TESTIMONY OF LINDA J. MORGAN
CHAIRMAN, SURFACE TRANSPORTATION BOARD
AT A FIELD HEARING OF

THE SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ON RAIL FREIGHT TRANSPORTATION IN NORTH DAKOTA

March 27, 2002

My name is Linda J. Morgan, Chairman of the Surface Transportation Board (STB or the Board). I am testifying at the request of the Committee to discuss the Board's jurisdiction over railroad rates. I have appeared before this Committee many times over the past several years and have discussed at some length matters before the Board, including issues relating to railroad rates.

Rate Regulation in General. Although the Board is charged with regulating railroad rates and routings, see 49 U.S.C. 10701(d)(1), 10704(b), 10707(b), its responsibilities are limited by the statute. Historically, customers often directed railroad routings, railroads were generally required to charge the same rate regardless of the routings a particular shipment used, and the rate regulation of the Interstate Commerce Commission (ICC) was pervasive. Through the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act) and the Staggers Rail Act of 1980 (Staggers Act), however, Congress ended the requirement that railroads provide service and rates over all possible routes, and instead gave carriers the discretion to choose the routes over which they will provide service, intending to free them to maximize their use of efficient routes and to eliminate less efficient ones. The 4-R and Staggers Acts also gave railroads more pricing freedom and curtailed regulatory rate review. The current statute reflects this changed

approach and provides for the review of complaints about unreasonably high rates under certain circumstances.[1] The current law also prohibits unreasonable discrimination (49 U.S.C. 10741), but the prohibition does not apply to the cancellation of joint rates, rail rates applicable to different routes, or different rates that result from different services.[1] Shippers have not made substantial use of the anti-discrimination provision in litigation before the Board.

Market Dominance. The Board may review a rail rate only where the railroad has market dominance (that is, where there is an absence of effective competition for the transportation to which the rate applies), 49 U.S.C. 10701(d)(1), 10707. There are two components to a market dominance inquiry. One is, in effect, a quantitative test. The statute establishes a conclusive presumption that a railroad does not have market dominance over transportation if the rate that it charges produces revenues below 180% of the "variable costs" of providing the service.

49 U.S.C. 10707(d)(1). This 180 revenue-to-variable cost (r/vc) percentage is thus the floor for regulatory scrutiny.

For situations in which the 180% threshold is met, the second component of a market

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[1] Complaining shippers bring cases under the procedures outlined below. Shippers are required to pay a filing fee (effective April 8, 2002, $61,400 for "large" rate cases and $6,000 for "small" cases), which has been a matter of concern to various parties. The Board (and the ICC before it), however, has been required for some time by statute to cover some of its expenses through filing fee assessments that reflect the costs to the Board of handling the various matters brought to it.

[2] The current law does provide a discrimination-type remedy for shippers of agricultural commodities by permitting them to protest an agricultural contract given to another shipper on one of two grounds: that the protesting shipper has been denied the same terms for contemporaneous movements of the same commodity provided under similar transportation conditions (in which case the protesting shipper will be entitled to receive matching terms), or that the contract with the other shipper constitutes a destructive competitive practice. See 49 U.S.C. 10709(g); 49 CFR 1313.

dominance inquiry involves a qualitative analysis in which the STB must determine whether there are any feasible transportation alternatives that could be used for the traffic involved. 49 U.S.C. 10707(a). Currently, in its market dominance determination, the STB considers actual or potential direct competition, that is, competition either from other railroads (intramodal competition) or from other modes of transportation such as trucks, pipelines, or barges (intermodal competition) for the same traffic moving between the same points. For many years, the ICC (and later the Board) also considered two other types of indirect competitive alternatives: geographic competition (the ability to use other railroads or modes to ship from or to other locations) and product competition (the ability to use other railroads or modes to ship substitute products). The STB no longer considers these forms of indirect competition because it found that they are unduly complicated for the Board to assess, that they prolonged the handling by the Board of rail rate cases, and that they discouraged shippers from pursuing legitimate rate complaints.[1/]

Large Rate Cases. In cases where market dominance has been found, the determination of what is a reasonable rate is not an easy task. It would seem that the relatively straightforward way to adjudicate reasonableness would be through reference to the cost of service. But the full costs of serving each individual shipper cannot be measured directly, due to the high degree of shared costs (e.g., overhead costs) and sunk costs (e.g., costs for tunnels, bridges, etc.) in the rail

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[3/] Market Dominance Determinations--Product and Geographic Competition, STB Ex Parte No. 627 (STB served Dec. 21, 1998), pet. for reconsideration denied (STB served July 2, 1999), remanded, Association of Am. Railroads v. STB, 237 F.3d 676, 679 (D.C. Cir. 2001) ("AAR v. STB"), decision on remand, Market Dominance Determinations—Product and Geographic Competition, Ex Parte No. 627 (STB served Apr. 6, 2001) for judicial review pending sub nom. Association of Am. Railroads v. STB, No. 01-1213 (D.C. Cir. filed May 15, 2001).

industry that cannot be attributed to individual traffic. Additionally, railroads are not able to price their services based on preset cost allocations because they serve a mix of captive and competitive traffic, and the competitive traffic would not pay a pro rata share of costs assigned by a formula if the resulting rate is any greater than the rate for using competitive transportation alternatives. Thus, a preset allocation formula would drive away those shippers with less costly competitive options, and the remaining captive shippers would then have to pay even higher cost-based rates once the departed shippers would no longer be contributing to shared costs.

Accordingly, to limit the rates on captive rail traffic to reasonable levels while affording railroads the opportunity to cover all of their costs and earn a reasonable profit, the STB uses demand-based differential pricing principles as contemplated by the statutory scheme. In other words, the statute anticipates that the railroads will apply differing markups (amounts by which rates exceed variable costs) based on the price sensitivity (degree of captivity) of the traffic. Shippers with more choices are offered lower markups in order to keep their traffic in the rail network and thus minimize the overall contributions to the railroads' shared costs needed from those shippers with few, if any, choices.

These pricing principles, which apply in many industries in addition to railroads, make determining the reasonableness of an individual rate a complex task. Neither attributable costs nor degree of captivity (demand elasticity) -- the bases for demand-based pricing -- can be measured directly. Therefore, to assess whether market dominant rates are reasonable, the Board uses a well-established concept known as "constrained market pricing" (CMP) whenever possible.[1/] CMP principles recognize that, in order to earn adequate revenues, railroads need the

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[4/] See Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985), aff'd sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987).

flexibility to price their services differentially by charging higher mark-ups on captive traffic, but the CMP guidelines impose constraints on a railroad's ability to price differentially.

The most commonly used CMP constraint is the "stand-alone cost" (SAC) test. Under the SAC test, a railroad may not charge a shipper more than what a hypothetical new, optimally efficient carrier would need to charge the complaining shipper if such a carrier were to design, build and operate -- with no legal or financial barriers to entry into or exit from the industry -- a system to serve only that shipper and whatever group of traffic is selected by the complaining shipper to be included in the traffic base. The ultimate objective of SAC in particular, and CMP in general, is to eliminate cross-subsidies from one shipper to another and to have optimal efficiency reflected in the rate base used to evaluate the reasonableness of rates paid by captive shippers. Thus, the SAC test allows railroads to price differentially, but it limits rates through the hypothetical efficient new railroad model by assuring that a captive shipper not be required to unreasonably subsidize a carrier's competitive traffic by being forced to bear the costs of any facilities or services from which it derives no benefit.

The Board has used this test to resolve five rate complaints since the agency was established at the beginning of 1996 (cases brought by West Texas Utilities Company, Arizona Public Service Company, McCarty Farms, Inc., FMC Corporation, and Wisconsin Power and Light Company), and the test is being used to evaluate the reasonableness of rates in several ongoing cases. The Board has also established procedures for expediting these cases. While presenting a SAC case is not inexpensive, large rail shippers have used it to obtain substantial rate relief. One shipper, for example, was awarded over $10 million in reparations for past

shipments, and obtained a rate prescription that lowered its rate for future shipments by 30%.[1/] Another shipper was awarded over $20 million in reparations and obtained a 40% rate reduction.[1/] The parties have reached voluntary settlements in various other large rate cases,[1/] while the railroad has prevailed in some cases.[1/]

[5/] West Texas Util. Co. v. Burlington N. R.R., No. 41191 (STB served May 3, 1996), aff'd sub nom. Burlington N.R.R. v. Surface Transp. Bd., 114 F.3d 206 (D.C. Cir. 1997); reparations calculated, No. 41191 (STB served Oct. 24, 1997).

[6/] Arizona Pub. Serv. Co. et al. v. Atchison, T.&S.F.R.R., No. 41185 (STB served July 29, 1997), modified (STB served Apr. 17, 1998). More recently, shippers obtained substantial rate relief in FMC Wyoming Corp. and FMC Corp. v. Union Pacific Railroad Company, STB Docket No. 42022 (STB served May 12, 2000) and Wisconsin Power and Light Company v. Union Pacific Railroad Company, STB Docket No. 42051 (STB served Sept. 13, 2001) (petitions for reconsideration pending).

[7/] E.g., Potomac Elec. Power Co. v. CSX Transp., Inc., STB Docket No. 41989 (STB served June 18, 1998); Sierra Pac. Power Co. v. Union Pac. R.R., STB Docket No. 42012 (STB served July 15, 1998); Pennsylvania Power & Light Co. v. Consolidated Rail Corp., et al., No. 41295 (STB served May 13, 1999); PSI Energy, Inc. v. CSX Transp., Inc., et al., STB Docket No. 42034 (STB served May 13, 1999); Northern Indiana Public Service Company v. Consolidated Rail Corporation, STB Docket No. 42027 (STB served Nov. 28, 2001).

[8/] E.g., McCarty Farms, Inc. v. Burlington N., Inc., Nos. 37809 et al. (STB served Aug. 20, 1997), modified (STB served May 11, 1998), aff'd sub nom. McCarty Farms, Inc. v. STB, 158 F.3d 1294 (D. C. Cir. 1998); Bituminous Coal--Hiawatha, UT to Moapa, NV, 10 I.C.C.2d 259 (1994).

Small Rate Case Simplified Guidelines. Although the CMP guidelines provide the most economically authoritative procedures for evaluating the reasonableness of rail rates, CMP can be impractical to use where the amount of money at issue is not great enough to justify the expense of such an evidentiary presentation. In the ICC Termination Act of 1995, Congress directed the Board to develop a simplified, alternative procedure to CMP. 49 U.S.C. 10704(d). Accordingly, in December 1996, the Board adopted simplified guidelines that employ three revenue-to-variable cost benchmarks as starting points for a case-by-case rate reasonableness analysis. Subsequently, the Board adopted procedures for expediting those cases. Although the evidence needed to use these benchmarks is available and inexpensive to obtain, no complaint cases have been filed by shippers seeking application of these guidelines, and the one case already pending to which these guidelines would have been applicable was settled by the parties. The customer community remains concerned that this process is still too burdensome.[1/]

Summary. The statute that the Board administers assumes that the railroads will price differentially, that is, price depending on market sensitivity. At the same time, the law is intended to ensure that, while customers may pay different rates, no customer will pay a rate that includes an unreasonably high share of the railroad's overall costs.

[9/] To address this continuing concern, the Board recently issued a decision seeking comment on the idea of legislation mandating the use of arbitration to resolve these small rate cases. Arbitration—Various Matters Relating To Its Use As An Effective Means of Resolving Disputes That Are Subject To The Board's Jurisdiction, Ex Parte No. 586 (STB served September 20, 2001).