Before The
U.S. House of Representatives
Committee on Transportation and Infrastructure
Subcommittee on Railroads, Pipelines, and Hazardous Materials

March 5, 2008 Hearing
Investment in the Rail Industry
11:00 A.M.
2167 Rayburn House Office Building

Testimony Of
Vice Chairman Francis P. Mulvey
Surface Transportation Board
395 E Street, SW, Suite 1290
Washington, DC 20423-0001
(202) 245-0210

Good morning Chairwoman Brown, Ranking Member Shuster, and other Members. Thank you for this opportunity to testify on investment in the rail industry.

Several months ago, at the September 25, 2007 full Committee hearing on rail competition and service matters, I expressed concern about potential "hedge fund" purchases of a significant stake in a railroad, followed by divestiture of the railroad's assets, deferred maintenance, and a rolling back of capital improvement programs. I noted that these actions could result in deterioration of service to shippers and a return to the "bad old days" of the 1970s when railroads were hemorrhaging cash and unable to adequately maintain the rail plant. Ultimately, a strategy of reduced investment could lead to a failing firm and less railroad capacity.

In a letter dated October 24, 2007, I and my fellow Board Members responded to several follow-up questions from Committee Members, one of which was about the limits of our authority over rail acquisitions, and specifically about investment in rail carriers by certain types of investors. We noted that, as it currently stands, the Board does not appear to have any authority under existing law to limit such investments by hedge funds or other "short term" investors.

Today, I would like to elaborate on my prior testimony on the topic of investment in the rail industry. First, I would like to review the investment trends in the industry and then turn to the topic of the Board's authority in this area.

During the period between the Staggers Rail Act of 1980 and 2006, annual investment in rail plant and equipment trended upward in nominal dollars, but has remained relatively static when adjusted for inflation. In fact, compared to 1980, capital spending in constant dollar terms was 20 percent less in 2006 (see graph 1 attached).

Of course, it is also true that the rail plant has shrunk over the years. Miles of Class I railroad track have declined from 340,779 miles in 1980 to just 162,056 miles today—a reduction of more than 50 percent. Similarly, miles of road served by the Class I's have fallen from 207,334 miles in 1980 to 94,942 miles in 2006 (see graph 2 attached). Net investment per track mile or road mile has fluctuated since 1980, but is on balance much higher today (see graphs 3 and 4 attached). Likewise, the locomotive and freight car fleets are also much smaller today than they were at the time the Staggers Act was passed. There were 28,094 locomotives operated by Class I carriers in 1980, compared to 23,732 in 2006. But, today's locomotives are much more powerful. The average locomotive has 51 percent more horsepower per unit than in 1980.

The railroads' freight car fleets are even more reduced than their locomotive fleets. While the Class I railroads' freight car fleets comprised 1,168,114 cars in 1980, there were only 475,415 cars in service in 2006. Some of this decline was offset by growth in the fleets operated by Class II and Class III railroads, and the spinning off of car supply responsibility to shippers and other car suppliers. Class II and III railroads grew their fleets from 102,161 cars in 1980 to 120,688 cars in 2006. More dramatically, shippers and other car companies expanded their car fleets from 440,552 cars in 1980 to

750,404 cars in 2006. Despite the overall reduction in the freight car fleet, today's cars have much greater capacity. The typical car can handle nearly 25 percent more tons than the average rail car in 1980. In addition, the railroads operate more cars per train and the trains travel longer distances today. The result is that the nation's freight railroads now generate roughly twice as many ton-miles of service as they did in 1980. In fact, the rail share of the intercity freight transportation market has grown from its low point of 37.5 percent in 1980 to 42.3 percent in 2003—the last year for which data are available.

So, physical infrastructure has shrunk, the rail labor force has been reduced significantly and traffic has expanded. The result is that the railroads have gone from a situation of pervasive excess capacity to one in which they face capacity constraints. The upshot, of course, is that, as demand has exceeded supply, prices have risen and the railroads today are more profitable than they have been in decades. One would anticipate that some of these profits would be plowed back into the infrastructure so that the railroads could continue to accommodate further growth in demand.

Indeed, the railroads have begun to invest more into growing the infrastructure. While railroad-specific data are not available, it is generally thought that about one-fifth of rail capital spending for infrastructure is used for expansion. In 2007, the AAR estimates that the Class I railroads spent $1.9 billion for expansion of capacity through the building of new roadway and structures. This represents a steady increase in recent years in spending for capacity expansion. For example, Class I railroads spent $1.1 billion in 2005 and $1.4 billion in 2006 to expand the infrastructure. The railroads are

reducing their spending on capacity somewhat in 2008, due to the recent downturn in rail traffic demand. Over the past several weeks, a number of the Class I railroads have announced their capital expansion budgets for 2008:

- BNSF Railway Company announced it plans to spend a total of $2.45 billion in 2008 on capital expenditures compared to $2.59 billion in 2007, of which $950 million will go toward capacity *expansion*. It will spend approximately $350 million *less* on its capital expansion program than it spent last year.[1]

- Norfolk Southern Corporation plans to spend 29% of its $1.425 billion capital expenditures budget --- about $413 million --- on growth and productivity projects such as infrastructure and terminal expansion investments, strategic opportunities, and projects to improve its productivity and efficiency.[2]

- Union Pacific Railroad will spend $840 million to expand its network and terminal capacity in 2008. This represents about a quarter of its total $3.1 billion budget for capital expenditures, and this total budget is about the same amount it spent last year.[3]

---

[1] "BNSF Announces $2.45 Billion Capital Commitment Program," *available at* http://www.bnsf.com/media/news/articles/2008/01/2008-01-29b.html; "Class I capex plans for 2008 are mixed," Argus Rail Business at 5 (Feb. 11, 2008).
[2] Remarks of Debbie H. Butler, Exec. V.P. Planning and Chief Information Officer, Norfolk Southern Corp., Financial Analysts' Meeting, New York, NY, Jan. 23, 2008, *available at* http://www.nscorp.com/nscportal/nscorp/Investors/Executive%20Speeches/2008/dhb012308.html.
[3] "Union Pacific Announces 2008 Capital Plan," *available at* http://www.uprr.com/newsinfo/releases/financial/2008/0201_capital.shtml?print; "Class I capex plans for 2008 are mixed," Argus Rail Business at 5 (Feb. 11, 2008).

- Canadian National Railway is targeting C$1.5 billion in capital spending for 2008, approximately C$500 million of which will go toward expansion projects.[4]

A recent report by Cambridge Systematics[5] for the AAR estimated that $148 billion will be needed for rail infrastructure capacity expansion to accommodate the projected growth in rail traffic demand through 2035. Of this amount, the Class I railroad share is $135 billion. This projection is for expansion capacity only, and does not include spending to maintain and support the new lines, acquire additional cars and locomotives, or operate, maintain and replace existing facilities. The report projected that the Class I railroads could supply $70 billion from earnings growth and an additional $26 billion from productivity savings to partly cover the $135 billion. This would still leave a shortfall of nearly $40 billion, or about $1.4 billion annually. And this is what is needed to simply sustain the status quo in terms of the rail market share. If the nation is serious about shifting substantial volumes of truck traffic off our streets and highways, the amounts needed and the size of the shortfall will be far greater than the Cambridge Systematics' projection.

Where will these monies come from? There are a number of potential sources, all of which have promise and problems. Investment tax credits, public/private partnerships, and the establishment of a railroad trust fund as advanced by a former member of this Committee are all potential ways to close the gap. However, there is another source of

[4] "Class I capex plans for 2008 are mixed," Argus Rail Business at 6 (Feb. 11, 2008).
[5] *National Rail Freight Infrastructure Capacity and Investment Study* (Sept. 2007), (prepared for Association of American Railroads by Cambridge Systematics, Inc.), *available at* http://www.aar.org/Newsroom/Capacity_Investment_study.asp.

investment capital that has recently gained the attention of many in the industry and in the Congress—investments by hedge funds—and I want to focus the remainder of my remarks on that subject.

Hedge funds and other non-traditional rail investors have recently become significantly involved in railroads. Because these types of firms are believed to have time horizons of five years or less and strategies of maximizing short-run returns, there are concerns that their investment strategies will run counter to the needs of railroads for long-term capital investment. Thus, investment in the rail industry by hedge funds could be at odds with the public interest and common carrier aspects of the rail industry. Railroads have a fundamental common carrier obligation to provide rail service upon reasonable request, and there is a public interest component to the Board's regulation of certain rail transactions. When investors demand a relatively quick return on their investments, that could result in deferred maintenance or a deterioration of assets and could conflict with the railroad's obligation to provide service to shippers and communities.

I want to stress that it is, categorically, not the source or identity of investors that is of concern, but the timeframes and goals for the investments. As you know, the rail industry is capital-intensive, with long-lived assets, and long lead times for the replacement and improvement of assets. Thus, investors with the goal of reaping short-term profits may be at odds with the very nature of this industry. A "long term" investment for a private equity firm may be 5 years. But in the rail industry, that is a

short period of time. Can a short time frame for rail investment result in a commitment to expansion capital? Can it even result in preservation of the status quo? The answer may depend on how actively the investors become involved in the management and strategic decisions of the railroad.

What is the Board's ability to address these concerns? If rail investment—or disinvestment—manifests itself in reduced service, the Board already possesses the power to replace an owner or operator of a line who is unwilling or incapable of providing adequate service, under our "feeder line" and directed service provisions.[6] We have used these provisions several times in the past few years. For example, following up on a 2006 authorization of alternative rail service at the request of a shipper in Lubbock, Texas, the Board extended the temporary relief until a long-term solution could be developed. In August 2007, the Board ordered divestiture of the lines involved, at a price set by the Board to reflect the value of the property, to enable improved rail service to the affected shippers.[7]

Concerning our jurisdiction over investments, as we stated in our letter of October 24, 2007, the Board has authority to regulate some railroad transactions, but not others. Any authority that the Board might have over the takeover of a rail carrier by a non-carrier such as an investment partnership or hedge fund would derive from either the

[6] 49 U.S.C. 10907 & 11123.
[7] PYCO Indus., Inc. –Alternative Rail Service—South Plains Switching, Ltd., STB Finance Docket No. 34889, et al. (STB served Nov. 21, 2006); PYCO Indus., Inc.—Feeder Line Application— Lines of South Plains Switching, Ltd., STB Finance Docket No. 34890, et al. (STB served Aug. 30, 2007).

provision in the law that applies to acquisitions of rail property by non-carriers[8] or the provision that applies when transfers of stock and control of a company are involved.[9] The latter provision might apply if a non-carrier were to acquire a single rail carrier that itself owns another rail carrier (for example, a large railroad that owns a small railroad), but under agency precedent the authorization requirement would not apply if the two or more carriers being taken over operate as a single integrated transportation system. And the former provision, which generally applies to transfers of physical property, requires Board authorization if a person other than a rail carrier acquires a "railroad line."[10] This provision appears to be focused on discrete lines, not carriers, and I do not believe that it would normally be applied if a non-carrier sought to take over a major rail carrier.

The question of the agency's jurisdiction over leveraged buy-outs arose in 1989 with respect to a proposed takeover of Chicago and Northwestern Transportation Company, then a Class I rail system, by Japonica Partners. In response to a request from the Senate Commerce Committee, the agency's predecessor, the ICC, prepared a report in which it analyzed the relevant statutory provisions and concluded that it would be difficult as a matter of law for the ICC to exercise jurisdiction over the proposed transaction.[11] Reacting to the ICC's report, Congress quickly moved to give the agency responsibility for approving such transactions.[12] In particular, the legislation would have required ICC approval for a non carrier to acquire direct or indirect control over a Class I

[8] 49 U.S.C. 10901.
[9] 49 U.S.C. 11323(a)(4) (providing that Board approval and authorization is required for the "[a]cquisition of control of at least 2 rail carriers by a person that is not a rail carrier.").
[10] 49 U.S.C. 10901.
[11] See Letter to the Hon. J. James Exon re: ICC Ex Parte No. 480 from ICC Commissioners (May 15, 1989).
[12] See Amtrak Reauthorization and Improvement Act of 1990, H.R. 2364, 101st Cong. § 8 (1990).

rail carrier. President George H.W. Bush, however, vetoed the legislation because he viewed it as a counterproductive step backward from prior deregulatory legislation. Although not dispositive, this legislative history tends to confirm that the agency would lack approval authority over the acquisition of a large rail system by a noncarrier.

In closing, I would like to note that while the Board generally does not have the power to order what investments are made or how much is spent on the rail plant, it does have the power under the existing statute to remedy severe service deterioration problems, which is the ultimate concern of shippers and communities. We as a nation need to find ways of encouraging, not discouraging, investment in the rail plant to ensure our continued mobility.

Thank you for the opportunity to testify today. I look forward to answering any questions you may have.