



Office of the Chairman

Surface Transportation Board
Washington, D.C. 20423-0001

December 21, 1998

The Honorable John McCain
Chairman
Committee on Commerce, Science, and Transportation
United States Senate
Washington, DC 20510

The Honorable Kay Bailey Hutchison
Chairman
Subcommittee on Surface Transportation and Merchant Marine
United States Senate
Washington, DC 20510

Dear Chairman McCain and Chairman Hutchison:

In our letter of June 30, 1998, Vice Chairman Owen and I reported to you on the Board's recent informational hearings to examine issues of rail access and competition in today's railroad industry. After summarizing the testimony, the Board responses to the testimony (including the Board's April 17 decision, copy attached hereto as Addendum A), and further actions that might be taken by Congress, our letter reported on certain ongoing private-sector initiatives. The purpose of this follow-up letter is to inform you of the outcome of the Board's proceedings and the private-sector initiatives undertaken as a result of the hearings; and to suggest possible ways in which related issues that are still outstanding might be addressed.

1. **Board Proceedings.** As we pointed out in our prior letter, the Board initiated rulemaking proceedings addressing market dominance and service inadequacies. The Board has completed those proceedings. In Market Dominance Determinations - Product and Geographic Competition, STB Ex Parte No. 627 (STB served Dec. 21, 1998), the Board repealed the product and geographic competition tests of the market dominance rules. This change applies to both large and small rail rate cases. In Relief for Service Inadequacies, STB Ex Parte No. 628 (STB served Dec. 21, 1998), the Board issued rules giving shippers and smaller railroads opportunities to obtain service from alternate carriers during periods of poor service, using either the emergency service or the access provisions of the law. Copies of these decisions are attached as Addenda B and C.

2. **Railroad Industry Discussions.** One of the issues that arose at the Board's hearings was the desire of smaller railroads to eliminate industry restrictions on their ability to compete.

The Board directed the railroads to address this issue through private-sector discussions. As our earlier letter noted, the large and small railroads separately indicated that they were having some difficulties in reaching agreement, but the Board encouraged them to continue their dialogue, and indicated that it would take action, as appropriate, if they did not reach agreement. We are pleased to report that in September, an agreement was reached, portions of which were formally approved by the Board. A copy of the Board's press release announcing the agreement is attached as Addendum D.

3. AAR/NGFA Agreement. In our June 30 letter, we advised you that, consistent with the Board's preference that private parties seek non-litigative dispute resolution mechanisms, the railroads were meeting with the National Grain and Feed Association (NGFA) in an effort to arrive at an agreement on a mandatory arbitration program to resolve certain disputes. The Association of American Railroads (AAR) and the NGFA recently announced such an agreement. A copy of the AAR/NGFA press release describing the agreement is attached as Addendum E.

4. Formalized Dialogue Among Railroads and Shippers. Another issue that arose at the Board's hearings involved the concern of some shippers that railroads had not been adequately communicating with them. To address this concern, the Board directed railroads to establish formalized dialogue with their shippers and their employees, particularly about service issues in general, small shipper issues, and any other relevant matters. The railroads have organized and conducted discrete and formalized meetings with various shippers and shipper groups throughout the Nation. The meetings, which have been attended by Chairman Morgan, were held in Chicago, IL; Houston, TX; Atlanta, GA; Newark, NJ; and Portland, OR. AAR's letter to the Board describing the meetings and the follow-up actions to be taken—including, among other things, issuance of performance reports by each of the large railroads, development of a plan for facilitating interline movements, and continuation of the outreach meetings—is attached as Addendum F. The Board, which supports the continued dialogue that the AAR letter promises, will be closely monitoring all of these follow-up steps. In addition to the AAR letter, a letter from various shippers regarding those meetings, and Chairman Morgan's response to that letter, are attached as Addenda G and H.

5. Additional Railroad/Shipper Discussions. Other shipper concerns that were raised at the Board's hearings involved railroad "revenue adequacy" and the Board's competitive access rules in general. Concluding that each of these issues could be better addressed initially in a private-sector rather than governmental forum, the Board directed railroads to meet with shipper groups to address the issues under the auspices of an Administrative Law Judge. Although extensive meetings were conducted, the parties could not reach agreement on these issues. Attached as Addendum I are copies of the reports that the parties submitted to the Board on their recommendations as to these issues.

Revenue Adequacy. Although the concept of revenue adequacy has thus far had minimal real-world impact, the existing judicially approved revenue adequacy measurement, which focuses on a railroad's return on investment, has been a source of controversy. Based on suggestions from railroad and shipper representatives at the Ex Parte No. 575 hearing, the Board

directed railroads to meet with shippers with a view toward selecting a panel of three disinterested experts to make recommendations as to an appropriate revenue adequacy standard, and to name a panel and report back to the Board by May 15, 1998. The panel was then to report back with final recommendations on July 15, 1998.

Shippers opposed this approach, contending that it would be expensive and inefficient for them to pay part of the costs of the expert panel, while also paying for litigation associated with the conduct of the proceeding before the panel and the Board (and, presumably, if either side wanted to litigate further, the courts). Ultimately, most of the participating shippers recommended that the Board itself initiate a new rulemaking looking to adoption of a revenue adequacy approach that would permit the Board to consider a variety of financial indicators in determining whether railroads are revenue adequate.¹ By contrast, contending that the multiple indicator approach advanced by the shippers would not provide enough certainty or predictability, the railroads supported the expert neutral panel approach.

Competitive Access. The Board directed railroads and shippers to attempt to find common ground, and to meet, negotiate, and report back to the Board by August 3, 1998. After extensive meetings, the parties reached an impasse. The principal areas of concern involved the definition of terminal areas; the scope of reciprocal switching; appropriate compensation to an incumbent carrier; and, perhaps most fundamentally, whether access to other carriers ought to be required only when an incumbent carrier has acted in some sort of an anticompetitive way, or whether it ought to be provided whenever additional competition is determined to be in the public interest.

6. Possible Resolutions of Revenue Adequacy, Competitive Access, and Small Rate Case Issues. The Board appreciates the opportunity to assist Congress in addressing the transportation issues that face the Nation during these important times and believes that it has appropriately addressed matters of concern within the scope of the authority given to it by Congress. Nevertheless, it is likely that certain legislative proposals will be discussed in Congress during the next session. Following are some thoughts on some of the issues as to which legislative proposals are likely.

Revenue Adequacy. The revenue adequacy issue, in our view, has unnecessarily polarized the transportation community. The underlying policy objective—that the Board’s regulatory approach among other goals permit railroads to earn adequate revenues—is a laudable one that should be retained. As we see it, however, and as we have testified before, the revenue adequacy status of any particular railroad has little practical effect. Revenue adequacy is not a factor in maximum rate cases prosecuted under the “stand-alone cost” (SAC) methodology. It is not a factor in construction, merger, or abandonment proceedings. Revenue adequacy does play a small role in rate cases brought under the “small case” guidelines, but to date, no such cases

¹ The shippers indicated that, given the Board’s own resources and their own priorities, they would not object if the Board deferred this rulemaking until a later date.

have been brought. Therefore, Congress may wish to consider legislatively abolishing the requirement that the Board determine on a regular basis which railroads are revenue adequate.

That is not to say that Congress should abandon the concept of revenue adequacy. As we have testified before, in order to oversee the industry, the Board needs to have some indication of how the industry is faring financially. Moreover, revenue adequacy is one of the non-SAC constraints in the Board's "constrained market pricing" (CMP) methodology for handling larger maximum rate cases. Although, thus far, all railroad rate cases brought under CMP have been handled under SAC procedures, if a "revenue adequacy" case were brought, the Board would need a basis on which to address it.

For those reasons, and because Congress may not wish to abolish the revenue adequacy requirement immediately, the questions that have been raised about the Board's current revenue adequacy methodology cannot be ignored. With its credibility on the issue under challenge by several shippers, however, the Board, with its limited resources, does not plan to undertake the shippers' proposed rulemaking at this time. Rather, given the benefits, the Board continues to support the expert panel approach that was suggested by both shipper and railroad interests during the Board's Ex Parte No. 575 hearings. The shippers are correct that someone would need to provide funding for the expert panel; that costs rise as layers of litigation are added to the regulatory process; and that it is the Board, and not a private expert panel, that is charged with establishing regulatory procedures. Nevertheless, the Board is willing to make a commitment to give great deference to the expert panel, which would be a competent body that would be perceived as neutral if selected after agreement among the private parties. If the private parties were also to give the expert panel deference, rather than to litigate should they disagree with its (and the Board's) conclusions, then not only would the parties' confidence in the objectivity of the process likely be enhanced, but the overall costs also would likely be contained.

Competitive Access. In its Ex Parte No. 575 decision served April 17, 1998, the Board addressed in some detail the implications of the competitive access debate. The differences between the railroads and the shippers on the Board's competitive access rules are fundamental, and they raise basic policy issues—concerning the appropriate role of competition, differential pricing, and how railroads earn revenues and structure their services—that are more appropriately resolved by Congress than by an administrative agency. Moreover, the so-called "bottleneck cases," which involve issues related to competitive access, are still being reviewed in court. For those reasons, although the Board has moved aggressively to adopt the new rules described above to open up access during times of poor service, the Board does not plan to initiate administrative action to otherwise revisit the competitive access rules at this time.²

² Should Congress choose to review the issue, we would note, as we did in our April 17 decision, that the shape and condition of the rail system that open access would produce is a significant but unresolved issue. Certain shippers assume that the replacement of differential pricing by purely competitive pricing would reduce the rates paid by shippers, and that added competition would result in increased infrastructure investment. The railroads, by contrast, argue

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Small Rate Cases. As you know, the Board has adopted small rate case guidelines, which apply in cases in which CMP cannot be practicably used. Under these small case guidelines, the Board reviews the profits that the carrier obtains from the challenged rate from three perspectives: it compares them with the profits that railroads in general earn from comparable traffic; it compares them with the level of profits that the carrier would need to obtain from all of its potentially captive traffic in order to become “revenue adequate”; and it compares them with the profits that the defendant carrier earns on all of its potentially captive traffic. Taken together, these three comparisons are designed to permit carriers to price “differentially” as provided under the law, in a way that will promote their financial health, while still protecting individual shippers from bearing an unfair share of a particular carrier’s revenue needs. Although the procedures may sound complex, in fact the information needed to make this sort of a case is readily available at reasonable cost. Moreover, the Board concluded, after reviewing many years of debate, that these guidelines are the only procedures that have been identified that readily address each of the concerns that the Board must consider under the statute.

Nevertheless, we are aware that certain shippers are concerned that, for small cases, anything other than a single benchmark test could unreasonably impede access to the regulatory process. If Congress agrees, it could adopt specific small rate case standards. As an example, it could provide that, for certain types of cases, all rates above a specified revenue-to-variable cost ratio, or series of ratios, would be considered unreasonable. If this approach were to follow the tenets of the existing statute, the specifics of such an approach—for example, the cases to which it would apply, and the level or levels at which rates might be capped—would have to balance issues such as differential pricing and railroad revenue need against the fairness in requiring captive shippers to pay substantially higher prices than competitive shippers.

7. The Override of Railroad Collective Bargaining Agreements. Another matter that may be presented to Congress next year is the question of limiting the authority of arbitrators under the standard labor conditions imposed by the Interstate Commerce Commission (ICC) or the Board to modify existing collective bargaining agreements (CBAs) in the process of implementing approved rail consolidations. This process has become extremely controversial since a decision of the Supreme Court in 1991. That decision, Norfolk & Western Ry. v.

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that, because their traffic base would shrink, the rates paid by those shippers that would continue to receive service would actually increase, even as overall revenues received by railroads would decline, because the overall traffic base from which costs could be recovered would be reduced. Additionally, as the Board noted in the April 17 decision, carriers could be expected to seek to maintain an adequate rate of return by cutting their costs, which could include shedding unprofitable lines and reducing new investment in infrastructure. Thus, while certain shipper representatives believe that an open access system would ensure better service, concern has been raised that, unless smaller railroads were able to fill in service gaps that could be created, open access could produce a smaller rail system that would serve fewer shippers, and a different mix of customers, than are served today, with different types and levels of, and perhaps more selectively provided, service.

American Train Dispatchers Ass'n, 499 U.S. 117 (1991) (N&W), held that the exemption from all other laws to carry out approved rail consolidations provided by former 49 U.S.C. 11341(a) and carried forward as 49 U.S.C. 11321(a) extends to existing CBAs and operates automatically to permit the override of CBA provisions as necessary for implementation of an approved rail consolidation.

Present practice for implementing Board-approved rail consolidations is for the unions and the railroads involved to negotiate agreements to enable implementation of the Board-approved transaction. If they are unable to agree, the matter is submitted to an arbitrator selected by the parties or the National Mediation Board if the parties cannot agree on the choice of an arbitrator. Because the arbitrator is acting under section 11321(a), he or she has the authority and the obligation to modify existing CBAs as necessary to carry out the transaction.

In the recent Conrail Acquisition³ decision, at the request of the various labor organizations, the Board specifically declined to make a finding in its decision approving the transaction that overriding provisions in Conrail CBAs was necessary to carry out the transaction. Rather, the Board specifically left the determination of necessity to the process of negotiation and, if necessary, arbitration. Even more recently, in the Carmen⁴ decision, the Board elaborated on the limitations on arbitrators' authority to modify CBAs as permitted by the Supreme Court's N&W decision. In Carmen the Board held that overrides of CBAs by arbitrators are limited, among other things, to the override authority exercised by arbitrators during the period 1940-1980, an era marked by labor/management peace regarding the implementation of rail consolidations. A copy of the Carmen decision is attached as Addendum J.

Nonetheless, the Board is aware that labor representatives oppose, and are understandably dissatisfied with, any provision or action that permits overriding any existing CBA provisions. If Congress were to agree with their position, given the Supreme Court decision in N&W, some modification of section 11321(a) so as to exclude CBAs, or some other legislative expression, could address labor's concerns in this area.

8. **Conclusion.** Again, we appreciate the confidence that Congress has shown by allowing us to play a role in this important process, and we remain committed to providing a

³ CSX Corporation and CSX Transportation, Inc., Norfolk Southern Corporation and Norfolk Southern Railway Company -- Control and Operating Leases/Agreements -- Conrail Inc. and Consolidated Rail Corporation, STB Finance Docket No. 33388, Decision No. 89 (STB served July 23, 1998).

⁴ CSX Corporation -- Control -- Chessie System, Inc. and Seaboard Coast Line Industries, Inc. (Arbitration Review), Finance Docket No. 28905 (Sub-No. 22), and Norfolk Southern Corporation -- Control -- Norfolk and Western Railway Company and Southern Railway Company (Arbitration Review), Finance Docket No. 29430 (Sub-No. 20) (STB served Sept. 25, 1998). This decision was not appealed by any party.

forum for constructive dialogue and appropriate regulatory relief. If we can be of further assistance in this or any other matter, please do not hesitate to contact us.

Sincerely,

Linda J. Morgan
Linda J. Morgan

Addenda

cc: The Honorable Ernest F. Hollings
Ranking Democrat
Senate Committee on Commerce, Science,
and Transportation