

October 3, 2021

The Honorable Martin J. Oberman
Chairman
Surface Transportation Board
395 E Street, SW
Washington, DC 20423

Dear Chairman Oberman:

Recently, you spoke at the 2021 North American Rail Shippers Association conference in Chicago on challenges facing the railroad industry. Foremost, your speech confirmed that railroads operate in a highly competitive marketplace with other modes, especially trucking, and our shared view that there are significant environmental and public benefits to shifting more freight from truck to the railroads. The industry's commitment to these shared goals to grow rail traffic was highlighted in many of the presentations made by railroads throughout the conference. Likewise, the railroad presentations demonstrated how proud the industry is of how railroad employees have responded to the challenges caused by the pandemic and how railroads have partnered with their customers to drive growth in these uncertain times.

However, I wish to respond on behalf of the Class I freight railroad members of the Association of American Railroads (AAR) to some of the issues raised in your speech, recognizing that we do not have the benefit of the data or analysis upon which you relied. Based on the best data available to the AAR, however, the evidence shows that railroads have fought to maintain and grow their volumes while keeping their rates comparatively low and continuing to invest in their networks.

Non-Coal Volumes Have Grown

First, you noted the volumes of freight that railroads move. One cannot talk about current rail volumes without recognizing the impact of the precipitous drop in coal traffic in recent years. Your statements acknowledged a drop in coal volumes in passing, but it is not clear on what basis your claims of other rail freight volumes dropping are based. Since 2006, annual ton-miles of coal have trended sharply down, dropping 41% from 2006 to 2019. However, excluding coal, ton-miles have increased 9% since 2006, and continue to trend

upward.¹ Moreover, because coal is a relatively heavy commodity, replacing it with another commodity on a ton-mile basis is even more difficult. Making up for the loss of coal volume will take time, but to imply that railroads have not worked to grow volumes, especially in the face of steep coal declines, is simply not the case.

The economic analysis you cited compared overall volume growth on the railroads with the growth in gross domestic product (GDP) over the same period. However, it is important to recognize that services have grown much more quickly in recent years than goods. If consumers are consuming more services like travel, education, data plans, cell phone apps, or health care—as they have been—railroads are not impacted. Rather, railroads depend on the production and consumption of *goods*, but the percentage of our nation’s total output related to goods is smaller today than it was 10 or 20 years ago. For example, if you consider the gross output of manufacturing, construction, farms, retail trade, and mining, excluding oil and gas extraction, as a share of combined gross output of all industries, that goods-related share of total gross output that railroads participate in has steadily declined over the past 15 years, dropping from 32.5% of the total share of gross output in 2006 to 27.8% in 2020.² That’s important because rail traffic growth is correlated quite closely with goods-related GDP. Thus, one cannot draw the conclusion that railroads have not sought to grow their volumes from overall GDP data.

Deregulation Has Led to Lower Rates

It is well known that average freight rail rates have fallen drastically since the partial deregulation of the rail industry, plummeting 44% since 1981, as measured by inflation-adjusted revenue per ton-mile. The economic analysis you relied on in your comments discussed rail rate increases of 30% since 2004 in inflation adjusted terms. While we are without the details on the analysis, conversations regarding percent change always hinge on where one chooses to begin and end the analysis. AAR is unaware of anything particularly noteworthy about 2004. Beyond that, railroads (like most of their customers) price their services based on the market—that is, based on the value of their service to their customers, rather than on input costs. That said, the Railroad Cost Recovery Index (RCR) is a measure of changes in rail input costs. It is calculated each quarter by the AAR using a methodology approved by the Surface Transportation Board (STB or Board). Over the past two decades, rail input costs as measured by the RCR have generally risen in line with rail rates. Simply put,

¹ See STB Office of Economics, *Rate Study Workbook*, available at <https://prod.stb.gov/wp-content/uploads/files/docs/railRateStudies/Post%20Rate%20Study.xlsx>; 2 *Digit STCC Summary Statistic Report*, available at <https://prod.stb.gov/wp-content/uploads/SUMSTCC2-2019.xlsx> (last accessed October 1, 2021).

² Bureau of Economic Analysis, *Gross Output by Industry*, <https://apps.bea.gov/iTable/iTable.cfm?reqid=150&step=2&isuri=1&categories=gdpind>.

average railroad rates remain significantly lower than when Staggers was passed and recent increases have been reasonable in comparison to railroad costs.³

In addition, traffic mix plays an important role, too. As is the case with volumes, when looking at revenue per ton-mile, coal matters. STB data show that from 2010 to 2019, overall revenue per ton-mile increased 27%.⁴ However, because coal historically has had the lowest revenue per ton-mile among major commodities and coal volumes have fallen so much in recent years, even if revenue per ton-mile had stayed constant for every major 2-digit commodity category from 2010 to 2019, overall revenue per ton-mile would still have increased by 12%. That is, overall revenue per ton-mile in 2019 would have been 12% higher than it was in 2010 even if there were no changes in rail rates for any individual 2-digit commodity category. This means the data cited regarding recent rail rate increases are, in essence, artificially distorted.

Investment Has Grown

Integral to the health of the railroad industry is the level of investment required to maintain and expand networks and equipment. Capital expenditures in the railroad industry have been significant. From 1980 to 2020, America's freight railroads spent nearly \$740 billion—averaging approximately \$25 billion annually in recent years—on capital expenditures and maintenance expenses. As a percentage of revenue, capital spending in the railroad industry over the last ten years has averaged nearly 19%. When you compare that percentage to other manufacturing industries, many of which are railroad customers, that amount is even more staggering. The average capital spending as a percent of revenue for all manufacturing is only 3%. Railroads, therefore, spend, as a percent of revenue, over six times more than the manufacturing industry's average.

Keep in mind, these other manufacturers are not only railroads' customers, but also railroads' competitors in the capital markets. This is important because railroads must have the capital to make the necessary investments, yet suppliers of capital have no obligation to earmark resources needed for any industry. Shareholders and lenders will seek the best return possible for the risk involved. If railroads, or any industry for that matter, cannot provide a risk-adjusted return comparable to what investors can get elsewhere, then capital will flee the industry or the capital will come with higher costs than previously required.

To be sure, your speech acknowledged these facts, but seemed to discount the amount of spending required to maintain the rail network and the effect of that maintenance spending on growth, efficiency, and safety. Maintenance spending on a railroad does not just replace

³ Railroads participate in dynamic markets and cannot price their services based on costs. Comparison of average revenue per ton-mile to railroad index costs over time are illustrative that any nominal increases in revenues reflect increases in input costs and not an increase in market power.

⁴ See Surface Transportation Board, *2 Digit STCC Summary Statistic Report*, available at <https://prod.stb.gov/wp-content/uploads/SUMSTCC2-2019.xlsx> (last accessed October 1, 2021).

same with same, but often replaces old infrastructure with the new, more advanced equipment (e.g., welded rail, improved signals, concrete ties), including when railroads are returning lines to service after catastrophic events like fires, floods, and hurricanes—all of which railroads have faced recently. Spending on upgrades allows railroads to provide better, more efficient service. This efficiency expands network capacity and allows for volume growth.

Even more important still, that spending has led to a safer and more resilient system for all stakeholders, including our rail employees, rail customers, and the public. Spending on the railroad network has led to a substantial reduction in track- and equipment-caused accident rates. Since 1980, there has been an approximately 86% reduction in track-caused accident rates and 80% reduction in equipment-caused accident rates. More recently, trends show the track- and equipment-caused accident rates have dropped, falling 44% since 2000, 16% since 2011, and 2% since 2016. By any number of measures, this is a tremendous safety success story, driven by sustained private investment in infrastructure, safety technologies, and the modernization of operating and maintenance practices.

In addition, the greatest resource for the railroad industry is the workforce. While one accident is one too many, worker safety trends have been improving immensely. Since 1980, there has been more than an 85% decrease in the employee casualty rate (i.e., fatalities, injuries, and occupational illnesses) in the railroad industry. I am proud to report that 2020 represented a record low rate of 1.66 casualties per 200,000 employee hours. From the perspective of recent trends, employee casualty rates have continuously dropped, plummeting 52% since 2000, 10% since 2011, and 11% since 2016. In addition, on-duty fatalities have dropped 54% since 2000, 48% since 2011, and 21% since 2016. Given these safety trends, the last twenty-, ten-, and five-year periods have boded quite well for safety, especially employee safety, which is an achievement that benefits labor, customers, and the public.

Share Repurchases and Dividends

In Chicago, you took issue with railroads' share repurchase and dividend programs. Your implication appears to be that these programs are evidence that railroads are, in essence, making too much money and can afford to lower their rates or spend more on infrastructure and equipment without adverse consequences to themselves or their shareholders. We respectfully but firmly disagree with you on this point.

It is an unavoidable fact that shareholders and lenders will seek the highest return possible commensurate with the risk involved. No law or regulation can force investors to provide resources to a firm whose returns are lower than what the investors can obtain elsewhere. If railroads are viewed as returning less to shareholders, for whatever reason, than comparable alternatives, then capital will seek those returns elsewhere or will only be available at higher costs than we see today.

Thus, a key responsibility for management of every publicly owned firm—including railroads—is deciding how much of a firm's profits should be reinvested back into the business (in the hope that the investments will boost profits, and therefore the share price, down the

road) and how much should be returned to shareholders via dividend payouts and stock buybacks. Typically, managers of successful modern companies seek a balanced approach that provides their investors the returns that capital markets demand while also meeting a firm's re-investment needs. That is certainly the goal for railroads. Indeed, the 19% of revenues that railroads have poured back into the network referenced above is six times the amount spent by the average U.S. manufacturer.

To be sure, a host of factors, including government monetary and tax policy, influence how a firm decides to deploy its funds, but it is clearly unlikely that outside parties are in a better position than a firm's management to decide what constitutes the proper balance.

2021 Is Not 1980

Finally, I agree with you that 2021 is not 1980. The world and markets have changed significantly, as has the railroad industry. Railroading in 1980 was less safe and less efficient than it is today, and many railroads were going bankrupt—the Staggers Act changed that. Thanks to the deregulatory efforts of recent decades, that is not a world to which we will return. While there are many positive reforms emanating from those laws that directly led to railroads' improved health, there is one, in particular, I'd like to highlight: the recognition that demand-based differential pricing is a necessary condition for a healthy railroad system. This recognition was not a temporary palliative attempt to restore an ailing industry. Instead, it is a reflection of the fundamental economics of the railroad industry. Differential pricing is key to our shared goal of moving more traffic off the roads and onto the rails. Because differential pricing allows a railroad to efficiently cover its costs by charging relatively higher rates (i.e., more contribution to joint and common costs) to customers with higher demand for service, railroads can effectively compete with trucks and other modes. Without differential pricing, traffic that would be truck-competitive in a differential pricing structure, would need to cover a greater share of unattributable costs in the form of higher rates, which would result in less competitive prices vis-à-vis trucks. Freight traffic would shift to that mode with its attendant drawbacks, be it environmental, track congestion, or impacts on roads and taxpayers. Like you, we are committed to achieving the opposite—growing traffic and shifting freight from trucks to rails.

The story of American railroading in the last 40 years is one of success that owes much to sound public policy and balanced regulation. I look forward to continuing to engage with you and the rest of the Board on the railroad industry's salutary record on investment, safety, and service.

Sincerely,



Ian Jefferies