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Good morning and thank you for inviting us to speak to you today. I appreciate the opportunity to appear here with Senator Dorgan to address issues of concern to the agricultural community.

The Board has taken a number of steps during the past year to proactively monitor the railroads and improve our regulatory practices. But before I elaborate on these efforts, I want to provide a brief overview of the Board and its responsibilities to set the backdrop against which we've taken these latest actions.

### **Statutory Responsibilities**

The STB is charged by statute with resolving railroad rate and service disputes and reviewing railroad restructuring transactions (mergers, line sales, line constructions, and line abandonments). We also have limited jurisdiction over certain trucking, bus, household goods, ocean carrier, and pipeline matters.

The Staggers Rail Act of 1980, as supplemented by the ICC Termination Act of 1995, directs the Board to exempt from economic regulation traffic where the market is deemed competitive. The Board's governing statute, like virtually all other modern statutes of economic regulatory agencies, assumes that aggressive regulation is not necessary where competition exists, because in such circumstances market forces will discipline firms and prevent market abuse. The law directs us to rely to the maximum extent possible on competition to establish reasonable rail rates. The Board can intervene in railroad rates only if it determines that a rail carrier has market dominance over the transportation to which [the] rate applies. *I want to note that we recognize that competition often does not exist in the transportation of many agricultural commodities and therefore the transportation of grain and most other agricultural commodities is NOT exempt from active regulation by the Board.*

A carrier is presumed not to have market dominance where its rates produce revenues that are less than 180% of variable cost of providing the service. Also, if there are competitive alternatives for moving the traffic between the same points – either from other railroads or from other modes of transportation – then the Board does not have authority to regulate the rate. Finally, the Board has very limited jurisdiction over traffic that moves under contracts between shippers and carriers.

Back in 1980, the Nation's rail system was in desperate financial straits. It was burdened with unproductive assets, forced to provide unprofitable services, and hampered by excessive government regulation. Congress put in place reforms directing that railroads be treated, in most respects, more like other businesses. Since that time, the railroad industry's financial condition has steadily improved. Today, the industry is considered by most independent analysts to be relatively healthy.

Unlike most businesses, however, railroads are common carriers. As common carriers, they have an obligation to provide service to the general public on reasonable request. In order to ensure that shippers receive the needed level of service, the railroads' financial resources must be sufficient to maintain and appropriately expand the rail infrastructure. At the same time, transportation of commodities vital to the Nation's economic well-being must be efficient and reasonably priced.

The Staggers Act made it easier to shed excess capacity and the system has now been largely rationalized and made more productive. But in recent years, the U.S. economy has expanded, and the rail network, like other parts of our transportation system, has become capacity-constrained. This past April, we held a hearing on rail capacity, traffic forecasts, and infrastructure requirements. The Class I railroads testified that – despite their recent increases in infrastructure spending and their planned future

capacity investments – they will not be able to keep up with the projected increase in the demand for rail service. The capacity shortfall that we see in many markets today will dramatically worsen unless bold new policies and strategies are adopted.

So, are the railroads earning enough to maintain and expand the network? Are the railroads revenue adequate?

Each year the STB contrasts the railroads earnings with what they need to earn to cover their costs and invest in the infrastructure. We examine the railroads' cost of capital. A railroad's cost of capital includes both the cost of borrowing and the cost of equity. While the cost of debt is easy to determine, the cost of equity is far more difficult. Since 1981, the Board has been using the same basic approach to estimate the cost of equity, but concerns have been raised that our approach may be overstate the industry's cost of capital and thus the revenue needs of the industry.

Last year we launched a rulemaking to examine our methodology and to ensure the accuracy of this important measure. Last week, we issued a final rule that changes the way we calculate the cost of capital. This new estimate will lower somewhat our estimate of the cost of rail equity capital.

### **GAO Report and STB Competition Study**

The Government Accountability Office (GAO) recently issued reports<sup>1</sup> on railroad rates, competition, and capacity. GAO noted that between 1985 and 2005, rates rose by less than the rate of inflation for each of the four major categories of rail traffic -- coal, grain, motor vehicles, and miscellaneous mixed shipments. Moreover, GAO found that despite an uptick in recent years, rail rates overall in 2005 remained below 1985

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<sup>1</sup> The report is entitled *Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed*. The supplement is entitled *Freight Railroads: Updated Information on Rates and Other Industry Trends*.

levels even in nominal terms. At the same time, the Board's index of railroad costs increased by 80%.

GAO did focus on the higher rates paid by agriculture shippers. Last November, the Board held a hearing on market conditions in the grain industry that may have caused grain rates to diverge from the long-term trend of reduced rail rates for most other shippers. We also wanted to hear about the interplay between the American and Canadian wheat markets, how the Canadian regulatory system differs from the American, and what impact those differences might have on the US grain market. Last week, the Board concluded this proceeding by issuing a decision which recognized the protections afforded grain shippers in the Staggers Act, and concluded that our recent revisions for bringing small rate cases should be the avenue for grain shippers to pursue rate relief.

There are of course areas – states like North Dakota and Montana – where rail rates tend to be higher than elsewhere. That is largely due to the economics of the railroad industry. Under the principles of “differential pricing,” railroads, which have a high proportion of fixed costs and which have fierce competition for most traffic, will charge more, often substantially more, to their captive shippers than to shippers who have competitive options. They must do this to earn enough revenues to cover their direct expenses, invest in necessary facilities, and still return dividends to shareholders.

Although differential pricing is practiced in many other industries – such as airlines, utilities, hotels, and movie theaters – we understand that the consequences for captive rail shippers might be much more severe than for air travelers, movie goers or hotel guests.

But if the railroads' ability to differentially price by is significantly restrained, then revenues will have to come from elsewhere. If other sources of revenue cannot be found, then infrastructure investment will suffer, as will rail service.

To further address the problem of inadequate competition, the Board has commissioned an extensive study of the issue. The study will also assess various policy issues, including current and near-future capacity constraints in the industry. The study is scheduled to be completed this Fall.

Another recent Board decision involves the paper barriers that are often part of sale or lease contracts when Class I railroads sell or lease lighter-density portions of their lines to smaller carriers. Some parties believe that these arrangements have been vital to the development of the short-line industry. Others, including myself, are concerned that they have tend to freeze in place the status quo, rather than allowing the development of new competitive options not available before the transaction. In October 2007, the Board ruled that it would henceforth review these restrictions on a case by case basis to determine whether they violate our statute. We also proposed disclosure requirements for new as well as existing paper barrier provisions to better enable parties who believe they are aggrieved by these restrictions to challenge them.

### **Rate Regulation**

When capacity is tight, railroads, like any other producer, will seek to raise prices. Those shippers without competitive options will see their rates rise the most. Thus, with capacity tight today and expected to be tighter tomorrow, the Board's rate relief processes are particularly important.

Rate Disputes. Under the statute, the Board is directed to ensure that rates are reasonable while at the same time not precluding railroads from obtaining adequate revenues. Balancing these potentially conflicting objectives is not an easy task. Many shippers have complained that it is too expensive and too time-consuming to bring a case before the STB. In response, we have recently changed our procedures for handling rate

cases, with one set of procedures designed to streamline large rate cases and two other procedures designed to reduce the cost and improve access for smaller cases. With the exception of coal shipments by utilities, most rail movements of captive traffic will fall under our small case guidelines.

Small Rate Cases. In 1996, the Congress directed the STB to develop procedures for addressing smaller cases for which the costs of bringing a full case to the Board were too costly. The STB adopted simplified guidelines, but no cases were filed under them until very recently. On September 5, 2007, the Board issued a decision updating our process for reviewing rate complaints in cases too small to warrant the cost of litigating a case to warrant a full fledged review. The Board's decision, which makes the rate review process available to shippers of all sizes, allows smaller rate cases to proceed on one of two tracks. First, freight rail customers may seek up to \$1 million in relief over a 5-year period, using a process that largely looks at the rates for moving comparable traffic. A shipper using that approach would have a Board ruling on its case within 8 months of the filing of its complaint.

Under a second approach, freight rail customers can seek up to \$5 million in relief over a 5-year period, by using a process that focuses on whether the carrier is abusing its market power by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper. This is a simpler form of the test that is applied in large cases. It relies on standardization of many of the components in order to reduce the cost and complexity of litigating the case. A Board decision in a rate case brought under this approach would be issued within 17 months after the filing of the complaint. The Board's new procedures – which have been challenged in court by numerous rail interests – are designed to ensure that the rate

review process will be accessible to all captive traffic that moves under common carrier rates.

Fuel Surcharges. Another matter that concerned shippers recently is the way the railroads were assessing fuel surcharges. Captive shippers voiced concerns that fuel surcharges that were expressed as a percentage of the rate, virtually guaranteed that they would bear higher surcharges than shippers in competitive markets.

In January 2007, we issued a decision declaring it an unlawful practice for carriers to levy a fuel surcharge that was not related to the increased fuel cost attributable to the particular movement. This action demonstrates that the Board will use aggressively the authority granted to it by statute to stop unreasonable practices, thereby protecting shippers and advancing the public interest.

### **Service Quality and Railroad-Shipper Relationships**

The Board actively monitors railroad industry performance. We receive monthly reports from each Class I railroad, tracking such performance indicators as average train speed and terminal dwell time. I meet with Board staff about service metrics at least every other week. Moreover, in addition to our annual request for each Class I carrier to detail how it plans to handle end-of-year peak demands, the Board now also requests the carriers to report their performance goals with respect to cars-on-line, terminal dwell time, train speed, and employment levels, as well as their capital spending plans for the next year. The carriers' responses are available on our website.

The Board has a Rail Consumer Assistance Program which handles about 100 disputes annually. Most of these relate to service including: car supply; claims for damages; demurrage; fuel surcharges; railroad employee complaints; and community concerns. Our staff cannot always resolve the issues informally, but they are often



successful at bringing the parties closer together and getting them to talk to each other without resorting to litigation or formal Board adjudication.

When parties cannot resolve their differences informally, they can engage the Board's formal processes by filing a complaint. The Board may temporarily substitute another carrier for a carrier that is unable or unwilling to provide adequate service on its lines. For example, we found that a railroad in Texas was not providing adequate service to a shipper and we ordered temporary service by another carrier. When it became clear that the issues were not resolvable, the Board ordered the lines involved to be sold, at a price set by the Board to reflect the value of the property. The Board's decisions demonstrate that we will use every available tool, where necessary, to protect shippers receiving inadequate service.

The Board acted to preserve shippers' service options in a case in Ohio last year involving a railroad that would not let another railroad cross its line. In that case, a Class I rail carrier had unilaterally removed the crossing diamonds that were needed for a short line to serve several potential shippers. The Board made clear that a carrier may not undercut another carrier's ability to fulfill its common carrier obligation by unilaterally severing track of the other carrier that is part of the national transportation system. The Board directed the Class I carrier to promptly reinstall the crossing.

### **Conclusion**

The past 12 months have been noteworthy for the number of proactive steps taken by the Board to reform, streamline, and modernize our oversight and rail regulatory procedures. Of the more important actions that will take place between now and the end of this year, the STB will:

- See that the competition study is completed, and analyze the results and recommendations contained therein;

- Test the new simplified rate guidelines on three newly filed small rail rate disputes (and perhaps more cases, if filed);
- Consult with our new energy advisory committee for guidance on a range of significant issues that affect the public interest in a reliable delivery network for coal and liquid biofuels;
- Review the recently announced proposal by the Canadian Pacific Railway to acquire the Dakota, Minnesota & Eastern Railroad, as well as the Canadian National Railway's proposal to acquire the Elgin, Joliet & Eastern Railway;
- Improve the Board's ability to ensure effective regulation of rail operations that handle municipal solid waste and related materials;
- Address the current ambiguity as to whether certain types of arrangements between rail carriers and shippers reflect contracts (for which regulatory remedies are unavailable), or whether they reflect common carrier service subject to Board regulation; and
- Prepare the STB to have the capability to address potential conflicts between passenger rail and freight rail operations and to implement potential legislative proposals in this regard.

I have also advocated that the Board take a closer look at the current status of the "common carrier obligation." I hope that we will hold a hearing into this multi-faceted issue in the near future.

I appreciate the opportunity to discuss these issues today, and look forward to any questions you might have.