

No matter what my past professional position, I have always believed that a financially viable, freight-railroad industry is in the public interest. After all, railroads are conduits that serve the function of providing time and place (location) utility to our nation's consumers. Adequately staffed and capitalized railroads are needed for such an important role, but at the same time, it is through the satisfaction of customer needs that railroads have the opportunity to become financially viable. Thus, the achievement of railroad financial adequacy and the satisfaction of rail customer needs are two sides of the same coin. And it is with this concept in mind, that I offer this testimony.

The current state of affairs in freight railroading is controversial, highly contentious, and somewhat beyond the comprehension of many people, but it retains the one constant that has characterized freight railroads since before World War II—a perceived financial need, commonly referenced as a capital shortfall. Railroads, in their presentations to the ICC, Surface Transportation Board (STB), and public policy makers, describe themselves as being burdened with “woefully inadequate earnings,” even if individual carriers were financially stable, and no matter what the railroads earned. The industry gained support for this view from the ICC beginning in 1978, when the first annual revenue-adequacy determination was made. This determination has been continued by the STB since 1996. During more recent years, the

railroads' mantra of "woefully inadequate earnings" has been replaced by "revenue inadequacy." In fact, of the four dominant railroads that currently control the overwhelming portion of railroad traffic, only the Norfolk Southern (NS) has been declared by the regulatory agency to be revenue adequate in more than a single year. The Burlington Northern (BN) was deemed to be revenue adequate in 1989 and the Union Pacific (UP) in 1995. CSX Transportation has never been found to be revenue adequate. However, what CSX's president, as well as other railroad executives, has stated in his company's annual report to shareholders is another matter.

Incredibly, the alleged state of railroad revenue inadequacy prevailed during the early and mid-1990s, even when railroads enjoyed record earnings and the president of the industry's major trade association -- the Association of American Railroads (AAR) -- touted the "Second Golden Age of Railroading." Magazine articles abounded with such positive headlines as "Back on the Right Track," and "Back at Full Throttle." Consider the financial strength at the time of the current four dominant railroads. In 1994, the BN earned an impressive 16.9% rate of return on equity (ROE) -- that is, net profit after fixed charges and incomes taxes are paid as a percent of the value of the owners' investment. Furthermore, the BN had the financial capacity to outbid the UP and acquire the Atchison Topeka & Santa Railroad (ATSF) in 1995 for \$4.1 billion. Similarly, in 1995, the UP earned a 16.7% ROE and completed its purchase of the Southern Pacific Railroad (SP) in the following year for about \$4.0 billion. In 1997, the CSX and NS railroads realized ROEs of 12.4% and 12.6% respectively, and consummated their joint purchase of Conrail for over \$10 billion in 1999. And yet, with the exception of the NS in 1997, these railroads were declared by the STB to be revenue inadequate during those years. At the same time, the four railroads expended billions of dollars in employee buyouts, distributed expected dividends to their shareholders, and paid sizeable bonuses to their executives.

What is especially troublesome about the current state of alleged railroad revenue inadequacy is that it comes when the industry has been merged into four dominant carriers based largely on the theory that such consolidation was necessary to achieve revenue adequacy. As shown below, the number of Class I railroads has shrunk from 109 in 1960, to 36 in 1980 and to seven in 1999 -- with two of these carriers being owned by the Canadian National and Canadian Pacific railroads. Furthermore, the concentration of power has greatly increased among the four largest railroads, rising from 25%

of Class I railroad traffic in 1960, to 43% in 1980, and an astonishingly 95%

<u>Year</u>	<u>Number of Class I Railroads</u>	<u>Percent of Traffic Carried By Four Largest Railroads</u>
1960	109	25%
1980	36	43
1999	7	95

in 1999.¹ These four dominant railroads -- two each in the East and West -- control more than the traffic they handle. They also have significant control over traffic on both local (short line) and regional railroads and either control or heavily influence: industry-wide procedures in regard to operating -- including, interline -- rules; accounting practices; car-repair billing; technological research and development; and, policy development and strategy.

What is additionally astonishing about the four "mega-railroads" is that they were created based on projections of huge financial benefits. For example, the BN's purchase of the ATSF came when the former was already making record profits, and when the BN projected that the purchase would save the railroad \$450 million annually in operating expenses and add another \$110 million in operating income. Similarly, the UP was earning record profits in 1996 when it purchased the SP based on an operating income benefit of \$820 million by the year 2001. And the CSX and NS purchase of Conrail in 1999 came at a time when those railroads were earning moderate profits, and when they projected significant benefits mainly in the form of cost reduction and traffic diversion from motor carriage.

No matter what it is called -- that is, "woefully inadequate earnings," "revenue inadequacy," or even "sub-par financial performance," where railroads can demonstrate a capital need, they have support, if not an outright propensity, for acceptance of their industry-wide, policy positions. The answer to the question of "How can we help the poor railroads?" may come in the form of: tax relief; low-interest loans; outright grants; approval of mergers and acquisitions; rate increases to rail-dependent customers; changes in demurrage provisions; and, the warding off of otherwise desirable market competition. Consequently, with railroads still being cast as revenue inadequate by the STB, the environment exists for more of the same -- that is, for more railroad

behavior based on alleged capital need; more explanations for inadequate service and increased freight rates; and an even greater concentration of power. This is not to say that in some years, railroads don't have a capital need, and it is not to say that the two railroads in the East are not currently earning sub-par profits. However, the permanent state of alleged railroad financial depravity is a frightening prospect for rail-dependent shippers and should be to the public at large.

The latest rationale of the railroads' alleged revenue inadequacy is that competition forced them to pass on their massive productivity gains to their customers, proving that railroad competition is more than adequate. The productivity gains have been attributed to deregulation as enacted by the Staggers Rail Act of 1980, as is seemingly all good things that have happened to railroads since that time. In turn, the combination of continued capital need and competitive markets means that the railroads cannot afford any more competition. After all, proffer the railroads, new competitors would "skim the cream" off the top and leave the incumbents with little more than the lower-margin, more competitive traffic. This is a picture which on the surface appears to be plausible, for to refute it requires an unusually deep understanding of railroad financial data, statistical methodologies, cause-and-effect relationships, rail-customer service levels, and railroad behavior in general. In essence, railroad issues relating to national transportation policy are often embodied in a mass of statistical information and economic theory.

My perspective of the state of the freight railroad industry is different from that being portrayed by the industry itself. As a reflection of my views, I present three observations below, including summary statements of support and recommendations, followed by a more detailed discussion leading to each of the three observations.

1. Railroad data presented in annual reports to shareholders, and supplemental data to the Securities & Exchange Commission (SEC), is often in conflict with industry-wide data distributed to and by the STB and especially that agency's annual determination of railroad revenue adequacy.
 - o Railroad revenue need is synonymous with capital attractiveness.

- Railroads compete for capital in open capital markets against companies who provide annual financial reports to their shareholders and supplemental financial information to the SEC.
- Potential investors rely upon the financial documents prepared and provided by the owners of businesses in consideration of where and when to invest their funds.
- Consequently, where railroad capital attractiveness is at issue, annual reports to shareholders and supplemental data to the SEC should be used as the basis for analysis.
- At the same time, the link between the STB's annual determination of railroad revenue adequacy and capital attractiveness is at best elusive and in all probability, non-existent.
- The annual STB revenue-adequacy determination should be terminated and railroad financial data submitted to the Board should be consistent with the information presented to shareholders and the SEC.
- Finally, railroad revenue need should be thought of in terms of: (1) individual railroads as opposed to an industry-wide average, (2) as a fluid, and thus temporal state of being, and (3) as a prospective concept.

Railroads are no different than other for-profit companies in that they must pay their operating expenses, meet the interest obligation on their funded debt, and have the ability to attract needed equity capital if they are to provide adequate service to their customers. By earning any level of net profit, operating expenses and interest charges are paid because such profit is calculated after those payments and income taxes are subtracted from revenue. Thus, stripped of its trappings, the issue in regard to railroad financial viability is that of capital attractiveness to providers of equity. This attractiveness is enhanced by a variety of factors including the most recent returns to the providers of equity capital – measured by the ROE – a strong balance sheet, significant cash flow relative to capital expenditures, and sound management

policies and procedures. Many of these considerations are discussed in the railroad's annual reports to their shareholders and other information provided to the SEC. In fact, the "President's Message" sets the tone for the annual report to shareholders. But the overall message, analysis of financial performance, and even thoughts about the future, are not revealed in the annual reports to the STB. They are also not reflected in the STB's annual revenue-adequacy determination. This disparity can lead to contradictory views by the railroad itself, and between the railroad and the STB. Consider an especially egregious case involving the UP in 1996.

By any reasonable standard, 1996 was a great year for the UP and its parent company, Union Pacific Corporation (UPC). As stated by the Chairman and Chief Executive Officer of UPC:

The Union Pacific merger, the spin-off of the Resources company and the full integration of the Chicago and North Western acquisition, made 1996 a banner year that created significant value for shareholders and positioned this company for the future as a highly competitive, premier transportation provider. Through all of these strategic achievements, we kept our eye on the numbers, reporting record financial results. Our income from continuing operations was \$733 million compared to \$619 million in 1995, a gain of 18 percent.²

UPC earned an ROE of 12.4% in 1996, largely sparked by the railroad's ROE of 16.6%. To UPC and the UP, these profits were more than adequate. They not only exceeded the corporate ROE threshold that triggered executive bonuses and the long-term compensation package (stock grants and options), they also exceeded the maximum-payout level to those executives. Consequently, aside from significant amounts of stock distributions, the average bonus given to 138 UPC executives in 1996 amounted to a record \$112,000.³ Furthermore, when in 1997 UPC earnings were below the executive-bonus threshold, the corporation still awarded \$7.1 million to 154 executives because "a balance was available in the reserve fund from prior years."⁴ In essence, surplus profits from 1996 were used to further reward executives in 1997. At the same time, the STB found the railroad to be revenue inadequate in 1996. Rhetorically speaking, who would potential equity investors be most likely to believe? – the company itself or the STB, which based its conclusion on a single, statistical and highly controversial calculation? The unfortunate result of the STB's declaration of revenue inadequacy is not only that it could be applied in

regulatory proceedings involving maximum rates, but that the UP could adopt it as support for its positions of public policy.

In general, the financial health of individual railroads is far better than that projected by the revenue-adequacy determination. Consider the case of the four dominant railroads in 1999. While they were all declared to be revenue inadequate, the BNSF earned a healthy 13.9% ROE and the UP a moderate 9.5% ROE. While these figures may have been below the STB's cost-of-capital calculation, did they really deter either railroad from attracting needed capital? Where is the evidence of such capital shortfalls? With interest rates around seven percent, the equity investors in these two railroads were rewarded for their risk taking, and both railroads spoke of even more promising returns in the future -- that is, in their annual reports to shareholders and in their presentations to Wall Street security analysts. Furthermore, in his oral presentation to the STB regarding the BNSF's proposed merger with the Canadian National system, the president of the BNSF boasted of his railroad being into its strongest financial position in history. The reality is, that the record abounds with examples of railroad executives calling attention to their strong financial results in the annual reports to shareholders, while citing their STB-determined revenue inadequacy in matters of public policy.

In essence, the STB's annual determination of railroad revenue adequacy serves no useful purpose and can be highly misleading. A railroad cost of capital can be estimated without an annual revenue-adequacy determination. At the same time, potential equity investors can employ the more credible railroad annual reports to shareholders, and if desired, supplemental financial reports to the SEC, to help them in their determinations as to where they funds should be invested. Annual reports to shareholders represent the "real world;" the same cannot be said for the STB determination.

2. Railroad deregulation as enacted by the Staggers Rail Act of 1980 has been given far too much credit for both the significant gains in railroad productivity and the ensuing constraints on freight rates, thereby inappropriately inferring that railroad market competition is ubiquitous.
 - o With the exception of liberalized procedures for eliminating light-density branch lines, there is no direct link between the Staggers Rail Act and increases in railroad productivity.

- Aside from a host of other factors, railroad productivity gains have emanated largely from favorable union contracts (supported by Presidential Emergency Boards) resulting in the elimination of many employees.
- The measure of freight-revenue-per-ton-mile is a limited surrogate for actual freight rates, and its use by the railroad industry and the STB results in improper conclusions regarding both freight rates and the impact of deregulation.
- Railroad productivity gains have been shared directly by shippers in competitive markets and the railroads themselves, but no matter how the benefits have been distributed, rail-dependent customers exist and are still faced with the lack of carrier choice.
- The existence of rail-dependent customers is a reality that should not be ignored by the STB – whose purpose is, in fact, to address the needs of such shippers -- or by national transportation policy.
- In addition to providing adequate carrier choices for rail-dependent customers, an appropriate remedy for their complaints appears to be the “Final Offer Arbitration” (FOA) process available to railroad customers in Canada.
- Professional arbitrators can replace the lengthy and costly STB maximum -rate procedures and as in Canada, complete the process within 60 days.

There is no disputing that since the Staggers Act was passed in 1980, the railroad industry has become more productive, and has passed on a portion of this productivity to some of its customers in the form of constrained pricing. But with the exception of the more liberal provisions to eliminate light-density branch lines, there is no evidence that links the Staggers Act with increased railroad productivity. The major contribution of deregulation was to free the railroads from the unnecessary cost of regulatory proceedings involving competitive traffic. Money was certainly saved in these instances, but this

regulatory efficiency had nothing to do with reducing the bloated labor force, eliminating duplicate facilities, and implementing cost-saving procedures. Those achievements were due to a combination of factors including: a heightened sense of need on the part of management; the introduction of new technology, economies of scale and density associated with mergers and acquisitions, and especially, favorably-negotiated labor contracts (including billions of dollars worth of buyouts). In fact, as shown below, the number of employees working for Class I railroads has been in a long-term decline since its peak of 2.1 million in 1916.

<u>Year</u>	<u>Number of Class I Employees⁵</u> (Thousand)
1916	2,148
1929	1,661
1955	1,015
1970	566
1980	458
1999	178

Mis-casting the Staggers Act as the cause of increased railroad productivity and constrained pricing inappropriately supports a continuation of present market conditions; and yet, this is exactly what the railroad industry and the STB do. They use an industry-wide, unaudited, inflation-adjusted, and deficient surrogate for railroad freight rates -- more specifically, freight revenue-per-ton-mile -- to proffer that railroad rates have declined since 1980, and then automatically tie those alleged decreases to the enactment of the Staggers Act in that year. What is not mentioned is that the rate surrogate had been declining before 1980, and its relationship to actual freight rates is at best, dubious. Furthermore, actual rate surveys undertaken by the AAR in 1980 provide evidence as to the inappropriateness of the surrogate measure.

The reliance on the average freight-revenue-per-ton-mile measure is an example of how the manipulation of large and varied databases can act to confuse issues. The issue before the STB should not be overall, average railroad freight rates. In the first place, freight rates should be related to individual railroads, individual commodities, individual markets, levels of cost, and levels of service. But even more importantly, in regard to railroad matters, the STB exists only because there are rail-dependent customers. These customers, as well as the STB, should not be concerned with averages,

surrogates, and inappropriate cause-and-affect relationships.

The reality is that deregulation did little, if anything, to address the needs of rail-dependent customers. These shippers have become increasingly vocal in regard to their captivity and the railroads' insensitivity to their needs. Similarly, they find virtually no relief in the regulatory process. While the Staggers Rail Act requires *fair and expeditious regulatory decisions*, the "fairness" of current standards is at best, questionable, and there has been nothing expeditious about regulatory decisions. Some maximum rate proceedings have taken more than 10 years to resolve, while regulatory proceedings in general are extremely costly, time consuming, and intimidating to shippers. At the same time, because of fewer and similar operations, railroads have strengthened their common resolve and have the financial resources to employ a delay-and-wear-them-down strategy. This has added to the lengthy and costly regulatory proceedings favoring the staying power of railroads.

An alternative to the ineffective regulatory proceedings administered by the STB, would be the concept of Final Offer Arbitration (FOA), similar to the practice in Canada. In a nutshell, FOA is a process employing either a single arbitrator, or a panel of three arbitrators, to resolve rate and/or service disputes between railroads and their dependent customers. Unless otherwise agreed to by the parties, decisions are binding and last for a stated period of time. Benefits of FOA as applied in Canada, compared with current railroad regulatory practices are as follows:

- The arbitrator's decision is made within 60 days compared with proceedings taking years – in some historic cases, over 10 years.
- Railroad customers would identify their rail dependency by committing to file FOA submissions. They are unlikely to be frivolous submissions because of the accompanying costs. This eliminates the need for theoretical and controversial determinations of "captivity" and "market dominance."
- FOA offers by both parties are likely to be moderate in that the arbitrator must pick one or the other (i.e., baseball-style arbitration). An unreasonable offer is likely to be readily rejected. This brings the dispute into a more practical zone of analysis and encourages a negotiated railroad-customer agreement prior to an FOA decision.

- There are a host of available arbitrators, and thus the process has more credibility than alternative regulatory decisions. Unlike members of the regulatory authority, arbitrators are not political appointees. They are qualified experts whose records and reputations determine whether or not they will be selected for arbitration.
 - The cost of arbitration is shared equally between the railroads and their customers. While the customers' initial experience in arbitration may be somewhat costly, it is far less than that of current regulatory proceedings. Furthermore, customer expenses decline as experience with FOAs is gained.
 - The FOA process takes railroad-customer disputes out of the political process. Often, the disputes are resolved by the involved parties after an arbitration application is filed but before a decision is made. In essence, moving from an FOA-type decision-making process seems to be a win-win situation for railroads and their dependent customers.
3. While prudent railroad cost control is admirable, public policy can best be served if railroads increase their traffic volume, thereby helping to relieve highway congestion, having a positive impact on the environment, and providing relatively low-cost transportation service; adequate competition should help to stimulate traffic growth and improve overall profitability.
- The major economic focus of railroads has been to maximize profits through cost reduction.
 - While intermodal traffic has grown significantly, massive railroad cost cutting has not helped railroads to increase their market share, especially vis-a-vie the motor carrier industry.
 - Traffic growth requires the satisfaction of shipper needs and in turn, this requires a sensitivity to those needs, a commitment to fulfill those needs, and innovative and flexible thinking.
 - The culture of the large freight railroads is one that is slow

to change and has never been known to have keen market sensitivity.

- Adequate railroad competition could add to railroad efficiency, but more importantly, could provide the needed sensitivity to shipper needs.
- The encouragement of railroad competition is consistent with the goals of the Staggers Rail Act of 1980.
- Public policy should not automatically preclude the enactment of provisions that provide for increased access – and thus, competition – to the railroad infrastructure.
- The very same public that provided railroads with exclusive rights-of-way and limited competition has the right to adjust the level of competition when conditions demand it.

The railroads' emphasis on cost cutting over the past 20 years is well documented. In fact, projected efficiencies were the major factor supporting the many mergers and acquisitions during these years. For example, in 1980 the railroads' operating expense per ton-mile was 2.75 cents compared with 1.95 cents in 1999.⁶ This decline was realized in the face of virtually a 100 percent rate of inflation during those 19 years. And as previously shown, the reduction in railroad costs was led by draconian cuts in the level of railroad employment. Rational cost cutting is admirable and in the interest of shareholders, but what is also important -- especially to the public at large -- is that railroads recapture some of their lost market share, and here, the story is not good.

The railroads' share of intercity tonnage has steadily declined -- from 46.7 percent in 1950, to 28.7 percent in 1980 and 25.1 percent in 1998.⁷ During the late 1980s and early 1990s there was a leveling off of this downward trend, but it again has started to recede. In 1996 the railroad percent of market share was 25.8 percent, falling to 25.1 percent in 1997 and remaining there in 1998. With the motor carrier industry currently carrying about double the tonnage hauled by railroads, there is a substantial traffic base available for railroad penetration -- or in reality, for market recapturing. This potential traffic base is expected to expand significantly in the future, as DOT

has projected annual average increases in the U.S. domestic freight market of 3.4 percent annual between now and the year 2010.⁸ Furthermore, DOT projections call for an annual 4.0 percent increase in U.S. international traffic over the next decade. Clearly, there is a sizeable market for potential railroad penetration. But such penetration requires more than continued railroad cost cutting. It requires the ability to meet customer service standards at reasonable prices. It requires competition. It requires compliance with the Staggers Rail Act, which recognized the need for competition among railroads.

The Staggers Rail Act supports and encourages the existence of rail competition in the marketplace. One of its policies is, *To ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes, to meet the needs of the public and the national defense.* This policy is supported by two other policy statements: (1) *to reduce regulatory barriers to entry into and exist from the industry,* and (2) . . . *to avoid undue concentrations of market power . . .* These policies are consistent with one of the findings of the Staggers Act, which is that: *Greater reliance on the marketplace is essential in order to achieve maximum utilization of railroads to save energy and combat inflation.*

There are many ways to induce adequate railroad competition in the marketplace. Railroads themselves can generate competition through commercial agreements and voluntary sharing of infrastructure. The selling of branch lines to local and regional railroads – without so-called “paper barriers” is a form of increased competition. So are expanded reciprocal-switching zones. The STB can induce added competition by disallowing bottlenecks in its decisions on maximum rates. And Congress can mandate adequate competition through a change in legislation that provides for increased access, somewhat on the order of the “running rights” provision available to shippers in Canada. In the case of running rights, a railroad would have to petition the STB for the use of another railroad’s facilities, but with over 400 local and regional railroads in existence, such a provision may be useful. The success of such a policy is already well documented right here in the U.S. and by the railroads themselves. Both BN and UP have testified that the application of 4000 miles of trackage rights—which were imposed by the STB as a condition of the UP-SP merger—are working very well for both customers and railroads. And despite claims to the contrary, when railroads oppose policies that would increase access in this way, trackage rights have resulted in no safety or operational problems, at least none reported by the

railroads at this time. The point is, that adequate competition is not evil. In fact, competition is the only route for ensuring long-term financial viability for the rail industry. Deregulation and competition are inseparable. With adequate competition, the partial deregulation that now prevails can be completed and full deregulation can be implemented. Partial deregulation with ineffective regulation is not a formula for traffic growth. Without meeting shipper needs, the future of a privately-owned-and-operated, financially viable, freight railroad structure in this country is dubious. Meeting customer needs is the number one priority of virtually all for-profit companies in competitive markets, and it must be at the core of national transportation policy affecting railroads. Adequate competition is what drives customer satisfaction, and this basic concept of the free-enterprise system is what drives the country's standard of living.

In conclusion, it is my belief that staying the present course – that is, preventing adequate competition while relying on ineffective regulation – will do little, if anything, to ease the burden on rail-dependent customers, to make railroads more customer-driven, and to grow the traffic. At worse, it will lead to further consolidation and possibly, to government subsidization of the freight-railroad infrastructure.

I thank you for the opportunity to present my views, and I would be pleased to answer any questions.

ENDNOTES

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UNITED STATES OF AMERICA
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 657

RAIL RATE CHALLENGES UNDER THE
STAND-ALONE COST METHODOLOGY

CERTIFICATE OF SERVICE

I hereby certify that I have served this 20th day of April, 2005, one copy of the foregoing "Comments of Edison Electric Institute" by first-class mail, postage prepaid upon the following parties of record:

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