Testimony of Linda J. Morgan
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Introduction

My name is Linda J. Morgan, and I am Chairman of the Surface Transportation Board (Board). I am appearing today at the Subcommittee's request to discuss issues of concern to railroad shippers. As I have testified about these and other Board matters numerous times before Congress in the past several years, my testimony today will offer a brief summary of the Board and its recent activities, with a particular emphasis on certain issues that are of concern to shippers.[1]

Overview of the Board

I first came to the Board's predecessor, the Interstate Commerce Commission (ICC), in the Spring of 1994, just before the House voted to terminate funding for the ICC. While legislation eliminating the ICC was not approved that year, Congress the next year did pass the ICC Termination Act of 1995 (ICCTA), which became effective on January 1, 1996. The ICCTA continued the trend toward less economic regulation of the surface transportation industry by eliminating the ICC and, with it, certain regulatory functions that the ICC had administered. The ICCTA established the Board as a three-member, bipartisan, decisionally

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[1/] In this Congress, I have provided testimony to this Committee on 3 occasions: 1) on March 21, 2001, I testified about the Board's activities in general; 2) on June 28, 2001, I gave testimony on the Board's recently issued major rail merger rules; and 3) I submitted testimony on the rail rate complaint process for the North Dakota field hearing on March 27, 2002.

independent adjudicatory body organizationally housed within the Department of Transportation (DOT). It transferred to the Board core rail adjudicative functions and certain non-rail adjudicative functions previously performed by the ICC, and provided it with limited resources to carry out these responsibilities.

The Board continues to be funded on an annual basis, operating at essentially the same resource level since its establishment in 1996, although, largely because of the debate over how the railroad industry ought to be regulated, the agency has not been reauthorized. Nevertheless, the Board has adapted to its mission and its resources. Even with limited resources, it has worked through its significant caseload, resolved many cases that had languished at the ICC, and tackled head-on the many hard issues that have confronted the rail sector in the last several years. In order to continue to perform its duties expeditiously and effectively, the Board's principal focus for the foreseeable future continues to be on hiring new employees capable of replacing the many experienced employees eligible to retire from the agency.

The Board's Approach to Its Work

The Board, I believe, has been a model of "common sense government," looking "outside of the box" for creative solutions to the serious regulatory issues entrusted to it, and promoting private-sector initiative and resolution where appropriate while undertaking vigilant government oversight and action in accordance with the law where necessary to address imperfections in the marketplace. This approach has been successful for addressing in a timely and effective manner a variety of difficult matters involving the rail sector.

For example, this approach worked in resolving the rail service crisis in the West during the late 1990s, which, as I have discussed with Members of this Committee on various occasions,

had to be handled in such a way as to not inadvertently hurt some shippers in an effort to help others. The approach proved successful in addressing the less extensive disruptions associated with the Conrail transaction, and it has helped the Class I railroads in improving the operations of the Chicago terminal, a major gateway between the East and the West. Because of the Board's prodding, we now have industry-wide operational reporting that allows us to monitor carrier performance in a way that we could not before; we have more cooperation among carriers with a view toward expanding and improving rail service; and we have private-sector agreements and other mechanisms in place to address issues that arise between various segments of the rail sector. And the Board's pragmatic approach also has worked in many individual cases in which the Board has facilitated private-sector solutions. Such an approach can produce the best solution to a problem: a private agreement will more likely reflect the interests of the parties to the agreement; the parties who have negotiated the agreement have a real stake in its success; and a private-sector resolution can provide more benefit to the parties involved than the Board can provide, given the limits of its authority. As a result of the efforts of the last several years, interactions among the various stakeholders are more constructive and rail service is more responsive overall than in past years.

Sometimes a private-sector solution is not forthcoming, however, and in those cases we do intervene aggressively when appropriate. Thus, after holding extensive hearings on access and competition in the railroad industry, in 1998, in addition to promoting private-sector initiatives, we pursued a variety of government actions, including the revision of the "market dominance" rules to eliminate "product and geographic competition" as considerations in rate cases. Similarly, although some rate cases have settled, others have not, and in those cases the agency has acted decisively, in decisions that were more often than not favorable to shippers, to

establish the rules of the road for the disposition of these important matters. And beyond the resolution of individual cases, I should note that the Board has handled tough problems by issuing rulings of broad applicability. As an example, in its "bottleneck" decisions, the agency read the law creatively so that it could give shippers an opportunity for relief while respecting the rate and routing freedoms that the law provides for railroads. I know that certain shipper interests consider the bottleneck relief illusory, but in fact a number of bottleneck complaints have been filed before the Board.

Rail Rate Cases

Overview. When I came to the ICC, the agency had rate guidelines in place, but it had decided virtually no cases under these guidelines. One of my main goals as Chairman was to resolve these cases with a view toward clarifying how the guidelines would be applied so that parties would know where they stood, and leveling the playing field by ensuring that the formal process would not be used simply as a delaying tactic. Also, by setting up fair and understandable procedures, and focusing on timely case disposition, I hoped to encourage private-sector resolution whenever possible. I believe that we have achieved those objectives, as many rate disputes have been resolved without Board intervention, and several cases that had been brought to the agency were settled before the agency issued a decision. Of course, not all cases are settled, and we are actively moving forward with several rate cases at this time. Rate regulation, however, is not a simple exercise, and so the cases take time.

Market Dominance. Congress has decided that there should not be rate regulation where there is effective competition, and so the first step in a rate case is the determination of market dominance (defined as an absence of effective competition for the transportation to which the

rate applies). The first component of a market dominance inquiry is to determine the "variable costs" of providing the service. 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, which means that this 180% revenue-to-variable cost (r/vc) percentage is the floor for regulatory scrutiny.

For situations in which the 180% threshold is met, the second component of a market dominance inquiry involves a qualitative analysis in which the Board must determine whether there are any feasible transportation alternatives that could be used for the traffic involved. Currently, in its market dominance determination, the Board 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). As referenced earlier, the Board 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. (The Board's decision is still under judicial review.)

Rate Reasonableness Standards. Thus, although the market dominance inquiry is still not easy, we have tried to simplify it. And even assuming that the elimination of product and geographic competition will be upheld in court, the remainder of the rate review process is quite

complex. Although a cost-of-service approach might be relatively simple, we cannot use such a methodology for two reasons. First, 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 industry that cannot be attributed to individual traffic. And second, 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 Board uses demand-based differential pricing principles. In other words, the Board expects railroads to 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. CMP principles recognize that, in order to earn adequate revenues, railroads need the 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 unwanted cross-subsidies from one shipper to another and to have optimal efficiency reflected in the rate base. 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 the shipper 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 (with decisions favorable to the shippers in 4 out of the 5 cases cited above).[2] One

[2/] The Board also resolved during this period a complex pipeline rate case in a judicially

complainant 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%. Another shipper was awarded over $20 million in reparations and obtained a 40% rate reduction.

Timing Issues. Some parties argue that it takes the Board too long to decide rate cases. I understand their concern. However, the review is an inherently complex one. And the parties themselves add to the time needed for resolution by asking the agency to resolve numerous discovery disputes, many of which they ought to be able to settle themselves, as well as other preliminary matters. With respect to the cases themselves, we must make hundreds of "calls" on the many substantive issues that come up in each proceeding. As these cases are data-intensive and quite technical, we have to be very careful, because a mistake on even one of these issues could result in a remand by a reviewing court. And we also have to spend considerable time on administrative petitions for reconsideration that are frequently filed, as well as court challenges to our rate decisions. All of this is handled by a small cadre of highly skilled and dedicated employees, who I can assure you are focused on producing a defensible product in these and the many other cases on which they work.

Additionally, I should note that the nature of the calls that we are required to make has changed with the recent filings. In the past, the questions that arose -- even the theoretical questions -- typically concerned more confined issues such as how to value property, the configuration of the hypothetical railroad's network, and the projections of the tonnage and revenues associated with the hypothetical railroad. More recently, however -- now that many of those matters have been resolved -- parties have attempted to test the boundaries of a SAC case,

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affirmed decision that resulted in substantial rate reductions and reparations.

and so we have been faced with a series of issues that go to the broad principles underlying the SAC analysis. Rather than resolving these questions after the parties and their consultants have made their entire cases, we have been called upon to address them at an earlier stage in order to guide the parties in presenting their evidence and arguments. Thus, late last year, we published a decision providing guidance on certain fundamental issues outstanding in several pending cases, including the Arizona Electric case. The Arizona Electric parties asked for further guidance, and we expect to issue a further decision in the very near future on that matter.

Small Rate Cases. In 1996, the Board issued simplified guidelines for the disposition of those rate cases where the amount of money involved does not justify pursuing the more complex method used in larger cases. No case has been filed seeking application of those guidelines, as some may view them as not being simplified enough, and not worth bringing given the amount of money at stake. In December 1998, I wrote to the Committee on a number of matters and suggested that, if Congress shared that view, legislation would be necessary to establish another approach. In May of this year, I again wrote the Committee summarizing the mixed record developed in a Board proceeding that explored whether legislatively mandated arbitration might be an appropriate approach to handling these cases.

Rail Mergers and Competition

Background on Past Rail Mergers. The trigger for much of the debate over access and competition was the move during the 1990s toward continued consolidation in the railroad industry. Since I came to the ICC, four Class I rail mergers have been approved, with substantial Board-imposed competitive and other conditions. The conditions in a variety of ways provided for significant post-merger oversight and monitoring that have permitted us to

stay on top of both competitive and operational issues that might arise. They provided for the protection of employees and the mitigation of environmental impacts, and our recent decisions employed a "safety integration plan" that draws on the resources of the Board, the Federal Railroad Administration, and the involved carriers and employees.

In varying degrees, these mergers have had the support of segments of the shipping public, as well as employees and various localities, and were considered by a number of interested parties to be in the public interest. A variety of shippers actively supported the Burlington Northern/Santa Fe (BN/SF) merger, the inherently procompetitive Conrail acquisition, and the Canadian National (CN)/Illinois Central merger. While the Union Pacific/Southern Pacific (UP/SP) merger was opposed by certain segments of the shipping community (although it was supported by others), the Board believed that merger was necessary not only to aid the failing SP, but also to permit the development of a second rail system in the West with enough presence to compete with the newly merged BN/SF. I should note that the conditions that the Board imposed in approving the UP/SP merger made it possible for UP/SP's main competitor, BNSF, to participate in several "build-outs" designed to produce new competitive service that did not exist before the merger, and that would not have been possible without the Board's conditions.

Some have said that rail mergers are inherently anticompetitive, that they cause service problems, and that the agency should have more actively discouraged them. But our approvals were based on public interest determinations made on extensive records and were conditioned to preserve and promote competition, ensuring that no shipper's service options were reduced to one-carrier service as a result of a merger.

New Major Rail Merger Policy and Rules. These recent mergers have changed the way

the rail system now looks. In the United States, we now have two competitively balanced systems in the West and two competitively balanced systems in the East. Future merger proposals would likely result in a North American transportation system composed of as few as two transcontinental railroads.

Given this prospect and the service disruptions associated with the most recent round of mergers, when the BNSF and CN rail systems announced their intention to merge in late 1999, the Board issued a 15-month "moratorium" designed to prevent the filing of merger proposals pending the development of new rules.[3] Before the moratorium ended, the Board revised its rail merger policy with a view toward more affirmatively enhancing competition, and ensuring that the benefits of a future merger proposal truly outweigh any potential harm. Given that the next round of mergers would put in place the rail network of the future, applicants under the new rules bear a substantially heavier burden in demonstrating that a merger proposal is in the public interest. Key provisions in the rules require applicants to more clearly show that the transaction would promote competition and improve service, and indicate that enhanced intramodal competition would be viewed as a benefit weighing in favor of approval. The rules also direct more accountability for benefits that are claimed and a showing that such benefits could not be realized by means other than a merger. And they require more details up front regarding the service that would be provided, as well as contingency planning and problem resolution in the event of service failures.

Some say that, if the current industry structure warrants conditioning any new merger on the enhancement of competition, then it also ought to warrant across-the-board

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[3/] I appeared before this Committee in the Spring of 2000 to discuss the moratorium and the merger policy rulemaking.

competition-enhancing actions -- in particular, revision of the competitive access rules and the bottleneck rate challenge procedures -- outside of the merger context. The new merger rules were adopted to address a scenario in which the industry would be moving toward two transcontinental systems. Absent any new major mergers, I believe that it would be difficult to defend actions reversing the longstanding competitive access rules or the more recent bottleneck procedures -- both of which have been judicially affirmed -- essentially to provide for two rail competitors upon request.

Rail Service. The merger integration process over the last few years has produced serious service disruptions. However, after significant efforts on the part of the rail carriers and extensive oversight by the Board, those service problems have been alleviated and rail operations overall are much improved. The performance metrics provided by the carriers show clear improvement, and the Board's Rail Consumer Assistance Program shows a steady decline in service issues brought to us for informal resolution. The 15-month merger moratorium imposed by the Board has ensured that the railroads have focused on running better the businesses that they now have in place without the distraction of more mergers.

Rail Line Construction Cases

The market, through new construction activities, is directing where new competitive services will be introduced. In addition to the build-outs initiated as a result of the Board's UP/SP merger conditions that I referenced earlier, during the past few years, railroads have pursued several new construction cases. The largest, and most controversial, has been the case involving the application of the Dakota, Minnesota and Eastern Railroad to extend its coal-hauling capability into the Powder River Basin, which the Board approved earlier this year

with substantial environmental mitigation conditions, and which is now in court. The Board has also approved, or is in the process of reviewing, several other rail construction cases geared to produce new competition where the market will support it. While these projects are typically supported by shippers, they are often opposed by local groups with concerns about environmental and community impacts. The Board must balance these concerns against the transportation benefits that the new projects are designed to produce in resolving these matters in a timely and judicially defensible manner.

The Rail Sector Today

The last few years have presented many challenges for the rail sector, and the Board has likewise been challenged. However, I do believe that good progress has been made in meeting these challenges. Service overall is much better and more customer-focused; the railroads are stronger operationally; and there is much more constructive commercial communication among the various segments of the rail sector.

And the Board has done its part. It has brought parties together informally to resolve their differences in a way that ensures that rail service is more responsive to the needs of the customers. And it has moved cases before it to resolution as expeditiously and effectively as possible.

Of course, there is always more work to be done. The industry must continue to strive to be a customer-focused industry that can remain a vital part of our Nation's transportation system. And the Board must continue its efforts toward that end, working formally and informally to resolve disputes in a timely and effective manner. While I know concerns still remain, we must work to ensure that the progress that has been made will be sustainable into the future.