ASSOCIATION OF
AMERICAN RAILROADS

Law Department
Louis P. Warchot
Senior Vice President-Law
and General Counsel

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Honorable Cynthia T. Brown
Chief, Section of Administration
Surface Transportation Board
395 E St., S.W.
Washington, DC 20423

228732

Re: Review of Commodity, Boxcar, and TOFC/COFC Exemptions, Docket No. EP 704

Dear Ms. Brown:

In response to the Board's October 25, 2010 Corrected Decision in the above-referenced proceeding, this constitutes the Association of American Railroads' ("AAR's") Notice of Intent to Participate. AAR is submitting with this Notice its Written Testimony, consisting of the statement of its President and Chief Executive Officer, Edward R. Hamberger, and the statement of Professor Robert Willig of Princeton University.

AAR requests that it be allotted a combined thirty (30) minutes of time at the public hearing scheduled in this matter for February 24, 2011, for Mr. Hamberger (who will be accompanied by Mr. Louis P. Warchot, Senior Vice President-Law & General Counsel of AAR) and for Professor Willig. Mr. Hamberger's testimony will address the rail transportation policies and principles that underlie the commodity, boxcar and TOFC/COFC exemptions, and Professor Willig's testimony will address the economic and policy principles of those exemptions.

Please direct any questions regarding this Notice of Intent or AAR's time allotment request to the undersigned.

Respectfully submitted,

Louis P. Warchot

Louis P. Warchot
Attorney for the Association of
American Railroads

425 3rd Street, SW | Washington, DC 20024 | P (202) 639-2502 | F (202) 639-2868 | lwarchot@aar.org

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Docket No. EP 704

REVIEW OF COMMODITY, BOXCAR, AND
TOFC/COFC EXEMPTIONS

WRITTEN TESTIMONY OF EDWARD R. HAMBERGER
ON BEHALF OF THE
ASSOCIATION OF AMERICAN RAILROADS

Of Counsel:

Paul A. Guthrie
J. Michael Hemmer
James A. Hixon
Theodore K. Kalick
Jill K. Mulligan
Roger P. Nober
John P. Patelli
David C. Reeves
Patrick Riley
Louise A. Rinn
John M. Scheib
Peter J. Shudtz
Greg E. Summy
Richard E. Weicher

Louis P. Warchot
Association of American Railroads
425 3rd St., S.W., Suite 1000
Washington, D.C. 20024
(202) 639-2502

Kenneth P. Kolson
10209 Summit Avenue
Kensington, MD 20895

G. Paul Moates
Paul A. Hemmersbaugh
Sidley Austin LLP
1501 K Street, N.W.
Washington, D.C. 20005
Counsel for the Association of American Railroads

Dated: January 31, 2011

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SURFACE TRANSPORTATION BOARD

Docket No. EP 704

REVIEW OF COMMODITY, BOXCAR, AND TOFC/COFC EXEMPTIONS

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ON BEHALF OF THE ASSOCIATION OF AMERICAN RAILROADS

INTRODUCTION

My name is Edward R. Hamberger. I am President and Chief Executive Officer of the Association of American Railroads ("AAR"). I am pleased to present the AAR's position regarding the Board's Notice dated October 21, 2010, in this proceeding.[1]

The AAR and its members respectfully submit that there is no basis for revisiting the rationale or the relevance of the TOFC/COFC, boxcar, and commodity exemptions. In the Staggers Rail Act of 1980 ("Staggers Act") and the ICC Termination Act of 1995 ("ICCTA"), Congress decided that the rail industry should be substantially deregulated and directed the Board and its predecessor, the Interstate Commerce Commission ("ICC"), to pursue exemptions aggressively. History proves that Congress made the correct judgment: freeing the railroads from unneeded regulation, the exemptions have led to increased competitiveness, enhanced service offerings, and increased productivity and efficiency, which continue to benefit the customers railroads serve and the public at large.

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[1] The Board issued a corrected Notice on October 25, 2010.

The Board should forcefully reject any suggestion that recent improvements to railroads' financial health call into question the continuing relevance of the deregulatory policies regarding exemptions adopted by Congress or their implementation by the ICC and the Board. Under the exemption statute and the Board's precedents, *competition* is the determinant of whether particular rail traffic or services should be exempt from Board regulation: a rail carrier's financial health is neither relevant to the Board's exemption mandate nor to consideration of a request for revocation of an exemption.[2] Congress has not changed the statutory framework that requires the Board to grant exemptions and allow competitive market forces to determine railroad price and service levels wherever possible. And there is ample evidence that competition has remained strong overall where exemptions had been previously granted. An independent study performed for the Board found no evidence of changes in competitive conditions that would justify re-visiting exemptions to expand the scope of rail regulation[3]. Moreover, the Board has clear authority to address any complaints that a specific shipper lacks competitive options through proceedings involving limited revocations of exemptions.

Perhaps more than ever before, our nation's economic growth will depend on the type of private investment in transportation infrastructure that Congress sought to promote through the policies it adopted in the Staggers Act and reaffirmed in ICCTA. Where the Board continues to have regulatory authority, it should focus its resources on actions that will encourage needed investment. At the very least, it should refrain from undermining investor confidence in railroads by threatening a return to the misguided heavy-handed regulatory policies of the past.

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[2] *See* 49 U.S.C. 10502(a), (d).

[3] *See* Laurits R. Christensen Associates, Inc. *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition,"* Revised Final Report at ES-1 (Nov. 2009) ("Revised Final Report").

The AAR and its members are deeply concerned about the Board's effective re-examination of many basic tenets of rail regulatory policy in this proceeding and in its companion proceeding, STB Ex Parte No. 705, "Competition in the Railroad Industry." Congress has not changed the statutory framework encouraging exemptions and calling for limited rail regulation. Accordingly, the Board has no mandate to expand rail regulation, either by restricting exemptions or by changing its policies regarding competition. Indeed, to the contrary, Congress' latest, authoritative instructions to the Board, reflected in ICCTA, strongly validate the limited regulatory regime that the ICC pursued between 1980 and 1995.

The "Rail Renaissance" that began in the last decade, the many public benefits that are being generated by the world's finest freight rail system, and the future ability of railroads to respond to the numerous calls for expanding rail service to solve problems of highway congestion and lack of public funding for transportation infrastructure—all of these hang in the balance when regulatory policies are revisited as the Board is doing in this proceeding. The Nation needs railroads to continue to invest significant private funds to grow and to keep freight on tracks instead of flooding the highways. They will be able to make those investments only if the federal government maintains a consistent, coherent, and transparent regulatory regime that allows railroads and their investors to pursue returns on their enormous investments. If the Board signals that it may adopt new policies (either in this proceeding or in Ex Parte No. 705) that will restrict rail earnings, you will hear from railroads and from other experts that changing the regulatory rules will lead to reduced investment and cost American jobs.

The railroad industry has already learned through painful experience the results of interference with marketplace forces. Even well-intentioned regulators cannot change the laws of supply and demand, or force private investors to invest in railroads. Efforts to produce short-term benefits for a few, ultimately lead to disastrous consequences for many. When the prospects of obtaining returns on investment fall, new investment in infrastructure and equipment declines. Next, the physical plant begins to deteriorate, and service becomes slower, less reliable, and less safe, which reduces revenues even further as shippers seek other options. History shows how long it takes for the rail industry to recover and move forward again, once errant policies are corrected. Board and ICC decisions have recognized that there is no real choice to be made between the past burdensome regulatory policies that proved so devastating to the railroad industry and those that Congress ushered in with the Staggers Act and reinforced in ICCTA. The Board must not deviate from that successful post-Staggers Act policy direction.

In the years since Congress adopted the Staggers Act, the ICC and the Board have responded to Congress' legislative directives by establishing a regulatory environment that has produced extraordinary results. Railroads have plowed approximately $480 billion into improving their infrastructure and equipment. In that same period, average rail rates (as measured on a revenue per ton-mile basis) fell by 55 percent, volume nearly doubled, service improved markedly, and accidents dropped by 75 percent. Railroads currently take millions of truckloads of freight off highways each year, reducing the need to spend scarce tax dollars on highways, improving highway safety, and reducing air pollution. As *The Economist* magazine recently observed, our nation's freight system is "one of the unsung transport successes of the past 30 years" and is "universally recognized in the industry as the best in the world."[4]

Under current policies that the ICC and the Board established and implemented over the last three decades, railroads are in a strong position to help respond to the many challenges of building a transportation system for the 21st Century. Reversing course would not only threaten

[4]*The Economist,* "High-speed Railroading: America's System of Rail Freight is the World's Best. High Speed Passenger Trains Could Ruin It." (July 22, 2010).

the many benefits of rail service that are accruing to customers and the public today, but they would also undermine efforts to invest in new facilities and service to meet the growing demand that almost everyone acknowledges is coming. With the government under pressure to expand the economy while restraining spending growth, consideration of regulatory policies that would discourage private investment in transportation infrastructure would be extremely counterproductive.

With respect to the specific exemption issues raised by the Board in this proceeding, in Part I, I summarize the basic transportation policies and principles that are core to the continued vitality of the rail network, and I discuss the relative roles Congress and the Board play in addressing the issues raised by this proceeding. In Part II, I emphasize that the legal and factual foundations for exemptions have not changed. In Part III, I discuss the lack of any need for a periodic review of the exemptions. In Part IV, I explain why the exemptions remain warranted and necessary. Finally, attached to my testimony is a separate appendix setting forth in more detail the legal basis for the Board to continue aggressively seeking exemption opportunities and to address any specific allegations of abuse of market power on a case-by-case basis.

The AAR's submission also includes a statement from Professor Robert D. Willig of the Woodrow Wilson School at Princeton University. In his statement, Professor Willig discusses the economic policy rationales for exemptions and the appropriate public interest standards for reconsidering or revoking exemptions. Several AAR members are also submitting separate filings that address issues raised by the Notice and demonstrate that there is no basis for revisiting the exemptions at issue.

I. RAIL TRANSPORTATION POLICIES AND PRINCIPLES

The Board is well aware of the consequences of the misguided regulation of railroads prior to the Staggers Act. For present purposes, suffice it to say that excessive regulation nearly destroyed the rail industry only 30 years ago.[5]

The Staggers Act represented a sharp departure from the failed policies of the past. It ushered in a new era in which railroads could allow the market to direct what routes to use, what services to offer, and what rates to charge. The regulatory sea change embodied in the Staggers Act was founded in some basic, powerful insights and principles that had been disregarded for decades: If the Nation is to have a viable and effective freight rail system, users must pay full value for the infrastructure and services they demand. And, in most instances the market is far superior to the government in efficiently determining what services should be provided, who should pay how much, and in how limited rail resources should be allocated.

In enacting the Staggers Act, Congress intended that the market would govern railroads where competition exists — that is, by private actors making decisions about the use of privately-owned property — with regulation continuing only where effective competition was absent, and as a remedy for anticompetitive railroad conduct. As explained by Professor Willig, the genius of the Staggers Act and the key to its success lies in the fact that a competitive market serves the public interest far better – efficiently allocating resources and services, promoting service that is responsive to customers requirements, fostering innovation, matching supply and demand, facilitating flexible and nimble responses to changing business and commercial conditions and transportation needs, and maintaining reasonable rates – than any regulation.

[5] For details, see the Comments of the Association of American Railroads in "STB Ex. Parte No. 658, *25th Anniversary of the Staggers Act of 1980: A Review and Look Ahead,*" (filed Oct. 12, 2005).

Consistent with its animating principles, the Staggers Act eliminated many of the most egregious regulatory barriers that prevented railroads from operating efficiently and competing effectively. Together, the ICC and the Board have implemented the policies of the Staggers Act and ICCTA by gradually paring government regulation of rail rates and service, thereby making great progress toward the aim of limiting such regulation to instances in which it is essential (*e.g.*, to avoid abuse of market power or respond to other market failures).

The tremendous success of the deregulatory scheme embodied in the Staggers Act and ICCTA has been well documented. As the recent Christensen study conducted for the Board summarized, "following the passage of The Staggers Act, the railroad industry experienced dramatic reductions in costs and increased productivity, which yielded higher returns for carriers and lower inflation-adjusted rates for shippers. Thus both railroads and their customers benefited from regulatory reform." Revised Final Christensen Report at ES-1.

After three decades of the gradual limitation of rail rate regulation to where it is essential, the American freight rail system has become the envy of the world. The resulting benefits to rail customers, the American economy, and our environment would not have been possible without the regulatory changes mandated by Congress and implemented by the Board and the ICC. The Board's continuing statutory mandate and regulatory responsibilities have not changed – it must promote the goals of the rail transportation policy in accordance with specific statutory standards and requirements.[6] *See, e.g.,* 49 U.S.C. §§ 10101, 10502, 10701 -10709; *see generally* 49 U.S.C. Subtitle IV, Part A.

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[6] The Appendix to this testimony discusses in more detail the legal bases for the Board's authority and responsibility to grant, maintain, and expand exemptions from regulation. As the Appendix further demonstrates, the Board's statutory mandate provides no basis for general revisiting of existing exemptions, and the Board should consider only specific revocation requests, on a case-by-case basis. *See* Legal Appendix.

The salutary results of federal rail policy since 1980 – higher rail volumes, better service, safer operations, increased investment, more productive operations, and improved railroad financial health – were outcomes that Congress *intended* the Staggers Act to generate. Those outcomes are in the best interest of our nation. None of those intended results of congressional policy could form a sound or principled basis for increased regulation of rail rates or services.

Re-imposition of unnecessary regulation could reverse the remarkable progress and attendant benefits that have accrued to rail carriers, their customers, and the public in the post-Staggers Act era. Such distorting regulation carries a great risk of discouraging investment in the rail industry, which would deprive rail carriers of the ability to maintain and improve their networks and service. The resulting curtailment of investment could severely impair rail carriers' ability to assist the Nation in achieving consensus policy goals such as reducing highway congestion, fuel consumption, and air pollution, as well as mitigating the need for public spending on transportation infrastructure.

In sum, existing exemptions and policies are consistent with the statutory goals and mandates of the Staggers Act and ICCTA. Governing law has not changed since ICCTA, and there is no basis to change the policies carefully developed to implement that law over the course of three decades. *See generally,* Appendix[7]. Under the current regulatory approach and principles, America's railroads are poised to be make very positive contributions to the Nation

[7] Such new regulatory intervention would not only run counter to the lessons and hard-won productivity and investment gains of the post-Staggers Act era, it would flatly contradict the President's recent Executive Order on "Improving Regulation and Regulatory Review" which, *inter alia,* directs federal agencies to streamline existing regulations and make them "more effective or less burdensome in achieving their regulatory objectives." (Executive Order issued January 18, 2011, Section 6(b)). The clear policy directive of the Obama Administration to federal agencies in 2011 is to *eliminate* and reduce unnecessary regulations and regulatory burdens, *not* to impose greater regulatory requirements and burdens on an industry in which the current policies of limited regulation are clearly working.

and its economy in the coming years and decades. To facilitate those important contributions, and to continue to faithfully implement the Board's unchanged statutory mandates and responsibility, the AAR urges the Board to stay the regulatory course and continue to limit economic regulation to those few areas where it may be needed.

Based upon current law and based upon the facts before the Board, this proceeding should be concluded following the hearing without further action. Any decisions as to whether there should be changes to the Congressional policy adopted in the Staggers Act – and validated and expanded in ICCTA – should be left to Congress.

II. THE LEGAL AND FACTUAL FOUNDATION FOR EXEMPTIONS HAS NOT CHANGED.

A. The Board's Statutory Mandate to Aggressively Exercise Exemption Authority is Unchanged

In enacting the Staggers Act, Congress rejected a statutory regime that had allowed rail regulators to substitute their views of appropriate pricing, service, and operating outcomes for the results that would emerge in a competitive market. Congress structured its new legal and policy directives not merely to revive an industry that was in dire straits, but also to ensure that the mistakes of the past would not be repeated. Congress did not intend deregulation to be a temporary measure—one that would last only until railroads had regained their financial footing. Congress recognized the need for a permanent change in regulatory philosophy. As Professor Willig explains, "the lessons of the times were learned." Congress directed the ICC "to let markets work where they are actively or potentially competitive," and intervene only "where competition demonstrably cannot work."

If there were any doubts about Congress' intent, they were erased by ICCTA, in which Congress re-emphasized its intent that regulators allow market forces to determine rail rates and services whenever possible. Congress reviewed the results of the Staggers Act reforms and found that they had "result[ed] in the restoration of financial health to the rail industry."[8] But Congress did not conclude from this success that exemptions had outlived their relevance or usefulness. To the contrary, it recognized that "exemptions have proven highly beneficial to shippers and railroads,"[9] and recommitted to the policy of freeing railroads from unnecessary regulation by making it "an explicit part of the [Board's] statutory duty to utilize exemptions *to the maximum extent permissible under the law*."[10]

Under ICCTA, the Board is required to exempt a person, transaction, or service from regulation whenever it finds that regulation (1) is not necessary to carry out the statutory rail transportation policy, and (2) is not needed to protect shippers from the abuse of market power.[11] The Board may not refuse a requested exemption because the railroad has adequate resources to withstand the burdens of regulation. Nor may the Board refuse a requested exemption because it views continuing regulation as harmless or believes it could produce a better outcome through regulation than the market would produce through effective competition.[12]

ICCTA provides a mechanism for parties seeking revocation of an exemption, but Congress has ensured that its deregulatory policies cannot be circumvented through revocation proceedings. The Board may revoke an exemption only if it finds that re-regulation is necessary

[8] S. Rep. No. 104-176, 104th Cong., 1st Sess. 3 (1995).

[9] *Id.* at 8.

[10] H.R. Rep. No. 104-311, 104th Cong., 1st Sess. 96 (1995) (emphasis added).

[11] *See* 49 U.S.C. § 10502(a).

[12] *See Coal Exporters Ass'n of U.S., Inc. v. United States*, 745 F.2d 76 (D.C. Cir. 1984); *see also Exemption from Regulation – Boxcar Traffic*, 367 I.C.C. 425, 432 (1983) ("*Boxcar Exemption Decision*") ("The ultimate issue is not whether regulation is harmless, but only where it must be retained to carry out the rail transportation policy and protect shippers from market power abuse.").

to carry out the statutory rail transportation policy.[13] As Congress emphasized when it enacted ICCTA, a party seeking revocation is required to meet the same standards that would be required to oppose an exemption in the first place: "[w]hen considering a revocation request, the Board should continue to require demonstrated abuse of market power that can be remedied only by reimposition of regulation or that regulation is needed to carry out the national transportation policy."[14]

In enacting the Staggers Act, Congress required the ICC to adopt broad, general exemptions, with the understanding that particular shippers might claim that they do not have the same competitive alternatives as others and that they were subject to abuse. Congress instructed the ICC to aggressively remove regulations, and to review any shipper complaints about abuse of market power as they were raised in conjunction with individual complaints and petitions for revocation:

> Particularly, the Conferees expect that as many as possible of the Commission's restrictions on changes in prices and services by rail carriers will be removed and that the Commission will adopt a policy of reviewing carrier actions after the fact to correct abuses of market power.[15]

There is no reason to depart from the framework established by Congress.[16] Most of these exemptions have been in place for decades. In all that time, no shipper has petitioned to revoke an exemption in its entirety, and only a handful have sought even partial revocations to

[13] 49 U.S.C. § 10502(d).

[14] H.R. Conf Rep. 104-422, at 168.

[15] H.R. Conf. Rep. 96-1430, at 104-105; *see also Boxcar Exemption Decision*, 367 I.C.C. at 441 (noting that, in to avoid the potential for "'paralysis by analysis,'" Congress "declared that we should instead make exemptions and then deal with any special problems 'after the fact,' not on *a priori* possibilities.").

[16] Other provisions of the Interstate Commerce Act demonstrate that where Congress intends that the Board conduct periodic reviews of exemptions, it expressly confers such authority in the statute. *See* 49 U.S.C. § 13703(c)(2) (providing for periodic review of Board exemption of certain motor carrier agreements from antitrust laws).

address specific claims of abuse. In the few cases that have been brought, the agency has addressed the shippers' claims and provided relief where appropriate. The AAR submits that a case-by-case approach is not only sufficient to protect shippers of exempt traffic, but also consistent with the statute and Congress' intent that market forces should govern outcomes whenever possible.

Lastly, the AAR urges the Board to reject the notion that the TOFC/COFC, boxcar, or commodity exemptions may have outlived their relevance or usefulness in light of improvements to railroads' financial health. Congress' directives that the ICC and the Board adopt exemptions reflect a policy judgment that competition and demand for service, not government regulation, should determine the rates and services that railroads offer whenever possible. As Professor Willig observes, the public's interest in rail markets that are governed by competition "persists unabated, and the Board's exemptions appropriately persist where competition persists." Rail revenues are irrelevant under this framework.

B. Competition in the Rail Transportation Marketplace Continues to be a Fundamental Predicate for Exemptions

The AAR submits that the rationale behind the commodity, boxcar, and TOFC/COFC exemptions – the presence of effective intermodal, intramodal, product, and geographic competition – still applies today.

The decisions of the ICC to grant the commodity, boxcar, and TOFC/COFC exemptions were based largely on the agency's finding that there was effective competition for the railroad services at issue – and, therefore, regulation was not needed to protect shippers from the abuse of market power. As the Board recently summarized, "[t]he exemptions are based on prior findings that there is a sufficiently competitive market for the transportation involved that regulatory protections are not needed." Ex Parte No. 661, *Rail Fuel Surcharges,* Decision at 13 (served

January 26, 2007). As the Notice acknowledges, the ICC's decisions to grant the commodity exemptions relied heavily on the fact that the railroads' movements of these goods "were subject to strong competitive forces" and "traffic for [the] individual commodities was sufficiently competitive and ... railroads lacked sufficient market power such that abuse of shippers was not a substantial threat." Notice at 2-3.

The evidence that you will hear in this proceeding belies any notion that the railroads hold market power that would warrant any modification or revocation of the existing exemptions.

First, the data presented by Professor Willig show that rail rates generally declined for more than 20 years after the enactment of the Staggers Act, and even today remain below their pre-Staggers Act levels. This evidence, by itself, strongly supports the position that regulation is not needed to protect shippers from any abuse of market power.

Second, independent studies have confirmed that the railroads do not possess significant market power over much of their traffic. For example, the Christensen study commissioned by the Board shows that the percentage of tons and ton-miles moving at rates exceeding 180% of URCS variable cost declined in 2007 and 2008 from the 2005 and 2006 levels. The study's Final Report, issued in January 2010, states that Christensen's pricing models "do not suggest any wholesale shifts in pricing behavior that would exacerbate 'captive shipper' problems," and that any increases in revenues per ton mile since 2004 have been due to "costs rather than markup factors."[17]

[17] Laurits R. Christensen Associates, Inc., *An Update To the Study of Competition In the U.S. Freight Railroad Industry – Final Report* (Jan. 2010), at 6-16 – 6-17.

C. The Competition Forming the Basis for Specific Exemptions Remains Vibrant.

Each of the ICC and Board decisions granting an exemption was based primarily on the agency's conclusion that railroads face pervasive competition – from trucks, railroads, and other modes – as well as geographic and product competition. There have been no subsequent developments that would affect those conclusions.[18]

1. Trucks Remain Highly Effective Competitors.

A key finding supporting most of the exemptions was the presence of pervasive truck competition, which continues unabated today.[19] Based upon service reliability and flexibility considerations, trucks often provide shippers with viable competitive options even when rail rates may be lower.[20] Motor carriers are physically able to reach each and every location that a rail carrier serves, but rail carriers do not reach every location that a motor carrier serves. The vibrant competition trucks offer is not fully reflected in a static view of the transportation marketplace. In some circumstances, rail may appear to provide the best economic proposition while in others trucks may appear to provide the best value. But in today's dynamic transportation markets, any attempt by a rail carrier to obtain excessive rate increases or to

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[18] Some were also granted on the basis that the service at issue was "of limited scope," which is no less true today for these commodities. *See, e.g., Rail General Exemption Authority— Liquid Iron Chloride*, Ex Parte No. 346 (Sub-No. 9A), 367 I.C.C. 347 (1983). Even if railroad market share for these "limited scope" commodities were to increase in the future, such an increase alone would not justify revocation. *See Rail General Exemption Authority—Fresh Fruits and Vegetables*, Ex Parte No. 346 (Sub-No. 1), 361 I.C.C. 211, 214 (1979).

[19] *See, e.g., Boxcar Exemption Decision*, 367 I.C.C. at 433 ("The fundamental premise underlying the proposal for a boxcar exemption is that truck competition for the transportation of boxcar commodities is pervasive and limits the railroads' pricing freedom. . . .").

[20] *See, e.g.*, Brian A. Weatherford, et al., *The State of U.S. Railroads: A Review of Capacity and Performance Data*, RAND Supply Chain Policy Center, 59 (2008) ("Despite the direct cost advantage of long-haul rail over long-haul truck, it is clear from the prevalence of national trucking firms that many companies find trucking to be more competitive or reliable.").

otherwise exploit shippers' marginal preferences for rail movement would risk diversion of the traffic to trucks.[21]

One railroad success story of the past several decades has been the growth in intermodal traffic, with trucks remaining competitive with intermodal movements for both shorter and longer hauls:

> For shorter hauls, all-truck movements tend to have cost advantages over intermodal movements, despite relatively high per-mile costs for trucks, as all-truck movements avoid "drayage" costs associated with hauling the container or trailer to and from railroad terminals, as well as the costs of loading and unloading the railroad flat cars. For longer hauls, truck shipments may have more desirable service qualities despite higher costs, although railroads have developed and expanded higher-speed and scheduled services in competition with trucking.[22]

In sum, the fierce truck competition that justified the exemptions originally remains a powerful constraint on the railroads' market power, even with respect to intermodal traffic.

2. Competition From Other Railroads

For certain of the exempt commodities – including TOFC/COFC service, finished automobiles, and others – another critical factor in the grant of broad commodity-based exemptions was the existence of pervasive competition between railroads. Some experts believe that competition between railroads is stronger than ever.[23] An important factor in today's rail-to-

[21] As the Board explained in the *Boxcar Exemption Decision*: "Virtually anything that can be transported in a boxcar can be transported in a truck. Motor carriage tends to be faster, more accessible, more convenient, and sometimes less damaging to freight than rail service, *meaning that boxcar transportation generally must be priced to reflect these service differences to compete successfully*. Thus, the market itself places an effective ceiling on rail rates for boxcar transportation, and regulation is unnecessary to assure that boxcar rates do not rise to unreasonably high levels." 367 I.C.C. at 432 (emphasis added).

[22] Christensen Assoc., Revised Final Report at 15-1 (Nov. 2009).

[23] *See, e.g.*, Lawrence H. Kaufman, "Competition Is Alive and Well," *Journal of Commerce*, May 21, 2007, at 27 ("Not only are railroads competing with trucks, they are competing vigorously with each other. Competition is alive and well").

rail competition is the increased competition provided by rail-truck transportation options, including transloading. Thus, even for exempt traffic for which direct rail-to-rail competition may not be pervasive, in many instances a rail-truck transportation combination provides very effective competition for rail transportation.

Some critics of the Board's regulatory policies have suggested that intramodal competition has diminished as a result of the numerous major mergers approved by the ICC and the Board in past decades. However, fewer Class I carriers does not mean that competition is less effective.[24] Railroad consolidation has reduced railroad costs and enabled new and improved single-line and other services, which were some of the benefits underlying the Board's original conclusions that the proposed transactions, as conditioned to preserve competition, were in the public interest. Those benefits have been validated by independent studies.[25]

More generally, as DOT explained to the Board in reviewing the history of the Staggers Act reforms in late 2005, "although there certainly have been a large, large number of mergers," in each merger case the agency imposed conditions that "sought to ensure that no rail shipper that was [served by] at least two carriers received less than that." Accordingly, DOT was "not aware of any merger related gain in the number of captive shippers."[26]

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[24] As a matter of fact, although the number of Class I railroads has declined since the passage of the Staggers Act, "the total number of railroads has *increased* from about 490 in the mid-1980s to the current 559." Laurits R. Christensen Assoc., Inc., *A Study of Competition in the U.S. Freight R.R. Indus. and Analysis of Proposals that Might Enhance Competition, Executive Summary of Revised Final Report*, Prepared for the S.T.B., ES-8 (Nov. 2009) (footnote omitted) (emphasis added).

[25] Even the most controversial mergers approved by the Board achieved benefits. *See, e.g.,* FTC Bureau of Economics, Working Paper No. 269, *The Union Pacific/Southern Pacific Rail Merger: A Retrospective on Merger Benefits,* Denis A. Breen (Mar. 11, 2004) (published in Review of Network Economics).

[26] *The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead,* STB Ex Parte No. 658, Transcript of Hearing (Oct. 19, 2005), pp. 22-23 (remarks of Paul Samuel Smith).

3. Product and Geographic Competition

The STB and ICC have also granted a number of exemptions where the record showed the existence of robust product and geographic competition, which prevents railroads from exercising market power.[27] As the Board has explained, these types of competition "can provide effective alternatives that may be sufficient to constrain a rail rate to a reasonable level." *Market Dominance Determinations – Product and Geographic Competition,* 5 S.T.B. 492, 493 (2001) ("*Market Dominance I*"), *petition for review denied sub nom. Assn. of American Railroads v. STB,* 306 F.3d 1108 (D.C. Cir. 2002).[28]

Today, product and geographic competition remain significant for those commodities and services that were exempted from STB regulation based on those forms of competition. Ports on the Pacific and Atlantic Coasts (such as Long Beach, Oakland, Tacoma, Vancouver, Prince Rupert, Halifax, New York, Baltimore, Hampton Roads, and Charleston) compete for business

[27] *See, e.g., Rail General Exemption Authority – Exemption of Rock Salt, Salt,* 10 I.C.C.2d 241, 246 (1994) ("extensive geographic competition ... inhibits railroads from exercising market power"); *Rail General Exemption Authority – Exemption of Hydraulic Cement,* Ex Parte No. 346 (Sub-No. 34), Decision served July 26, 1995, 1995 WL 438371 (I.C.C.), at *4; *Rail General Exemption Authority – Exemption of Ferrous Recyclables,* Ex Parte No. 346 (Sub-No. 35), Decision served May 16, 1995, 1995 WL 294272 (I.C.C.), at *3; *Rail General Exemption Authority – Exemption of Grease or Inedible Tallow,* Decision served Dec. 9, 1994, 1994 WL 687462 (I.C.C.), at *5; *Rail General Exemption Authority – Exemption of Carbon Dioxide,* Ex Parte No. 346 (Sub-No. 32), decision served Nov. 18, 1994, 1994 WL 650543 (I.C.C.), at *3; *Petition To Exempt From Regulation the Rail Transportation of Scrap Paper,* 9 I.C.C.2d 957, 959-960 (1993); *Rail General Exemption Authority – Lumber or Wood Products,* 7 I.C.C.2d 673, 676-678 (1991.

[28] *See also Market Dominance Determinations – Product and Geographic Competition,* 3 S.T.B. 937, 946 n.49 (1998) ("*Market Dominance I*), *remanded on other grounds sub nom. Assn. of American Railroads v. STB,* 237 F.3d 676 (D.C. Cir. 2001) ("We have no doubt that in certain circumstances product and geographic competition effectively limit railroad pricing").

from ocean shipping companies, and the railroads serving those ports in turn compete with one another and with trucking companies for the intermodal traffic moving through them.[29]

Similarly, there is robust product and geographic competition for many other commodities and products, including, for example, paper and forest products commodities, which are exempted from STB regulation. Forest products originating in the Pacific Northwest and Western Canada compete with similar products originating in the Southeastern United States, Eastern Canada, and even with European products shipped to East Coast ports. Exempt steel and scrap products are not only subject to vigorous rail and truck competition, but significant foreign source competition as well – with much of those products moving from Asian and European origins through West Coast and Gulf ports, and often delivered to their ultimate destinations by truck. Other examples of significant product and geographic competition of exempt commodities and services abound, and individual railroad members of AAR will be addressing them.

III. PERIODIC GENERAL REVIEW OF EXEMPTIONS IS UNNECESSARY AND INCONSISTENT WITH THE BOARD'S STATUTORY MANDATE.

The last issue on which the Board requested comments is "whether the exemptions should be subject to periodic review." Notice at 3. As I have stated, the AAR does not believe that any general review of existing exemptions by the Board is warranted or appropriate. Congress has established, in Section 10502(d), a specific procedure and criteria for revisiting specific exemptions in the event that an affected person petitions for a change of an existing exemption. If a shipper believes that a particular exemption should be revoked as to a specific

[29] The pending expansion of the Panama Canal will further facilitate geographic competition between East and West Coast ports, and between East Coast ports. *See generally*, Jean-Paul Rodrigue, PhD, *Factors Impacting North American Freight Distribution in View of the Panama Canal Expansion* (Van Horne Institute 2010).

commodity, movement, or service, it may file a petition for revocation pursuant to Section 10502(d). Indeed, other provisions of the Interstate Commerce Act demonstrate that where Congress intends that the Board conduct periodic review of exemptions, it expressly confers such authority in the statute.[30] There is neither any specific statutory authority, nor expression of legislative intent, for the Board to conduct periodic reviews of the exemptions it has granted pursuant to the mandate of Section 10502(a).

Moreover, AAR respectfully submits that the Notice asks the wrong question. The more appropriate inquiry for the Board under Section 10502 is whether – consistent with the Board's exemption mandate – there are *additional* commodities as to which regulation is no longer necessary to protect shippers from the abuse of market power. The AAR submits that the Board should initiate proceedings regarding whether additional commodities meet the criteria of the statute pursuant to which the Board "shall" exempt such traffic.

IV. EXEMPTIONS REMAIN WARRANTED AND NECESSARY

The commodity, TOFC/COFC, and boxcar exemptions remain warranted and necessary. It has been well recognized that the deregulatory policies that Congress adopted in the Staggers Act and reinforced in ICCTA reversed the long-term decline of the nation's freight railroad system and cleared the path that has led to the current "Rail Renaissance."[31] The TOFC/COFC,

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[30] For example, 49 U.S.C. § 13703(c)(2) provides for periodic review of Board exemption of certain motor carrier agreements from antitrust laws.

[31] For example, FRA's Preliminary National Rail Plan found that "[b]efore 1980, when railroads were partially deregulated, they focused on survival. In recent years, they have been thriving and privately funded freight railroads have focused on enhancing the reliability of their service and their intermodal capacity." Preliminary National Rail Plan at 4. The Plan further found that: "Freight rail infrastructure maintenance and capacity enhancements, however, can only occur with Federal legislation and policies that allow rail carriers to earn revenues that are sufficient to encourage their continued investment in the system." *Id.* at 4.

boxcar, and commodity exemptions reflect an enduring tenet of those policies—that the public interest is best served when the competitive process is allowed to determine the prices that railroads charge and the services they offer. They also played a critical role in restoring the industry to financial health. Freedom from regulation gave railroads the flexibility to tailor their rates and service offerings in response to customer demand and strengthened their incentives to develop new and innovative services by removing the risk that regulators would negate the benefits of those investments.

The TOFC/COFC, boxcar, and commodity exemptions remain relevant and warranted today, not only in principle, but in practice. Railroads increasingly have made progress toward financial health, but the Nation needs railroads to invest more and expand service even further. To meet that call, railroads need the same freedom to tailor their offerings in response to demand and the same assurance that they will be allowed to pursue returns on the new investments that has brought them to this point.

APPENDIX TO WRITTEN TESTIMONY OF
EDWARD R. HAMBERGER ON BEHALF OF
THE ASSOCIATION OF AMERICAN RAILROADS IN STB EX PARTE NO. 704

ICCTA *REQUIRES* THE BOARD TO GRANT EXEMPTIONS TO THE MAXIMUM EXTENT POSSIBLE.

It is essential that the Board consider this proceeding in the context of the statutory framework established by Congress in the Staggers Act and the ICC Termination Act ("ICCTA"). That legal framework consists of:

- Congress's directive to exempt all rail traffic and services that meet the statutory criteria for exemptions (codified at 49 U.S.C. § 10502(a));
- Statutory policies requiring reliance on marketplace competition rather than regulation, and other goals of the federal Rail Transportation Policy (49 U.S.C. § 10101); and
- Legislative standards and procedures governing revocation requests, which require a petitioner to demonstrates that regulation is *necessary* to carry out the Rail Transportation Policy. (49 U.S.C. § 10502(d)).

Governing law has not changed since ICCTA, and these congressional policies remain as binding on the Board today as when they were enacted. Thus, viewed in this congressionally mandated framework, it is clear that there is no sufficient basis for revoking or broadly "revisiting" exemptions issued by the Board pursuant to the statutory command of Section 10502(a). The agency should continue to follow its statutory duty to exempt traffic "to the maximum extent possible" and review only narrow, specific requests for revocation on a case-by-case basis.

A. Congress Directed That Competitive Market Forces, Not Agency Regulation, Govern Rail Transportation Services Wherever Possible And Mandated That The Board Aggressively Use Its Exemption Power.

The exemption provisions of the Interstate Commerce Act originated in the regulatory reforms enacted as part of the Railroad Revitalization and Regulatory Reform Act of 1976 ("4-R Act"), Pub. L. No. 94-210, 90 Stat. 31 (1976). At the time of the 4-R Act, a large part of the railroad industry was either in bankruptcy, on the brink of bankruptcy, or in serious financial decline. Congress directly attributed the poor financial and operational condition of the rail industry, and the industry's declining transportation market share, to nearly a century of excessive, heavy-handed, and stifling regulation by the ICC under an outdated regulatory regime. *See, e.g.*, H.R. Rep No. 94-725, at 80 (1975); S. Rep. No. 94-499, at 2, *reprinted in* 1976 U.S.S.C.A.N. 1, 15; *American Trucking Ass'ns, Inc. v. ICC*, 656 F.2d 1115, 1118 (5th Cir. 1981) ("*ATA*").

In an initial effort to ameliorate the negative effects of excessive regulation, the 4-R Act amended the Interstate Commerce Act to permit competitive forces to play a larger role. Specifically, the 4-R Act authorized the ICC to grant limited exemptions from regulation, authority that the ICC had actively sought. In enacting the exemption provision, Congress found that "the power to exempt from regulation in whole or in part will enable the Commission to commit its limited resources in areas where they are most needed...." S. Rep. No. 94-499, *supra; see also* H.R. Rep. No. 94-725, at 242. This general finding and direction remains at least as relevant and important today as the day it was issued. The actual exemption authority conferred by the 4-R Act, however, was modest and permitted the agency to grant an exemption only when (among other findings) the matter was "limited in scope" and application of the regulation at issue "would serve little or no useful purpose." 4-R Act, Sec. 207.

In 1980, Congress recognized that the limited reform measures enacted in the 4-R Act were insufficient to revive the rail industry and that far more extensive deregulatory measures were required. In response, Congress enacted the Staggers Act, which was premised on Congressional findings, *inter alia*, that "(3) today, most transportation in the United States is competitive; (4) many of the Government regulations affecting railroads have become unnecessary and inefficient... [and] "(9) modernization of economic regulation for the rail industry with a greater reliance on the marketplace is essential .... in order to achieve maximum utilization of railroads to save energy and combat inflation." S. Rep. No. 96-1430, at 3 (1980) (Conference Report). The new Rail Transportation Policy ("RTP") goals established by the Staggers Act reflected the congressional intent that effective competition, not regulation, was the best protection against potential abuses of market power by rail carriers and that agency regulation was necessary only in those limited circumstances where effective competition did not exist to provide such protection. *See* former 49 U.S.C. § 10101a.

An "important cornerstone[]" of the Staggers Act was the strengthening and expansion of exemption provisions. H.R. Rep. No. 96-1035, 96th Cong., 2d Sess. 60 (1980); *Coal Exporters Ass'n, Inc. v. United States*, 745 F.2d 76, 82 (D.C. Cir. 1984) ("*Coal Exporters*"). Although the Commission retained the authority to grant exemptions under the 4-R Act's "limited scope" criteria, Section 213 of the Staggers Act (codified at former 49 U.S.C. § 10505) also imposed on the ICC a *statutory duty* to grant exemptions from regulation where the ICC found that regulation, in whole or in part, was not necessary to carry out the RTP and was not needed to protect shippers from the abuse of market power.

Congress further determined that it was impracticable – and a serious impediment to prompt implementation of one of the Staggers Act's most important regulatory reforms – to require the ICC to make an individualized "effective competition" determination with respect to each of the thousands of specific transportation movements subject to a proposed exemption before allowing an exemption to take effect. To eliminate that obstacle to issuance of exemptions, Congress made clear that it favored the issuance of broad, general exemptions. *See, e.g.*, *Brae Corp. v. U.S.*, 740 F.2d 1023, 1040-41 (D.C. Cir. 1984) ("Congress encouraged the Commission to apply its exemption authority under section 10505(a) in a manner of 'general applicability'"). At the same time, the Staggers Act included a provision allowing an affected party to seek revocation of an existing exemption on the ground that application of a regulatory provision was necessary to carry out rail transportation policy with respect to its traffic.[1] Together, the exemption provisions of the Staggers Act established statutory policies favoring broad exemptions of general applicability, subject to revision (through the revocation process) only to the extent necessary to eliminate carrier abuses of market power or otherwise effectuate the RTP. As Congress summarized in the Staggers Act Conference Report:

> <u>The Conferees expect that, consistent with the policies of this act, the Commission will pursue partial and complete exemptions from remaining regulation</u>. The Conferees anticipate that through the exemption process the Commission will eventually reduce its exercise of authority to instances where regulation is necessary to protect against abuses of market power where other federal remedies are inadequate for this purpose. Particularly, <u>the Conferees expect that as many as possible of the Commission's restrictions on changes in prices and services by rail carriers will be removed and that the Commission will adopt a policy of reviewing carrier actions after the fact to correct abuses of market power.</u>

H.R. Conf. Rep. 96-1430, at 104-105 (1980) (emphasis added).

In the course of enacting ICCTA, Congress reviewed the ICC's exercise of the exemption authority conferred by the Staggers Act. Congress endorsed the ICC's aggressive use of its

[1] *See* former 49 U.S.C. § 10505(d).

exemption authority since the Staggers Act and found that "[t]hese exemptions have proven highly beneficial to shippers and railroads." *See* S. Rep. No. 104-176, at 8 (1995). Further reviewing the success of the Staggers Act reforms, Congress found that reliance on deregulation where effective competition existed, and retention of regulatory protections for shippers where it did not, had proved highly effective. "The bill [ICCTA legislation] generally does not attempt to substantively redesign rail regulation. Rather, it would preserve the careful balance put in place by the 4R Act and the Staggers Act that led to a dramatic revitalization of the rail industry while protecting significant shipper and national interests." S. Rep. No. 104-176, at 6. As Congress further found in evaluating the positive changes facilitated by Staggers Act deregulation, "[t]he Staggers Act has produced a renaissance in the railroad industry ..." (H.R. Rep. No. 104-311, 104th Cong., 1st Sess. 91 (1995)), and has "result[ed] in the restoration of financial health to the rail industry." S. Rep. No. 104-176, at 3 (1995).

Far from paring back the regulatory reforms of the Staggers Act because the railroads' financial position had improved, Congress moved in the opposite direction in ICCTA. In recognition of the crucial role of the exemption provisions in restoring financial health to the rail industry and successfully implementing the regulatory reforms of the Staggers Act, ICCTA strengthened the exemptions provision by amending 49 U.S.C. § 10502(a) to "make[] it an explicit part of the agency's *statutory duty to utilize exemptions to the maximum extent permissible under the law.*" H.R. Rep. No. 104-311, at 96 (emphasis added).[2]

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[2] ICCTA amended and recodified the exemption provisions at 49 U.S.C. § 10502(a), which now provides as follows:

> (a) In a matter related to a rail carrier providing transportation subject to the jurisdiction of the Board under this part, the Board, *to the maximum extent consistent with this part*, shall exempt a person, class of persons, or a transaction or service *whenever* the Board finds that the Application in whole or in part of a provision of this part—

The legislative history and express language of the statutory exemption provisions thus clearly demonstrate that Congress recognized and approved of the critical role of the exemption provisions – and the ICC's exercise of authority under those provisions – in restoring the financial health of the rail industry and that Congress has specifically directed the Board to use its exemption powers aggressively "to the maximum extent permissible by law." *See* 49 U.S.C. § 10502(a). Congress has not changed the law or the successful policies that animate it, and there is no basis for this agency to attempt, whether directly or indirectly, to change statutory policy when Congress has manifestly declined to do so.

B. The Law Requires the Board to Grant Exemptions Meeting the Statutory Criteria.

Under governing statutory criteria, the Board is *required* to exempt a person, class of persons, or a transaction or service whenever the Board finds that the application in whole or in part of a provision of Subtitle IV of Title 49, U.S.C.: (1) is not necessary to carry out the Rail Transportation Policy of Section 10101; and (2) either (a) the transaction or service is of limited scope; or (b) the application in whole or in part of the provision is not needed to protect shippers from the abuse of market power. *See* 49 U.S.C. § 10502(a). As the D.C. Circuit has confirmed, where the STB finds the conditions of its exemption mandate are satisfied, "it has no choice but to grant an exemption." *Coal Exporters*, 745 F.2d at 82.

> (1) is not necessary to carry out the transportation policy of section 10101 of this title; and
> (2) either—
>
> > (A) the transaction or service is of limited scope; or
> > (B) the Application in whole or in part of the provision is not needed to protect shippers from the abuse of market power.

49 U.S.C. § 10502(a) (emphasis added to show substantive language added by ICCTA).

Federal courts have held that these "intertwined" standards are satisfied by an agency finding of "effective competition" for the transportation or service in question:

> [T]he major shipper-protective limits on [the agency's] exemption authority are [49 U. S. C. 10101(6)] and [10502 (a)(2) (B)]. The former provision establishes that national railroad policy is "to maintain reasonable rates where there is an absence of effective competition" so long as railroads earn revenues "which exceed the amount necessary to maintain the rail system and to attract capital." The latter limits the exemption power where regulation is necessary to "protect shippers from the abuse of market power." . . . [T]he limits these provisions place on [the agency's] exemption power are met with a proper finding of an absence of "market power" and the presence of "effective competition."

Coal Exporters, 745 F. 2d at 79, 90. *See also Brae Corp.*, 740 F.2d at 1042 (boxcar exemption properly based on finding of no "market dominance" or "monopoly power" by railroads).[3]

The linchpin for exemption is thus an agency finding of "effective competition" for the transportation or service at issue. Once the Board makes such a finding, it is mandated to grant an exemption.

Moreover, where a finding of "effective competition" is made – and the mandated exemption is granted – it promotes several important Rail Transportation Policy goals, including: "allowing, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail" and "minimiz[ing] the need for Federal regulatory control over the rail transportation system." 49 U.S.C. § 10101(1)-(2). Exemptions also help to "ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes," *id.* § 10101(4); and to "foster sound economic conditions in transportation to ensure effective competition and coordination between

[3] *Coal Exporters* further recognized that the "Staggers Act Conference Report makes clear that even where there is no effective competition constraining railroad market power an exemption may be proper if there will nevertheless be no abuse of market power." *Id.* at 90 n.18; *see* H.R. Rep. No. 96-1430, at 105.

rail carriers and other modes," *id.* § 10101(5). The Board must continue to pursue these statutory goals underlying both the Staggers Act and ICCTA, in implementing the exemption provisions.

C. Consistent With its Statutory Mandate, The Board Properly Considers An Array Of Factors to Determine Whether An Exemption Is Required.

In an exemption proceeding, the initial inquiry in the agency's "effective competition" analysis is whether the carrier has market power over the transportation service in question. As the legislative history makes clear, in examining whether "effective competition" exists, the agency is required to consider "*all* competitive transportation factors that restrain rail carriers' actions and that affect the market for transportation of the particular commodity or type of service" at issue. *See* H.R. Conf. Rep. 104-422, at 168 (1995) (emphasis added); *see also* H.R. Rep. No. 96-1035, at 54-56 (1980). These "competitive transportation factors" include not only intermodal and intramodal competition, but also geographic and product competition, and all other relevant competitive transportation factors that can effectively limit carrier market power. *Id.; see also Mr. Sprout, Inc. v. United States*, 8 F.3d 118, 123 (2d Cir. 1993) ("[Q]uestions such as product substitutability and transportation alternatives were relevant in assessing the rail carriers' market power").

Accordingly, in making exemptions determinations, the ICC and STB have properly evaluated evidence relating to such competitive factors as: rail market share versus truck market share; evidence of intramodal, intermodal, geographic or product competition; and other relevant economic factors (such as indicia of shipper leverage, declining rail carrier average revenue per ton, amount of traffic moving under other exemptions, percentage of traffic moving under contracts, and revenue/variable cost ratios for the traffic at issue).[4] Consistent with its statutory

[4] *See, e.g.*, Ex Parte No. 230, Sub-No. 5), *Improvement of TOFC/COFC Regulation*, 364 I.C.C. 731 (1981); Ex Parte No. 346 (Sub-No. 8), *Exemption from Regulation—Boxcar Traffic*, 367 I.C.C. 425 (1983); Ex Parte No. 346 (Sub-No. 14), *Rail General Exemption Authority—*

mandate to maximize exemptions, the agency also has generally relied upon aggregated transportation data to determine if competitive forces are generally effective to protect against abuses of market power and has emphasized its willingness to address any specific instances of carrier abuses after the fact. *See, e.g., Brae Corp.*, 740 F. 2d at 1042-1043 (D.C. Cir. 1984); *ATA*, 656 F. 2d at 1123-24; Ex Parte No. 346 (Sub-No. 32), *Rail General Exemption Authority—Exemption of Carbon Dioxide* (served Nov. 18, 1994), 1994 WL 650543, at *4; Ex Parte No. 346 (Sub-No. 31), *Rail General Exemption Authority—Exemption of Grease or Inedible Tallow,* 1994 WL 687462 (served Dec. 9, 1994); *Rail General Exemption Authority—Nonferrous Recyclables*, 3 S.T.B. 62 (1998).

D. Revocation is Available Only to Remedy Conditions That A Petitioner Demonstrates are Inconsistent With The Rail Transportation Policy.

While revocation is the appropriate remedy to correct after-the-fact abuses of market power, Congress did not intend that revocation authority to reverse the congressional mandate favoring exemptions. Thus, the exemption statute and congressional direction establish stringent standards for revocation of exemptions.[5]

The statute provides that the Board may revoke an exemption *only* if it finds that the proposed re-regulation is *necessary* to carry out the Rail Transportation Policy. *See* 49 U.S.C. § 10502(d). And, upon receipt of a petition seeking revocation of an exemption, the Board has only 90 days to determine whether to begin a revocation proceeding. *Id.* Congress emphasized that revocation requests must be "given careful consideration by the Board" and that, "[w]hen

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Miscellaneous Agricultural Commodities, 367 I.C.C. 298 (1983); Ex Parte No. 346 (Sub-No. 30), *Rail General Exemption Authority—Exemption of Rock Salt*, 10 I.C.C. 2d 241 (1994); STB Ex Parte No. 561, *Rail General Exemption Authority—Nonferrous Recyclables*, 3 S.T.B. 62 (1998).

[5] The discussion in this section focuses primarily on requirements of the statute, not agency decisions implementing the statutory commands. As demonstrated below, ICC and STB precedents are fully consistent with the statutory policies and standards discussed in this section.

considering a revocation request, the Board should continue to require demonstrated abuse of market power that can be remedied only by reimposition of regulation or that regulation is needed to carry out the national transportation policy." H.R. Conf. Rep. No. 104-422, at 168, (1995).

Congress further directed the Board "to examine all competitive transportation factors that restrain rail carriers' actions and that affect the market for transportation of the particular commodity or type of service for which revocation has been requested." *Id.* Accordingly, the Board must exercise its revocation power judiciously on a case-by-case basis consistent with the statutory mandate favoring exemptions and allowing reimposition of regulation only to the extent that a petitioner demonstrates it is necessary. As the Board itself has recognized, in exercising its limited revocation authority it must "reconcil[e] the RTP with the statutory admonition to be liberal in granting exemptions when regulation is not necessary to protect against abuse of market power." *WTL*, 2006 WL 392132, at *2.

With respect to the TOFC/COFC exemption, the Board must take into account the additional fact that "Congress specifically authorized the Commission to exempt TOFC/COFC rail service." *ATA*, 656 F.2d at 1118-20 (citing former 49 U.S.C. § 10505(f)). This express, specific statutory authorization warrants even greater caution in considering any proposal to revisit or revoke the longstanding TOFC/COFC exemption.

E. The Board May Exercise Its Revocation Authority Only To Address Situations Where, In An Exempt Environment, A Railroad Has Market Power, Has Abused Its Market Power, And An Existing Regulatory Remedy Would Address The Abuse.

The exemption and revocation precedents of the ICC and the Board have provided additional substantive guidance for implementing the limited revocation authority conferred by Section 10502(d). Although the statute remains the touchstone and provides the core standards and requirements for revocations, the Board's decisions have put more "meat on the bones" of the statutory mandate and standards.

Should a shipper seek revocation of an exemption, in whole or in part, based on a claim of carrier abuse of market power, or on a contention that competitive market conditions have changed materially since the grant of the exemption and that revocation of the exemption is necessary to carry out the Rail Transportation Policy, the Board has clear procedures in place to evaluate such claims. A shipper may file a petition with the Board seeking revocation of the exemption pursuant to the provisions of 10502(d) and contemporaneously file a complaint challenging the carrier's conduct as a violation of a specific provision of ICCTA. *See, e.g., Rail Exemption Misc. Agricultural Commodities*, 8 I.C.C. 2d at 682; *see also FMC Wyoming et al. v Union Pacific Railroad*, 4 S.T.B. 699, 711 n.18 (1999) (Petition to partially revoke coke exemption denied on grounds that shipper failed to prove market dominance in rate case); *Rail General Exemption Authority – Nonferrous Recyclables* (served April 21, 1998).

If the petitioner meets the stringent statutory criteria for revocation of the exemption, the Board has statutory authority to revoke it to the extent necessary. Although the Board may not apply a revocation of an exemption retroactively (which would defeat the purpose of the exemption provisions), it may grant prospective relief. *See Pejepscot Industrial Park—Pet. for Declar. Order*, 6 S.T.B. 886, 891-893 (2003).

The party seeking revocation has the burden of proof, and petitions to revoke must be based on reasonable, specific concerns demonstrating that reconsideration of the exemption is warranted. *Minnesota Commercial Ry., Inc. – Trackage Rights Exemption – Burlington N. R.R. Co.*, 8 I.C.C. 2d 31, 35-38 (1991); *Watco Companies, Inc. – Continuance in Control Exemption – Boise Valley R.R., Inc.*, STB Finance Docket No. 35260, 2010 WL 3375018 (S.T.B. Aug. 26, 2010). Similarly, in order to obtain a revocation, a petitioner must show that revocation is necessary to protect against demonstrated abuses of market power or is otherwise necessary to realize the goals of the Rail Transportation Policy. ICC Docket No. 40774, *American Rail Heritage Ltd., d/b/a/Crab Orchard & Egyptian Railroad, et. al v. CSX Transportation, Inc.*, 1995 WL 358842 (served June 16, 1995); *see City of Ottumwa v. STB,* 153 F.3d 879, 883-84 (8th Cir. 1998) ("[T]o obtain revocation of an exemption, the burden of proof was on [the complainant] to show that regulation was required to carry out [rail transportation policy]").

In a revocation proceeding, the threshold showing a petitioner must make – and the first thing that the agency must determine – is "whether the carrier possesses substantial market power." *Rail Exemption Auth. Misc. Agricultural Commodities*, 8 I.C.C. 2d at 682; *see also WTL Rail Corp. Petition for Declaratory Order,* STB Docket No. 42092 (served Feb. 17, 2006), 2006 WL 392132, at *2 ("*WTL*") ("[T]he extent of railroad market power is an essential issue in exemption revocation proceedings"); *ATA*, 656 F.2d at 1123. If the Board finds that a petitioner has failed to make the threshold demonstration that the carrier possesses substantial market power over the exempted commodity or type of service, there is generally no basis for revocation. *Rail Exemption Auth. – Misc. Agricultural Commodities*, 8 I.C.C. 2d at 682; *see also Brae Corp.*, 740 F. 2d at 1043 (showing of railroad market power over the transport of a specific commodity would be an essential predicate for post-exemption revocation proceeding).

If a petitioner makes a showing that the carrier(s) has market power, it next must show both that the carrier has abused that market power and that regulation is necessary to protect against carrier abuse of shippers as a result of such market power. Mere assertions of "a priori possibilities" of market power abuse do not constitute evidence of carrier abuse of market power that would warrant revocation of (or agency refusal to grant) an exemption. *See* Ex Parte No.

346 (Sub-No.8), *Exemption from Regulation—Boxcar Traffic*, 367 I.C.C. 425, 441 (1983). Instead, a revocation decision of the Board must be based on a strong evidentiary record supporting its decision. As the Board has explained, existing exemptions "are based on prior findings that there is a sufficiently competitive market for the transportation involved that regulatory protections are not needed." Ex Parte No. 661, *Rail Fuel Surcharges,* at 13 (served Jan. 26, 2007); *see also Misc. Agricultural Commodities*, 8 I.C.C. 2d at 676-677.

A party seeking revocation must provide substantial probative evidence that there has been a material change in the competitive marketplace for the exempted service or product or that there has been an actual carrier abuse of market power to rebut that finding. *Rail Fuel Surcharges,* at 13; *see also Rail Exemption Misc. Agricultural Commodities*, 8 I.C.C. 2d at 676-77 ("[A] revocation petition focuses on traffic that has previously been exempted from regulation . . . on the basis of this agency's conclusion that the marketplace itself is sufficiently competitive so as not to require continued government regulation. Thus, a party has a burden of showing that our prior findings supporting the initial exemption were clearly wrong, or that changed circumstances require us to revisit them").

Where a revocation petitioner demonstrates that a carrier action would constitute a violation of an otherwise applicable regulatory provision,

> violations must be serious enough to indicate abuse of market power which can and ought to be corrected by regulation. Thus a finding of what might be a minor violation (if regulation were in effect), or a slightly adverse impact on one component of [rail transportation policy], does not necessarily indicate that reregulation is appropriate.... An element [of the agency's] assessment may be the effect of the exemption (and of potential revocation) on the rail industry and the shipping public overall.

Rail Exemption Misc. Agricultural Commodities, 8 I.C.C. 2d at 676-77. "Finally, in assessing whether regulation is necessary or appropriate, [the agency] address[es] whether regulation or exemption would, on balance, better advance the objectives of the [] RTP and the interest of the shipping public overall." *Rail Fuel Surcharges*, at 12.

In sum, in order to implement the exemption mandate of Section 10502 and congressional policy animating the statute, the Board's revocation authority must be used judiciously on a case-by-case basis. "Exemption analysis takes a broad brush approach to analysis of the competitive environment as a whole and looks to the remedy of partial revocation to address specific competitive situations should that become necessary." *Santa Fe Southern Pacific Corp.*, 2 I.C.C.2d at 741; *see Ass'n of Am. Railroads – Petition to Exempt Indus. Dev. Activities from 49 U.S.C. §§ 10761(a)(1), 11902-03, & 11904(a)*, 8 I.C.C.2d 365, 377 (1992) ("The legislative history of the Staggers Act reveals a Congressional intention to have the Commission be liberal in granting exemptions and to correct problems with particular exemptions after the problems actually arise"); *Brae Corp*, 740 F. 2d at 1043 ("Congress itself envisioned after the fact review to correct isolated market abuses that may follow the lifting of protective regulations under section 10505(a)"). To date, the ICC and the Board have exercised revocation authority judiciously and on a case-by-case basis, as Congress intended. The law has not changed, and neither should the Board's faithful implementation of the requirements of the law.

1905443

Before the
Surface Transportation Board

Hearings Regarding
Docket Number EP 704:
Review of Commodity,
Boxcar, and TOFC/COFC Exemptions

Statement of

Robert Willig

Professor of Economics and Public Affairs

Princeton University

January 31, 2011

I. Witness Introduction

Thank you for the opportunity to appear in this proceeding. My name is Robert Willig. I am Professor of Economics and Public Affairs in the Economics Department and the Woodrow Wilson School of Public and International Affairs of Princeton University. I also serve as a senior consultant to the economics consulting firm Compass Lexecon. I have been asked by the AAR to present my review of policy towards various exemptions from regulation granted by the Board and its predecessor, the Interstate Commerce Commission. I have done extensive research and economic analysis of the railroad industry over the course of my career.[1] I have also testified before the Surface Transportation Board, and its predecessor, the Interstate Commerce Commission about issues affecting the rail industry on many occasions. In general, my academic area of focus for teaching and research is microeconomics, with particular specialization in the field of industrial organization, including competition and regulatory policy. I have extensive experience analyzing such economic issues arising under the law. While on leave from Princeton, I served as Deputy Assistant Attorney General in the Antitrust Division of the United States Department of Justice, and in that capacity served as the Division's Chief Economist. I have consulted to international public agencies, national governments, private companies and law firms, and appeared as an expert witness before

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[1] See, for example, "Competitive Rail Regulation Rules: Should Price Ceilings Constrain Final Products or Inputs?" (with W. J. Baumol); Journal of Transport Economics and Policy, vol. 33, part 1, pp. 43-53 ; "Restructuring Regulation of the Rail Industry," (with Ioannis Kessides), in Private Sector, Quarterly No. 4, September 1995, pp. 5 – 8; "Competition and Regulation in the Railroad Industry," (with Ioannis Kessides), in Regulatory Policies and Reform: A Comparative Perspective, C. Frischtak (ed.), World Bank, 1996; "Railroad Deregulation: Using Competition as a Guide," (with W. Baumol), Regulation, January/February 1987, vol. 11, no. 1, pp. 28-35; "Pricing Issues in the Deregulation of Railroad Rates" (with W. Baumol), in Economic Analysis of Regulated Markets: European and U. S. Perspectives, J. Finsinger (ed.), 1983.

Congress, federal and state courts, federal administrative agencies, and state public utility commissions on subjects involving microeconomics, competition and regulation, in a wide variety of sectors including transportation and railroading specifically.

Today, I shall address the economic policy rationales for existing exemptions from rate regulation that have been granted and implemented by the Board and its predecessor, the ICC. These exemptions cover various rail-hauled commodities, as well as boxcar and intermodal (TOFC/COFC) traffic. I would like to discuss appropriate public interest standards for approaching the question of reconsideration of existing exemptions.

I will start with a brief overview of basic economic principles and a discussion of the public interest rationale for price regulation. I will then move into a discussion of the tools currently available to the Board with regard to exemptions and analyze the question of whether there are economic and policy justifications for revisiting exemptions as a whole. Before concluding my remarks, I will briefly assess some of the more prominent arguments that have been offered in support of a blanket revocation of exemptions.

II. Basic Economic Principles of Rate Regulation

The public's interest is served by prices that reflect competitive conditions of supply and demand, going down where consumers' demands weaken and going up where consumers' demands strengthen, both relative to supply. In this way, prices can serve their important function of signaling where resources are most needed in the economy, and motivating those needed supplies. Interference with these elements of the competitive process, even if well-intended by policy-makers, is recognized to cause systematic economic problems and counterpart social harms. In particular, while it can be politically expedient to always promise consumers lower prices, lower prices are not always in the public interest. In a well-functioning economy, the public's interest is served by prices that move with the competitive influences of supply and demand and provide producers, consumers, and investors with accurate and motivating information about underlying market dynamics. As governments world-wide have learned, and still need periodic reminders, policies that block this process by artificially holding prices down in otherwise competitive markets invariably discourage supply that is genuinely needed, while over-encouraging demand relative to supply. Even the special interests that may benefit in the short run from artificially depressed prices will all too soon be harmed as much as any by the disruptive shortages that inevitably follow.

A. The Economic Rationale for Price Regulation

Just as the public interest is well-served by the prices that result from the dynamic economic forces at work in competitive markets free from regulatory interference, some form of regulatory attention may promote the public interest in markets where competition is decidedly absent. Where there is no competition due to the costly nature of alternative sources of supply and due as well to high barriers to entry, market forces cannot be relied upon to yield prices that conduce to economic efficiency and the public interest. Here, instead, abuses of market power may systematically harm consumers with excessively high prices and suppression of healthy levels of supply. So, where competition is absent, and is expected to remain absent due to underlying conditions of costs and entry barriers, regulation may be warranted to control prices, prevent abuses of market power and encourage the provision of additional supply. When employed wisely, price regulation is not aimed at holding prices down for the sake of the special interests of one side of the market over the other, nor to render more politically comfortable the outcomes of real competition. Rather, where competition is not actually feasible, public interest regulation holds prices down relative to monopolized prices and aims at replicating the results that the market would yield *if* the market were actively or potentially competitive.

These fundamental precepts of economic policy towards competition and price regulation have crucial implications for the railroad industry. Since each major railroad provides transportation services of many different types, in many different markets, and under widely varying competitive conditions, the Board's rate regulation authority is properly targeted at specific markets where there is demonstrable evidence of abuse of market power or at least a high risk of such conduct. As a matter of fundamental economics, "abuse of market power" should correspond to a sustained absence of competition due to underlying conditions, and a concomitant high likelihood that unregulated pricing would result in continued abuse of such power. By the same token, in situations where competition can work effectively, the public's interest is best served by allowing competition – not regulation – to set railroad rates. In fact, adherence to this straightforward framework has been central to the success of U.S. railroad policy over the last several decades.

Indeed, we should remind ourselves how destructive to the industry was its prior regulatory policy. Before the Staggers Act and the immediately following wise rule-makings of the ICC, regulation paid little heed to the actualities of competition and to the role model of competition where it was absent. Instead, regulation replaced competition with formulaic pricing that was rigidly unresponsive to market forces of supply and demand, and attempted to mandate much of the service, structure and operating practices of the rail industry. Some rates were held up above the levels needed aggressively to attract compensatory competitive traffic. Many rates were held below the levels needed to pay for expensive mandated services, structures, and practices that we now know customer demands in the market would not support. It was unfortunately not surprising that this anticompetitive posture of regulation resulted in deteriorating equipment and systems – deterioration that generated the need for increasing layers of costly, stop-gap regulation which attempted to prop up service to understandably frustrated shippers. Indeed, some regulated rates were set at such low levels relative to regulation-inflated costs that railroads became uninterested in pursuing the business, or were unable to provide service at sufficient levels of quality to retain customers.

Because much of the railroad industry's capital is so long-lived, it took decades for the pre-Staggers system to fully reveal its effects. In the end, however, the result was the economic dislocation and national embarrassment of disinvestment, declining quality, and failed railroads. The attempt to regulate unreasonably, via various misplaced and malformed, anticompetitive, stultifying, formulaic mandates and restrictions that overrode the forces of the marketplace was a clear failure for railroads, shippers, and the overall national economy.

Fortunately, by the late 1970s, the lessons of the times were learned: In railroading as well as other major sectors of the economy (from trucking to telephone service), we need to let markets work where they are actively or potentially competitive, and only intervene with price regulation where competition demonstrably cannot work. When we do intervene, the goal of regulation should be to replicate the results of active or potential competition.

B. Board Policy with Respect to Exemptions

To date, since the passage of the Staggers Act, the overall structure and practice of federal policy with respect to exempting rail service from rate regulation has embodied these basic principles of reasonable regulation. The Board is afforded the necessary authority to regulate rail rates effectively where needed, while it recognizes the propriety of allowing competition, rather than government edict, to determine prices where market dominance is absent. The National Rail Transportation Policy properly stakes out the framework: "In regulating the railroad industry, it is the policy of the United States Government...to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail."[2] Competition is the default strategy; regulation is the fallback protection only when and where competition is inadequate.[3]

By its prior analyses and decisions, the Board (including its predecessor, the Interstate Commerce Commission) has demonstrated its capacity to implement this policy framework. It has clearly established procedures and precedents that respect the public's interest in allowing competition to drive and discipline the nation's railroads unless it can be shown convincingly that competition is ineffective. In deciding to exempt services and freight categories such as boxcar, TOFC/COFC, lumber and wood products, rock salt, hydraulic cement, and other now-exempt commodities, the Board properly demanded extensive empirical evidence regarding the services or commodities at issue

[2] 49 U.S.C. § 10101.

[3] The Board has initiated an inquiry into broader areas of competition in the rail industry in Docket No. EP 705. I understand that the AAR intends to participate in that proceeding and will address the issues highlighted in the hearing announcement in detail in that proceeding.

within a coherent framework of competition analysis.[4] This framework has properly recognized that competition operates through intermodal, intramodal, geographic and product pathways, and that reaching defensible judgments as to the presence or prospects of market power abuse ultimately requires specific factual inquiry into actual traffic in actual markets, including into the frequently significant ability of motor carriers to compete with rail for most commodities.[5]

In granting exemptions, the Board and the ICC have historically followed the sound practice of assessing the forcefulness of competition across relatively broad categories of shipments and national or region-wide geographies. The idea, after all, is to maximize the scope over which competition governs the railroad *system*. The alternative of approaching exemptions as a micromanagement problem of examining, even litigating, each and every movement's competitive situation would imply a staggering and time-consuming task for the Board that would make it difficult, if not impossible, for the

[4] For example, In Rail Gen. Exemption Auth.—Nonferrous Recyclables, 3 S.T.B. 62 (1998), the STB cited detailed evidence on R/VC ratios, rev/ton-mile, and market shares, and evaluated the exemption request in light of both the likelihood of the abuse of market power and the need to protect shippers from "unreasonable rates." "The transportation of nonferrous recyclables is very competitive, as evidenced by the overall r/vc percentage of 98.9 in 1995, the decline in r/tm from 3.9 cents in 1981 to 3.1 cents in 1995, and the general decline in rail market shares. The record also indicates that motor carriers play a significant role in the transportation of these commodity groups. Generally, motor carriers possess advantages of access and speed, and they have become [citation omitted] more cost effective as motor trailer capacities have grown. Under these circumstances, we find no evidence that rail carriers possess sufficient market power to abuse shippers and, indeed, must operate efficiently to compete for this traffic. Thus, current transportation of these commodity groups is consistent with 49 U.S.C. 10101(1), (4), (5) and (9), which favor reliance on competition in the marketplace and encourage efficiency in rail operations."

[5] See, for example, Rail Gen. Exemption Auth.—Miscellaneous Agric. Commodities, 367 I.C.C. 298 (1983): "Such abuse, however, may occur only in the absence of effective actual or potential competition. Competition may come either from other railroads, other modes (trucks or water carriers), or market competition between the product in question and competing products or regions. The evidence with regard to the commodities to be exempt is ample to demonstrate the availability of competitive alternatives -- a small and/or declining rail market share indicating the existence of traffic diversion by competing modes, or relatively short hauls indicating a potential for effective motor carrier competition. In addition, where remaining rail traffic is profitable, market competition for the commodity or region in question will require that rates be kept at competitive levels for the railroad to retain the traffic." See, also, Exemption from Regulation—Rail Transp. Frozen Food, 367 I.C.C. 859 (1983).

Board to grant exemptions effectively. This would inherently undermine the primacy that sound policy gives to competition over direct rate regulation. At the same time that the Board, and the ICC before it, prudently treated exemptions systemically, it has emphasized that shippers have the ongoing right to request revocation of an exemption for specific movements when and where a railroad is shown to possess market power. In resulting revocation proceedings, the Board can then carefully consider evidence of market power in the particular circumstances pertinent to particular movements, while protecting the primacy of competition as the systemic governor of railroad rates and services.

Likewise, to date, the Board's approach to revocation of exemptions has entailed at least implicit recognition that it would be wholly inconsistent with the principles of sound economic policy to adopt a broad-brush approach of revoking exemptions across whole categories of service absent consideration of the facts that can tell us whether substantial risks of abuses of market power are present. As previously indicated, the Board or the ICC granted the boxcar, TOFC/COFC, and commodity exemptions on the basis of an extensive evidentiary record and with the participation of many parties. Given that background, any proponent of the wholesale revocation of such exemptions should be required to bear a heavy burden of proof to the effect that previously seen conditions of workable competition have broken down due to sustained alterations in fundamental conditions on a concomitantly broad basis.

Board policy would be particularly unwise to lose sight of the proper goal of producing competitive outcomes in favor of unsupported expostulations of the type now being asserted. Claims to the effect that "exemptions have served their purpose," or "the railroads do not need exemptions any longer," are substantively empty. The economic purpose of allowing competition to discipline and shape railroad rates did not run its course and expire. The public's need for rail service that is governed by competition is not temporary or closed-ended. It persists unabated, and the Board's exemptions appropriately persist where competition persists.

III. Exemption Policy Revisited

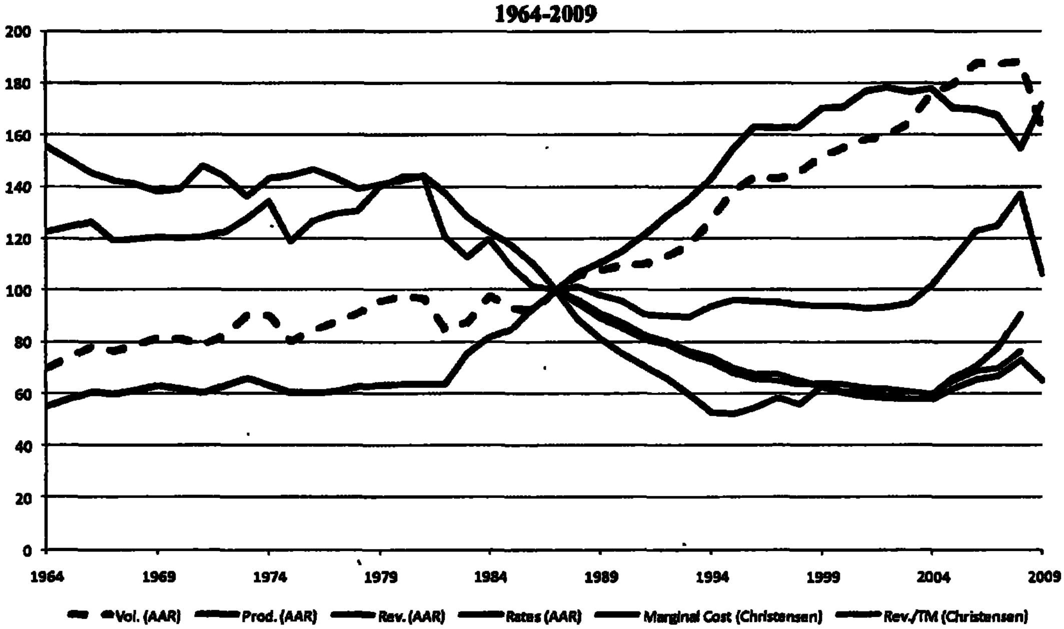
The Notice for the current hearing suggests that there may be exemptions that are no longer needed or appropriate. Suggestions in this regard appear to emanate from two primary factors. First, after some twenty-five years of steady decline in the post-Staggers era, the path of overall average rail rates appears to have bottomed out and started to turn upward in the mid-2000s. Second, federal policy in the post-Staggers era has succeeded in fostering improvement in the service performance and financial health of Class I railroads. Should this trend in rail rates and the somewhat improved financial health of carriers therefore cause us to return to more widespread use of regulation to set rates? While the call for re-regulation of otherwise exempt and competitive traffic is understandable from the perspective of the private interests of particular shippers, neither of these rationales withstands scrutiny when viewed against the public's interest in a well-functioning railroad industry and a healthy national economy.

A. Rising Prices Are Not a Justification for Removing Exemptions

Consider, first, increases in overall rail rates that started to appear in the first half of the 2000s after the long period of post-Staggers decreasing rail rates. (These trends can be seen in Figure 1.) Importantly, there is nothing in the economics of competition that implies that prices in competitive markets should move in only one direction – downward. Prices in competitive markets properly move down *and up* with the interaction of supply and demand. As the basic economics of supply and demand teach, rising prices are not in and of themselves at all evidence of abuse of market power. Prices can readily rise under competitive market conditions. Indeed, rising prices can play a critical role in an efficient and competitive economy. When supply and demand conditions are "tight" and prices are pushed upward in competitive markets, consumers are incented to shift toward less scarce resources and activities. At the same time, suppliers are incented to bring supplies to where they are needed most – i.e., as needs are indicated by consumers' willingness to pay. These most basic aspects of supply and demand are not diminished in their relevance by their familiarity.

In fact, the observed firming of overall average rail rates that began around 2003-04 is precisely what we should have expected in a healthy rail industry. Relevant trends in rail productivity, traffic volumes, and costs are graphed in Figure 1. The post-Staggers period is perhaps most notable for remarkable, decades-long improvements in productivity and the simultaneous sustained growth in rail volumes. But the process of "getting the fat out" in the post-Staggers era – eliminating gross inefficiencies and thereby improving productivity – could not have persisted indefinitely at the same pace. Moreover, the Great Recession from which we are now hoping to emerge makes it easy to forget that the period leading up to the recession was one of the longest sustained boom economies in the nation's history. And the rail industry was driven by this boom to be sure, as the economy's expansion meant ever increasing demands for moving goods and commodities.

Figure 1
RAIL RATES, REVENUES, PRODUCTIVITY, TRAFFIC VOLUMES, AND MARGINAL COSTS
1964-2009



Source: AAR (Vol. (in ton-miles), Prod., Rev., and Rates (in RPTM)) and Laurits A. Christensen Associates, Inc. (Marginal Cost and Rev./TM) using data from *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition* (Madison, WI, November 2008).

Figure 1 also shows the downward trend in overall rail rates and relatively stagnant total revenue from 1980 to 2003. After two decades of decline, however, rail rates finally began to increase around 2004. Could this overall shift in the trend coherently serve as a justification for revocation of exemptions from regulation? As I have indicated, doing so would require demonstration that the firming of rail rates somehow reflected an outbreak of abuses of market power permitted by fundamental losses of previously effective competition. However, the firming of rail rates in the mid-2000s is consistent with plainly rising costs, the workings of healthy forces of supply and demand in light of rising costs, and continuing competitive conditions.

First, the rate increases that began in 2004 are clearly consistent with a period of sharply increasing costs. The measure of marginal cost reported in Figure 1 is from the Christensen and Associates analysis of competition in the US freight rail industry ("Christensen Study").[6] As the figure shows, marginal costs increased sharply beginning in 2003. The Christensen study attributes this increase largely to increasing fuel costs, noting fuel cost increases of more than 200% between 2003 and 2008, resulting in a 28 percent increase in marginal costs over the same period.[7] Price increases in the face of increasing marginal costs are not indicative of an abuse of market power. Rather, they are entirely consistent with – and expected in – competitive markets.

In fact, there is nothing in the data to indicate that the firming of rail rates that began in approximately 2003-04 was the result of some general outbreak of abuses of market power or diminution of competition. The essence of the abuse of market power is the withholding of supply to drive up price. Thus, it is notable that the upticks we see in rail rates starting in 2003-04 occurred during a period of rapidly *growing* overall traffic volumes (Figure 1). This strong growth persisted through to the onset of recession in 2008; and the slowing of growth due to the recession has now begun to soften rail rates.

Furthermore, since the early 2000s and continuing even during the recession, upward pressure on rail rates has also been emanating from the trend toward lower productivity.[8] This can be seen in Figure 1. As noted, the process of eliminating the legacy of pre-

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[6] Laurits A. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition, Revised Final Report*, (Madison, WI, November 2009) (hereafter, "Christensen Rail Study - 2009") Christensen and Associates issued an update to their initial study in January 2010: Laurits A. Christensen Associates, Inc., *An Update to the Study of Competition in the U.S. Freight Railroad Industry, Final Report* (Madison, WI, January 2010) (hereafter "Christensen Rail Study – Updated 2010")
[7] Christensen Rail Study – Updated 2010 at 3-24.
[8] Christensen Rail Study – 2009 at 8-51. See also, Christensen Rail Study – 2009 at 18-1, 18-36.

Staggers gross inefficiencies could not continue forever. A more normal long-run path had to emerge, one in which productivity stabilizes and improves gradually, with "bumps in the road" when factors such as higher fuel prices raise input costs per unit of service. In fact, such "bumps" clearly held down and lowered overall rail productivity in the mid- and late-2000s[9], although the most recent data show that railroads achieved some productivity gains in 2009. (Figure 1).

Finally, the very strong demand that is reflected in the steady and steep rise in overall traffic volumes in the post-Staggers era strained capacity in the rail sector – and upward pressure on prices is precisely the expected outcome in workably competitive markets that run into congestion and limitations of capacity. Indeed, it is well documented that the strong growth in rail traffic, as with the growth in many other industries, eventually resulted in strains on rail capacity. As the Congressional Budget Office ("CBO") notes in a 2006 study on freight rail capacity: "After a long period of excess rail capacity, the pendulum has begun to swing toward tight capacity—at least at certain times and places."[10] The CBO goes on to cite the dramatic increase in rail traffic from 1990 to 2003, noting that traffic jumped more than 50% in that time period.[11] Similarly, a 2008 RAND Corporation report on demand for freight transportation offers corroboration, noting that over the past 25 years traffic density on the nation's rail network has "nearly

[9] Christensen Rail Study – 2009 at 8-51at 8-15-8-23; 8-26-8-27.
[10] Congressional Budget Office, "Freight Rail Transportation: Long Term Issues", (hereafter, "CBO Freight Rail Report") January 2006, at 1.
[11] CBO Freight Rail Report at 4.

tripled."[12] Congestion and capacity constraints - and their economic impact on transportation rates - are not limited to rail carriers. Strained capacity has been pervasive throughout the nation's freight transportation system and has had significant effects on motor carriers as well as railroads. By one estimate, volume on the nation's highway system increased by more than 10 percent between 2002 and 2007.[13] Urban areas, in particular, have faced significant capacity constraints due to limitations imposed by such factors as inadequate physical infrastructure, dense populations, and restrictions on delivery times which require trucks to incur significant costs waiting to deliver their shipments.[14] In addition to such infrastructure limits, the trucking industry has also had to contend with driver shortages, labor-related restrictions, and a host of other issues that constrain their operations.[15]

Economics tells us that when capacity is strained, we should expect to see increasing rates in a well-functioning marketplace. This is precisely what we see in the trend of average rail rates shown in Figure 1. In fact, even during the recent recession, accumulated growth over the preceding years has meant that, while volumes have been relatively stagnant over the past couple of years, *levels* of overall rail traffic have remained higher than they were at the beginning of the 2000s.

[12] Weatherford, Brian A, Henry Wills, and David S. Ortiz, "The State of US Railroads: A Review of Capacity and Performance Data," RAND Supply Chain Policy Center, 2008 (hereafter, "RAND Rail Study") at 3.

[13] U.S. Department of Transportation, Federal Highway Administration, "Freight Story 2008," at 3, available at: http://ops.fhwa.dot.gov/freight/freight_analysis/freight_story/fs2008.pdf, accessed January 26, 2011 (hereafter "Freight Story 2008") at 3.

[14] Freight Story 2008 at 15.

[15] Ortiz. David S., et. al, "Increasing the Capacity of Freight Transportation: U.S. and Canadian Perspectives," RAND Infrastructure, Safety, and Environment, 2007, available at· http://www.rand.org/content/dam/rand/pubs/conf_proceedings/2007/RAND_CF228.pdf, accessed January 26, 2011(hereafter, "RAND Freight Study") at 13-14.

While we as individual consumers wish that goods and services were not scarce and that conditions of relatively tight supply did not put upward pressure on prices in well-functioning markets, it is ultimately in our interests that they do so. Such pressure is the mechanism – economics says, "the signal" – that tells the economy where more capacity and supply are required to meet our needs. Indeed, this signal has been at work in the railroad sector. As seen in Figure 2, below, relative to manufacturing industries and electric utilities, for more than a decade Class I Railroads have been directing a very high share of their revenues toward capital investment.

Figure 2
CAPITAL EXPENDITURES AS PERCENT OF REVENUE FOR VARIOUS U.S. INDUSTRIES: AVERAGE 2000-2009

Average all manufacturing	**3%**
Food manufacturing	2%
Petroleum & coal products mfg.	3%
Machinery mfg.	3%
Motor vehicles & parts mfg.	3%
Wood product mfg.	3%
Fabricated metal products	3%
Chemicals	3%
Plastics & rubber products mfg.	4%
Paper	4%
Computer & Electr. Product mfg.	5%
Nonmetallic mineral product mfg.	5%
Electric Utilities	15%
Class I Railroads	**17%**

Source: US Bureau of the Census, AAR, EEI.

Since 2000, Class I railroads have invested $73.4 billion on capital spending. While temporarily slowed by the recession, if investment going forward continues at the rate of the last three years (2007-2009), it would be projected at more than $98 billion over the next decade.[16] This kind of response is precisely what we would expect under well-functioning market forces. Indeed, various industry measures of capacity and congestion such as terminal dwell time, the number of units in service, and the number of new cars have shown improvement in recent years.[17] While specific areas of congestion and strained capacity certainly remain along the nation's rail network, this pattern of investment and tangible improvement in capacity measures is at odds with an industry in which capacity is being artificially withheld as an exercise of market power aimed at raising rates.

This conclusion is reinforced by rigorous analyses of ratemaking and market power in the rail industry. The Christensen Associates study on competition in the U.S. freight railroad industry found that, overall, upward pressure on rail rates in recent years cannot be attributed to abuses of market power. Instead, price increases since 2003 are largely consistent cost increases.[18] While individual rates for specific commodities on specific movements might reflect either competitive forces or market power abuse and be a matter for specific factual inquiry, there is no basis for claiming that rail rates overall reflect a trend toward market power abuse or weakening of competition.

B. Revenue Adequacy or General Financial Condition of the Railroads Are Not Sound Metrics for Gauging the Appropriateness of Exemptions.

The suggestions that the restoration of financial health of a particular railroad, or even of the railroad industry as a whole, should be taken to mean that "exemptions have served

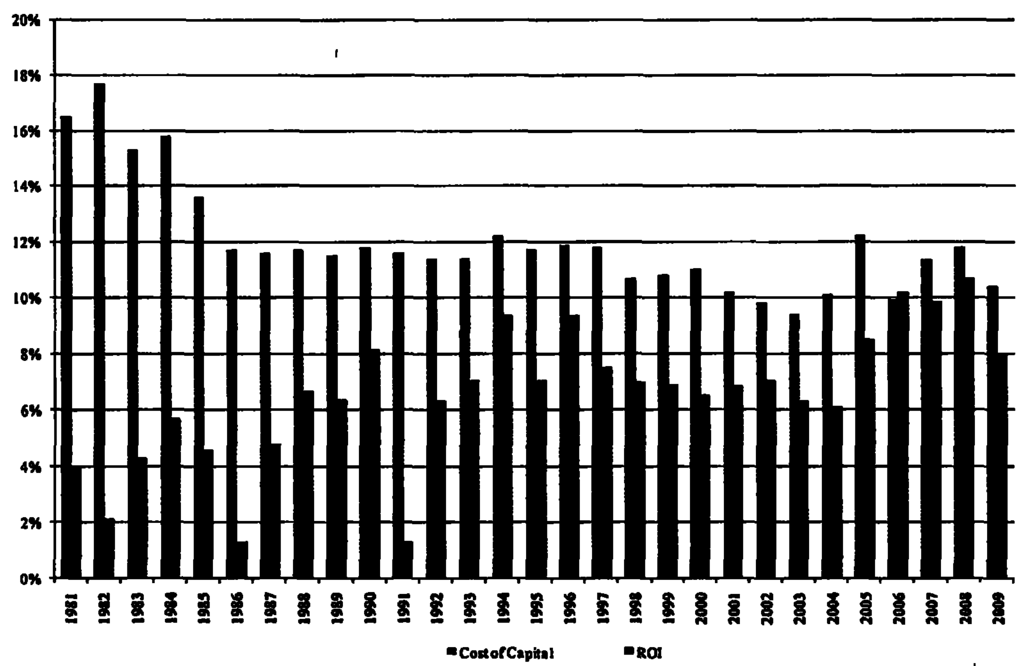
[16] "2010 Rail Facts", published by AAR, November 2010, at 44.
[17] Christensen Rail Study – 2009 at 16-22 to 16-23 and 16-31.
[18] Christensen Rail Study – 2009 at Preface and 10-12.

their purpose," or that exemptions should be repealed if and when financial health is restored, are strikingly contrary to the public's interest in a well-functioning rail system and a healthy economy. The proper test is <u>not</u> that if a railroad becomes financially healthy overall and over the long term we should regulate its rates, whether or not it operates in competitive markets. In fact, businesses in competitive markets can be expected sometimes to be financially flush and sometimes to be financially stressed as competitive forces of supply and demand drive their prices and their profits up and down over business cycles and through growth or stagnation periods for the products they sell. But whether the finances of a competitive business are flush or stressed, the public's interest lies in the pricing of the business' products that is driven by the competitive forces of supply and demand.

The public's interest in the level of the pricing of individual types of rail service for specific categories of traffic for which there is effective competition is not promoted by regulating prices just because a railroad is overall "revenue adequate," regardless of the period of time for which such a determination is made. Likewise, if a railroad overall is "revenue inadequate," the public interest is not well-served by eschewing regulation of an individual service where that railroad is determined to possess market dominance. Rather, the public interest in the level of the pricing of individual types of rail service for specific categories of traffic may be best served by regulating rates for transportation where a rail carrier does not face effective competition, and it is important for the public interest to exempt rates when competition is the driving force in that market.

In fact, the overall patterns to the *relative* financial health of the rail industry over recent years have been wholly consistent with those expected under a well-functioning regulatory system that allows maximum scope to market forces where regulation is not needed to substitute for competition. As we can see in Figure 3, strong demand and rising volumes pushing against effective limits of capacity resulted in increases in average rail industry rates of return in the first half of the 2000s. Then, as would be expected, those rates of return deteriorated with the deep recession of recent years. If nothing else, these patterns should tell us that rail industry financial health is precariously at the mercy of overall supply and demand conditions in the economy. Certainly, there is no basis for asserting that improved financial health for individual railroads or for the industry as a whole is the product of abuses of market power or across-the-board diminutions in competition and, thus, warrant wholesale revocation of exemptions from regulation.

Figure 3
CLASS I RAILROADS' COST OF CAPITAL v. RETURN ON INVESTMENT: 1985-2009



C. Questions of Market Power

So, on what grounds might it be appropriate to question the propriety of prior exemptions from rate regulation? The answer follows from the economics: When it can be shown <u>factually</u> and <u>convincingly</u> that a particular type of exempt traffic, on the whole, may no longer be subject to the forces of effective competition, and the lack of such competition may result in an abuse of market power, then it can be a proper matter for investigation and debate. From an economic perspective, across-the-board removal of exemptions should therefore not even be considered (much less approved) based only on gross assessments of railroads having "enough" revenue, or on a simplistic philosophy of "well, they're getting enough revenue on their non-exempt traffic, so we should take revenue away from them on the traffic where competition is setting their rates."

An appropriate debate, guided by sound principles of rate regulation, instead would entail reasoned examination of evidence on the specific markets and traffic in question, and that examination would focus on the central question of the presence or absence of competition that would prevent significant abuses of market power. Where the absence of competition is not evidenced, then continued – indeed, expanded – use of exemptions would be in the public interest. I understand that such a review is exactly what occurs on a case-by-case basis when a customer believes that a broadly applicable exemption should not apply to its shipments.

It is important to discuss here what constitutes "rigorous evidence" of market dominance -- or, more particularly, what *does not* constitute rigorous evidence of market dominance. Rigorous analysis of competitive forces in the overall transportation market includes examination of origin and destination competition, intermodal competition,

competition from other railroads (including through the important alternative of transloading freight between rail and motor carriers), and competition from other products. Then, too, attention must be paid to such factors as entry conditions of substitutes for a railroad's service, as well as the presence of sophisticated shippers who may have the capacity to counteract a railroad's attempt to abuse market power. These kinds of inquiries are, of course, the classic frameworks of antitrust economics and are very shipper and movement specific. There are no substitutes for them when it comes to actually understanding the force of competition in setting specific rail rates.

The post-Staggers era has brought extensive attention to measures of rail revenues relative to costs – and, especially, the ratio of revenues to variable costs, or "R/VC". Although often referenced (e.g., by shippers seeking rate relief) as direct evidence of market power, such an interpretation is a fundamental misunderstanding of R/VC ratios. Observation of a particular R/VC ratio offers information on the relative levels of revenue and variable costs, but offers no information on the market forces driving those measures or on whether a particular rate is reasonable.

Under competition, prices are expected to be sensitive to *marginal* costs, since prices must at least cover these costs to make supplying the market worthwhile. When demand is high and capacity is strained, the true marginal costs of service are driven above the average total and variable costs of service. This is particularly clear in network industries like railroading, where tightness of capacity at one point on the system can make it more expensive and difficult to serve other parts of the system. It follows, therefore, that in periods where prices reflect the interplay of strong demand and capacity-limited supply, R/VC ratios will be driven higher as marginal costs push prices up and, at the same time, rise relative to average variable costs (*i.e.*, VC). Thus, rising R/VC ratios in the presence of strained capacity are the expected results of a competitive marketplace.

Applying these basic economics to recent history in the rail industry, where rates and revenues started trending upward in 2003 (see Figure 1), should we believe that upticks in R/VC ratios can be explained only by new exertions of market power by railroads? The answer is no. There are no data to indicate that an event or events in 2003 caused the rail industry to become more prone to exercise of market power. Rather, over the 1990s and early 2000s, we experienced one of the longest periods of prolonged, unbroken economic growth in U.S. history. With increasing demand putting pressure on limited capacity, higher R/VC ratios and attendant improvement in financial conditions are not properly interpreted as evidence of a general outbreak of market power abuse. Rather, the pattern is consistent with rail rates being set by the normal interaction of supply and demand in the industry. The evidence of the aforementioned study for the Board by Christensen Associates confirms this conclusion, with the study reporting evidence of marginal costs rising above average variable and average total costs in the mid-2000s.[19]

By placing strong emphasis on other factors, including intermodal, intramodal, and product and geographic competition, the Board has implicitly acknowledged the limitation of R/VC ratios in analyses of market competitiveness and whether market power might be abused.[20] While the Board has looked to R/VC ratios as one piece of information about a market, it has been clear that a high R/VC ratio is not necessarily

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[19] Based on comparison of Figures 3-1 and 4-1 through 4-3 of Christensen Rail Study – Updated 2010.
[20] Ex Parte No. 346 (Sub-No.9-A), Liquid Iron Chloride, 367 I.C.C. 347, Served April 7, 1983.

indicative of market power.[21] The public interest would be ill-served if the Board misreads higher R/VC ratios or the improving financial health of the railroads as indicative of abuse of market power – by ignoring pertinent changes in relative supply and demand and by ignoring the continuing needs for investments in freight capacity.

The Board's demonstrated willingness and ability to isolate specific moves can apply equally to revocations of exemptions that have previously been granted. In light of the extensive, data-laden analyses that undergird Board exemptions to date, principles of sound regulatory policy advise, however, that revocations should require compelling, fact-based evidence of the absence of competition or abuses of market power. Requests for revocation based on substantively baseless claims to the effect that "exemptions have run their course" and demagogic calls for wholesale revocation, if not re-regulation, have no place in this process. And, under the economic principles described above, any revocation of an exemption should be limited to the particular movements or circumstances where market power has been shown by rigorous evidence.

In its enabling legislation, its regulatory practice to date, and the precedents embedded in its prior decisions, the Board is armed with the tools for undertaking coherent and publicly-interested consideration of the propriety of continuing past exemptions and the propriety of granting future exemptions. It should apply those tools and eschew calls for wholesale revocations of exemptions that it has previously granted. Above all, it is important to the nation's public interest that competition and competitive outcomes be the driving principles of rail rate regulation, and that rate regulation serve as

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[21] See, for example, Ex Parte No. 346 (Sub-No.8), Exemption From Regulation – Boxcar Traffic, 367 I.C.C. 425 (1983).

the backstop remedy only when there is a showing that market power from the absence of competition is abused.

IV. Conclusion

The nature of the railroad industry's long-lived capital makes it a "sitting duck" of sorts. It can be tempting to impose irrational policy – such as pushing prices below competitive levels – in response to pressures from shippers, in part because the inevitable harms may not take effect for quite some time. Even if imposition of unreasonable and unnecessary regulation were to put a halt to ongoing programs of investment in capital improvements and capacity expansion, the ensuing service deterioration and capacity congestion might not be sharply felt for several years.

Indeed, the facts that unnecessary unreasonable regulation will cause truly dangerous long-term harms to the rail network, and that attempting to favor one group of shippers with misguided policy ends up harming all shippers, are arguably the central lessons of the pre-Staggers era. We would be wise to remember those lessons and resist shooting sitting ducks.