CHAIRMAN NOBER: Well, thank you very much as always. Okay. We'll move now to our next panel, which may not be quite so quick. We don't even need nametags. They're all familiar to our agency. No, go ahead. It will be a few minutes before I can continue. Our witnesses are thirsty this morning. Okay.

We have representing the American Association of Railroads, from my left, Lou Warchot, who's the General Counsel of the American Association of Railroads; Ed Hamberger who, as I understand, is making his first appearance before our agency, but a familiar face at most hearings involving railroads in town. He's the president and CEO of the American Association of Railroads.

Larry Parsons, who is the Chairman and

CEO of te Wheeling & Lake Erie Railroad; Craig Rockey, who's the vice president of Policy and Economics from AAR, and Mr. William Rennicke, who is with Mercer Management Consulting. Mr. Warchot, are you beginning?

MR. WARCHOT: Yes, I am, thank you. Chairman Nober, Vice Chairman Mulvey, Commissioner Buttrey, on behalf of the members of the AAR, we are pleased to have the opportunity to appear before you today and present the rail industry's views regarding rail rate challenges in small rate cases.

As you will hear today from the panel before you, the AAR continues to support the STB's effort to simplify and expedite the resolution of small cases. The AAR presented testimony before the Board in April 2003, and in subsequent letters on June 23 and August 4, 2003 in this proceeding.

In its prior testimony, the principle recommendation was that the Board should adopt a program of mandatory and non-binding mediation for small rate cases. It remains the AAR's position today that such a program is still the best program for dealing with small rate disputes.

It is a logical extension of the Staggers Act preference for a private sector conflict resolution, and is consistent with the mediation approach as promulgated by the Board in *Ex Parte* 638.

For those cases that cannot be resolved through such a mediation process, we believe that procedural reforms can be enacted, to speed up the process, make it as efficient and as inexpensive as possible, and we will be prepared to offer concrete suggestions in the context of any rulemaking proceeding that the Board may institute in that regard.

Now with respect to the substantive criteria for evaluating rate reasonableness, as well as eligibility standards for small rate cases, Mr. Hamberger will be presenting the AAR's position.

I do wish to note at the outset a general concern regarding eligibility criteria that we have. It has been well-established in court and board decisions that constrained market pricing is the only recognized economically sound method for evaluating the reasonableness of railroad rates, and also that non-CMP small cases guidelines will necessarily be cruder and less exact than CMP.

If the overall scheme of regulation is to have an economically-grounded basis, non-CMP cases must be the exception rather than the rule.

As we will explain on the panel, proposals which would include traffic from a single origin destination pair having an annual freight bill of less than $4.8 million, or as we now understand the proposal to be $7.2 million, this would account for the vast majority of the rail traffic of the large carriers, and essentially all of the traffic of smaller carriers. This is clearly a situation where the exception ends up swallowing the rule.

As Mr. Hamberger and the other witnesses on this panel will also discuss, while the AAR supports efforts to simplify and expedite resolution of small cases, we are deeply concerned that the approaches which the Board may follow in this regard might have a counterproductive effect on the ability of the railroads to earn adequate revenues, meet their capital requirements, address the capacity challenges that you discussed and provide services that the shipping public and the nation require.

The AAR's presentation will be as follows: Mr. Hamberger will describe the AAR's proposals regarding eligibility standards, and the substantive criteria in cases involving small shippers, especially truly small shippers, and incorporating the written statement of the Railroad Chief Financial Officers, discussing the importance of the railroad's ability to earn adequate revenues.

Mr. Parsons will provide the perspective of a smaller regional railroad on the issues, reflecting the potential disproportionate adverse impact that proposed rules may have on smaller carriers.

I also want to add that Mr. Parsons has been authorized to speak also on behalf of the American Short Line and Regional Railroad Association for this proceeding.

Mr. Rockey will describe the substantial amount of railroad traffic and revenue subject to various proposed criteria and standards, and lastly, Mr. Rennicke will discuss how regulatory approaches will impact on the railroad's ability to attract capital and meet its long-term funding needs.

At the conclusion of this testimony, we'll be pleased to answer any questions that you may have. Thank you.

CHAIRMAN NOBER: Thank you.

MR. HAMBERGER: Mr. Chairman and Vice Chairman Mulvey, Commissioner Buttrey, thank you for the opportunity to be here this morning, and let me add in public my congratulations to Commissioners Mulvey and Buttrey for your nomination and confirmation by the United States Senate.

Like their customers, AAR members strongly desire to avoid the costs and risks associated with litigation before the Board. Of course, rate litigation is largely avoided because in the overwhelming majority of instances, rail rates are patently reasonable.

When a rate is challenged, and the dispute is not appropriate for resolution under full SAB procedures, railroads want the dispute resolved as efficiently and inexpensively as possible, while at the same time remaining consistent with the constrained market pricing principles embodied in the Staggers Act.

For almost a quarter of a century, rail rates and services have been determined by market forces as envisioned by the Staggers Act.

Thanks to that Congressional policy, the country has benefitted from a robust rebound in the freight rail industry. Rail productivity has surged 177 percent since 1980, and those savings have largely been shared with our customers, with rail rates having declined 60 percent in inflation-adjusted terms, saving shippers and ultimately the consuming public as much as $10 billion per year, according to a Smithsonian Institution study.

Just as importantly, the rail accident rate has fallen 65 percent, with the employee injury rate down 76 percent.

I recite this history because it is important that as you focus in this hearing on small shipper protection, that you not lose sight of the critical Congressionally-mandated charge that you have, and that is ensuring the revenue adequacy of the freight rail industry. That is indeed a tall order.

As the statement submitted for the record by Railroad CFOs, Chief Financial Officers, including all seven Class 1 railroads attests, the financial demands on the industry are mammoth and they're growing.

The ability of the industry to meet its investment needs is in doubt, and any actions you take must not further diminish the resources needed to preserve and expand capacity to meet the needs of the growing economy.

If I might take issue with your question, Vice Chairman Mulvey, the industry not shying away from making those investments. We are in fact five times more capital-intensive than any other industry in this country, have for the past ten years averaged between 16 and 20 percent of investing all revenues back into the industry. So we recognize the opportunity, and we're stepping up to the plate as our resources allow.

It is not only rail jobs, but the jobs of the employees of all of our customers, that depend ion the continued viability of the world's most efficient freight system.

With that as background, let me turn to the task at hand, how to give small shippers their day in court while staying as true as possible to the principles of constrained market pricing.

First, we all agree that there is a class of rate cases suitable for stand-alone cost analysis. But the problem obviously comes when the customer believes that either the value or, I submit here today, that they believe that the merits of the case, do not warrant a full SAB proceeding.

The Board addressed this issue by promulgating the guidelines in Ex Parte 347, Subpart 2. Now I do not subscribe to the belief that no cases should have been brought under 347 Subpart 2, because it is too murky or too expensive.

Economic regulations in every industry are, by their nature, somewhat general. Only through their application in real world cases, with specific facts, can a body of law develop.

That is exactly what happened, and what is still occurring under Subpart 1 in the SAB cases. It is AAR's belief that the vast majority of companies represented on the next panel have the financial resources available to utilize the current guidelines.

Let us decide we do agree that there is some merit in addressing the reliability of the RCM calculation, albeit in a different manner than suggested by the next panel, and Craig Rockey will address that issue in more detail.

Beyond those customers who do have the resources for a Subpart 2 proceeding, some of whom by the way have higher market caps than our entire industry, we do believe that there may be a class of shipper, in fact there is a class of shipper who is so small that he cannot, as a practical matter, avail himself of the Subpart 2 guidelines.

As you recall Chairman Nober, I testified after you before both the House and Senate, that we would cooperate with the Board to try to develop a bright line test, to determine who is truly a small shipper and who would subsequently qualify for a simplified small case rate reasonableness procedure.

We believe that there should be a way to define a truly small shipper, through a combination of size of the company and annual railroad freight shipments, so that there is no need for any further analysis.

This determination would then qualify the case for a simplified rate reasonableness procedure. I am disappointed that the next panel does not concur that there is such a subset of non-coal rate guideline class of cases, and instead of addressing the small shipper issue raised in both the House and Senate hearings, is actually recommending even broader criteria to define what could be covered as a small shipment case than its last submission.

Should the Board agree that such a subset of small shippers is advisable, we stand ready to work with you to develop standards for a bright line eligibility test, and for expedited lower cost procedures.

In closing, I want to reference the testimony submitted by the U.S. Department of Transportation, drawing the Board's attention to the admonition in that testimony to be aware of the fact that the rail system is approaching its capacity; that more investment will be needed to meet the demands of the economy; and that any rate system developed by the Board must provide the appropriate incentives for the industry to make those needed investments. Thank you.

CHAIRMAN NOBER: Thank you. Mr. Parsons.

MR. PARSONS: Thank you, gentlemen. It's a pleasure to be here, although I'd rather be back home calling on customers. I come here today wearing two hats. I'm old enough to remember when railroad officers had to wear hats if you wanted your job.

Now the first hat I'll assume is that of the Short Line and Regional Railroad Association. I'm on the executive committee and board of that organization. Like everyone else int hat organization, the publicity surrounding this proceeding had alluded attention because of the word "small shipper."

I think the Short Line and Regional Railroad Association has great sympathy for small shippers. When Mr. Hamberger called and informed me that the definition of a small shipper was 4.8 million or less on an OD pair, 4.8 million or less on an OD pair, the thought suddenly struck me that on the Wheeling Lake Erie, we have no small -- we have no large shippers.

One hundred percent of the shippers on our railroad are small by this definition. The semantics obviously become small shipments from large companies, versus small shippers.

So Mr. Timmons is submitting testimony

to this Commission today, which I think well summarizes the Short Line and Regional Railroad position. But had it not been for the attention Mr. Hamberger called to this definition, the Short Line and Regional Railroad Association would have stayed out of this proceeding, and remained neutral.

But once the Executive Committee learned of the definition, everyone, and unusually so, were in agreement that this is not good. We do not need regulation of rates from customers that, for an example, and I don't mean to pick on a customer, but the first one, when Ed explained this to me, was U.S. Steel. We feel not too strong when we deal with U.S. Steel, or any other large customer, or even a small customer.

But that's the point here, that the Short Line and Regional Association support small shipper access, not small shipments.

Having said that, I'll put my other hat on, and as a member of the AAR Board and for the Wheeling and Lake Erie, just as a point of reference, we have approximately 900 miles of railroad in northeastern Ohio and western Pennsylvania.

We serve approximately 150 customers, and we have 500 employees. As a point of reference, we have grown the employment from 400 to 500 this year, because of increased demand for transportation of our rail services. Year-to-date, that increase is 19 percent over a year ago, which is unprecedented in my experience, a little over $50 million in revenue.

As the CEO of the Wheeling, and speaking on behalf of the AAR, I do not believe that we have small shipper rate problems. I would suggest that two years ago we surveyed all of our customers, with a fairly indepth attempt to understand what they thought of us.

Not one customer -- we had about a 55 percent response, which is very good for a survey of this type -- not one customer mentioned rates as an issue. Nobody.

Obviously the most important issue for customers using rail transportation today, and I can go back to the late 60's when I did market research in the industry, it's exactly the same today as it was then, and that's consistency of service. That's the Achilles heel of our industry. The problems don't change.

The current management at the Wheeling and Lake Erie has been in place 12 years, and for 12 years, we have poured 100 percent of our free cash flow back into the facilities -- cars, locomotives and track.

That's still not enough. We have just been awarded a $25 million RIF loan, which the investments have started. We have 30,000 ties in route and six miles of new rial. All $25 million will go back into the infrastructure.

Now if I'd have been paying more attention to this proceeding, I might have rethought taking that $25 million of debt on, even though it's at very favorable terms under the FRA program. Yet I thought our energies and resources would be devoted to something other than working with our customers and improving business.

We have four sales representatives on the railway and four marketing people, and I consider myself, and I think I am the chief marketing officer. Although our chief marketing officer would take exception to that, I feel that’s my role.

Fifty percent, over 50 percent of the revenue that we have on the Wheeling Lake Erie today comes from customers that did not exist, or sources that did not exist 12 years ago. That’s a remarkable story, I believe, for any railway or railroad.

I do not believe we achieve that by fighting with customers over unreasonable rates. As a matter of fact, I’ll guarantee we have never done that. Now if you ask any of our customers would they like lower rates, I am sure you would get an answer in the affirmative.

But I would like lower fuel prices, but it ain’t going to happen. Thank you.

CHAIRMAN NOBER: Thank you, very much. Mr. Rockey.

MR. ROCKEY: Good morning, gentleman. I'd like to address two topics this morning, the first being the analysis of the shipper proposal that's been addressed briefly before.

The AAR performed on behalf of the railroads two different types of analyses. One, the traffic exposure that was brought about by this proposal, and secondly, the potential revenue loss.

First, the traffic exposure. If one looks at regulated traffic, that is, above 180, not excepted by virtue of traffic type or car type or service, and also including contract.

I included contract in this, all but two percent of the over 20,000 OD commodity pairings that exist across the railway network qualify as small under the proposed shipper definition. Over two-thirds of all regulated revenue are classified as small. That's over $9 billion.

The new proposal of $7.2 million does not materially change these numbers, simply because they're so encompassing the first place. The 98 percent moves to 99 and so forth. The two-thirds of revenue goes to three-quarters.

I think my Exhibit 1 in the statement, which is a bar chart, is probably the most vivid or dramatic illustration of what is brought about by the proposed measure. That looks at all almost 100,000 OD commodity pairings across the network. It slots them into bars of $100,000 worth of rail charges.

For instance, the first being zero dollars to 100,000; the next being 100 to 200 thousand dollars and so forth. What one finds is that the first 48 bars, which of course are encompassed by the definition, represent more than 97 percent of all the OD payers in the United States. Only that last little bar out there on the end, which is all the other traffic, less than three percent, is not small.

Now to the possible revenue loss. Of course the shipper’s proposal was one of the an eligibility criteria and didn’t get to the substantive standard of what is reasonable and what is not reasonable.

But I took the liberty, without endorsing any of these measures, of looking at four. One is 180 percent; the average of RVC (ph) ratios above 180 percent and the two RSAM (ph) measures.

They generated revenue losses, if all the traffic was affected by the measure based on these four criteria, of anywhere from almost $3 billion down to $800 million per year, and this amounts to an equivalent of anywhere from six to 21 percent of the regulated revenues.

The revenues generated by the regulated traffic at the upper end, that would eclipse essentially all of the Class 1 industry’s income on an annual basis.

Lastly, with regard to the shipper proposal and beyond the obvious unworkable characteristics with regard to the proposal that I just noted, I would like to point out that, and as I understand them, some of the full-blown stand-alone cost cases that have been brought before the Commission, the Board, are in fact an amalgamation of individual small shipper movements, and would qualify as small shipper under the definition.

In that regard, we certainly believe that that would be totally unrealistic and unworkable.

The second subject is in regard to the filing of the shippers for this proceeding and the comments on RSAM. Clearly, the shippers have had a focus on our RSAM and some sharp criticisms of the RSAM methodology.

I think there are at least three criticisms which I would challenge, and one being the questioning of whether the Board's reasonableness standard should include a recognition of shortfall from revenue adequacy.

Secondly, I believe the six-step description of the sources and computations which underlie the RSAM appears to be me to be confused and inaccurate in places.

Lastly, the --

CHAIRMAN NOBER: Go ahead and finish.

MR. ROCKEY: The shippers postulate at the Board is wrong in the implementation of RSAM, and they assert that it improperly ignores the revenues of the traffic above 180.

I would submit that the purpose of the RSAM is to calculate a threshold target for that traffic, and what it has to achieve, and that in fact the revenues generated by the above 180 traffic are in fact irreleavnt to that calculation.

In the end, the conclusion is that the RSAM methodology should be reviewed, despite the fact that there is a lengthy detailed proceeding to generate the Sub 2 procedures in the first place.

We believe that a review of the RSAM procedures would be beneficial, and would treat a lot of the issues involved the small shipper debate, then we would certainly agree with that evaluation.

After all, we did also have some issue with RSAM on a technical basis, but clearly not the same ones and not to the extent that was voiced in the shipper statement. Thank you.

CHAIRMAN NOBER: Mr. Rennicke, of course we’ve all had a chance to read your statement, and if you’d like to take a moment and summarize.

MR. RENNICKE: Just a couple of points. First of all, analysis of the rate patterns, we've completed over the last four or five years for other reasons.

These were essentially for business and commercial reasons, since the revenue improvement programs did not, after looking at millions of rates, rail rates, show us any particular kind of pattern that discriminated against any customers.

In all cases, we found some rates were high, some rates were low, but there was not, as we looked at this again for other reasons, mostly for yield management reasons, did we come up with a finding where there was clearly patterns.

In fact, the work we were doing for the various companies we worked for was to look for patterns, and we didn't find them.

I think one of the key points I would like to make is that I think the increasing, the exposure of a significant portion of railroad traffic to regulatory action will complicate the railroads' ability to attract external capital for the needed financial improvements.

Already, we believe that the railroads have a difficult time, and because of several issues or occurrences that are external to this process, we think things are going to get harder right at the time possibly where additional funds are going to be needed for capacity improvements.

The hangover from the financial loss is suffered by many investors and lenders in the airline industry, who are in essence the same companies who are lending to the railroads, and often the same people and the same promoters in the companies, and the tightening supervision of investment by regulators and internal risk management and credit processes required by Basil II (ph), will increase the scrutiny of railroad investments.

Under the credit process of the last several decades, the capital attributed to individual businesses like rail is insufficiently risk sensitive at many banks today. Their credit and risk policy people have made that finding.

Given that, there will be an increased process that will look and calibrate much more of all aspects of the lending programs, to a risk potential. One of them, of course, that they will focus on is what is the probability of revenue loss for many reasons -- for competitive reasons, for business cycles.

But changing the exposure of the revenue base to regulatory scrutiny also will be something that will run into the processing model. I think those particular activities in an already difficult environment may get more difficult and more expensive for the railroads to attract the capital that they need. Thank you.

CHAIRMAN NOBER: Thank you. Well, Vice Chairman Mulvey, you want to begin?

VICE CHAIRMAN MULVEY: Thank you. I agree with you that the railroads do invest tremendous amounts, and I've been educated by you and the AAR over the years that they're several times, 18 percent versus three percent for manufacturing, I can quote the numbers, that you invest far more of your revenues in infrastructure than anybody else.

But you also said that you invest all you can do as resources allow. I think the issue is, is whether or not the resources are sufficient to allow you to invest enough, to not only meet the railroads' private need for investment, but also the larger public need for further growth and further investment than our nation's infrastructure. And we've talked about how to put together those public-private partnerships and who should be responsible for what.

One of the things that you mentioned in your testimony is that you suggested mandatory non-binding mediation. Wouldn't that just be talk and further delay without resolution? Wouldn't mandatory and binding arbitration or mediation be more productive?

MR. WARCHOT: Well, I think that a mediation, the non-binding mediation would in fact be productive. It would allow both parties the opportunity to share information about their respective positions, before positions were locked in in a litigation manner.

In fact, the interested parties' statement in the context of, I believe, seeking clarification through Board action with respect to the specific standards, did make a comment that the more information, the more intelligence that the two parties had about each other's position, and about the overall constraints they were operating within, does lead one toward commercial resolution of disputes or issues more readily than regulation would.

So I think there's a general feeling that mediation would be helpful, and also when we're dealing in a situation where you have a large carrier and perhaps a smaller shipper, who may not have received the same attention on the marketing side from the carrier as a larger shipper would, the larger carriers may not have the same marketing approach that Mr. Parsons has with Wheeling Lake Erie.

But I think just that opportunity to

share information does provide the basis or the opportunity for a settlement before parties get locked into a litigating position.

With respect to arbitration, we believe or mandatory mediation, which effectively would be arbitration, we don't believe that an arbitration process really would provide any different result ultimately than a Board proceeding.

It still is somewhat of an adversarial proceeding. You would still hopefully follow the dictates or the Regulatory guidelines of the Staggers Act and ICTA (ph), which would allow for the opportunity for railroads to earn adequate revenues and to differentially price their services.

You would have a decisionmaker assessing that. With all due respect that, we think, is what the Board should be doing.

VICE CHAIRMAN MULVEY: Okay, thank you. Could you explain how you arrived at the $2.9 billion loss in annual revenues, from adopting the shippers' eligibility test. I know you go through it some detail, but let me explain where I'm coming from on this.

It’s stated that the vast majority of all rail traffic would be eligible under the shipper’s bright lime test. But my understanding is that much more traffic would not be, because much rail traffic is competitive with other railroads and so would not be subject to the Board’s jurisdiction.

So it’s not the majority of rail traffic. It’s only the majority of regulated traffic, if I understand correctly. Do you feel that the $2.9 billion is the outside estimate? That it is the high end of it and, the $800 million is the low end of it?

You are talking only about the regulated traffic, not the unregulated traffic, correct?

MR. ROCKEY: That’s correct. I’m talking only about the regulated traffic, that which is above 180, which has not been exempted specifically, and the application to get to the 2.9 once that traffic has been identified, and we know the 4.8 criteria encompasses almost everything in the regulated arena.

To that, then, was applied those four criteria that I mentioned. Two of the three legs of the stool from Sub 2, and 1.8. And that's how the 2.9 came out. It's the high end of that proving.

CHAIRMAN NOBER: Why don't we do a couple of rounds, and we'll get back. Commissioner Buttrey?

COMMISSIONER BUTTREY: Thank you, Mr. Chairman. Mr. Warchot, I would like to ask you if you have any thoughts on the concept of how we might avoid, as a Board, sort of wandering off into the woods, so to speak, and doing some things that might cause considerable problems when this matter gets to the courts?

Because I think we all sort of contemplate that whatever the Board does here is going to wind its way into the courtroom fairly quickly, and I would be very surprised if it didn't.

I was wondering if you have any thoughts on how we might avoid really having, getting into a problem with court review on the standards that we adopt?

MR. WARCHOT: Well, that of course was the issue that took the AAR to the court back in 1996 on this issue, that was dismissed on ripeness grounds. That's the question of how the Board would apply the current 347 Sub 2 standards.

We do not take the position that the standards cannot be applied in a manner that's consistent with the Staggers Act, consistent with the principles that would allow the railroads the opportunity to earn adequate revenues and consistent with the opportunity to differentially price.

A formulaic approach using the three rations in a way that results in a system or a structure which drives all the rates down to specific revenue cost-ratio levels, or any specific rate level, that takes away from the railroads the opportunity to differentially price, would be something that we think would be inconsistent with the statute and inconsistent with allowing us to attract the revenues that we need.

So the approach that we would again advocate is that any application of the Sub 2 standards, as they currently are in effect, or any other approach that the Board may take, needs to adhere to those principles, of allowing the railroads to earn adequate revenues, and allowing the railroads to differentially price their services.

COMMISSIONER BUTTREY: Thank you. Do I get another question?

CHAIRMAN NOBER: Of course, until the bells go off.

COMMISSIONER BUTTREY: Mr. Hamberger?

MR. HAMBERGER: Yes?

COMMISSIONER BUTTREY: Good morning.

MR. HAMBERGER: Good morning.

COMMISSIONER BUTTREY: You had expressed earlier your desire for, assuming the Board did something in this regard and came up with new standards, you had expressed a desire to have fairly quick resolution of the matter.

I think we have about six months built into the process now, and some period of time before that to develop a record. What are your thoughts on how long this whole matter should take, in terms of, you know, the months involved?

Because I think it's in everyone's best interest that if we do this, that we come up with something that is better than what we have now. I'm not sure what it is we have now, but it hasn't really been tested yet.

But do you have any thoughts on how long this whole process should take, given the fact that you said that you were interested in a fairly quick resolution?

MR. HAMBERGER: Well, I assume that there are some dictates of the Administrative Procedures Act, which I am not conversant with, but that would probably provide some guidelines to that. So I don't really have a specific time frame.

But we are ready, as I indicated, should the Board indicate that you believe that establishing a subset of truly small shippers, who would then be eligible for an expedited process, I think we're ready to sit down and begin to work with you immediately.

CHAIRMAN NOBER: You have more time.

COMMISSIONER BUTTREY: Mr. Rockey?

MR. ROCKEY: Yes sir.

COMMISSIONER BUTTREY: The chart on page five of your prepared statement is a chart that sort of grabs one's attention. Any chart that looks like that, I think, would be, would draw most everyone's attention, when all the top, the large long bars are amassed over on one side of the chart there.

It seems to be your position that basically what a proposal like this would do would be to essentially re-regulate the industry, so to speak, when the attempt earlier was to deregulate the industry to the extent possible.

MR. ROCKEY: I think that is the practical effect.

COMMISSIONER BUTTREY: Would you comment on that?

MR. ROCKEY: The practical effect, yes sir.

COMMISSIONER BUTTREY: Thank you.

MR. PARSONS: I would concur with that.

That's exactly the way I see it, is re-regulation.

CHAIRMAN NOBER: I'm going to turn it out in a second. We'll start with Mr. Hamberger and Mr. Parsons. Is it the positions of the -- can I infer from your statements that it's the positions of the AAR and the American Short Line Association, that there needs to be some change in the current guidelines and standards?

MR. HAMBERGER: It would be our recommendation that you establish a subset of Subpart 2 for truly small shippers.

CHAIRMAN NOBER: So the AAR concurs. There needs to be some change. What about the Short Line Association?

MR. PARSONS: Yes, I'm not sure. That's a very specific subject.

CHAIRMAN NOBER: We'll get to what that is, but there needs to be some change?

MR. PARSONS: Without referencing subparts, I believe that the Short Line Association believes there should be some procedure for small, emphasis on the word "small" shippers, not shipments.

CHAIRMAN NOBER: Okay. I've heard a lot about, over the past year and a half, that -- your view that truly small shippers or small shippers ought to be the ones who have, who are entitled to relief under the Interstate Commerce Act, and that anything else would be re-regulation.

Under the current law, and I'm going to expand this to the whole panel, what rates are currently regulated? How would you all -- I mean, are the rates, are they -- are only small shippers' rates regulated, or is it traffic that's the railroad has market dominance, the RVC is over 180. Isn't that what's regulated currently?

MR. WARCHOT: Yes. That's right.

CHAIRMAN NOBER: So would altering the procedures to make them more useable, how is that re-regulating any rates? We're not -- they're the same rates that are currently regulated; is that correct?

MR. WARCHOT: We would submit that, as I mentioned in my opening statement, that if you are establishing procedures for this group of shippers or whatever the 347 Sub 2 criteria are right now for that group, that are not CMP guidelines for regulation, the type of regulation that you would impose is something which has not been recognized as economically valid regulation or regulatory assessment of the reasonableness of a rate, whether it be a rate -- I'm sorry.

CHAIRMAN NOBER: Isn't that a different question? You're saying larger shippers ought not to be able to have their rates challenged, but smaller shippers ought to be able to, and that allowing larger shippers to have their rate challenge is re-regulating those rates?

But that's different than constrained market pricing.

MR. WARCHOT: But what it's doing is getting the Board into the middle of what is currently a commercial arrangement. Right now, a lot of this traffic, for example, on Larry's railroad, moves under contract.

If all of the sudden these rates were

challengeable, one could infer that, as has happened in the larger rate cases, that those contracts when they expire would not be renewed, and there would be a spate of cases brought to you, getting you back into the middle of, in fact, determining what the rates should be, which is, in our parlance, of regulating those rates.

CHAIRMAN NOBER: Aren't they challengeable today? The contract rates aren't, but aren't, you know, rates that are under tariff, no matter what the size of the shipper, they're challengeable today, right?

MR. WARCHOT: They are challengeable today. Contract rates are not.

CHAIRMAN NOBER: Contract rates are not. But we wouldn't be changing none of what rates are challengeable, simply the procedures for how they'd be evaluated? I think that is an important distinction there.

MR. WARCHOT: But by providing what, that opportunity, it is going to really drive more rate cases, and it's going to drive and inhibit the contract rates.

CHAIRMAN NOBER: Let's say we were to agree with you all and say that okay, you know, your view that small shippers ought to be the ones who ought to have -- for whom there ought to be changes to the procedures.

How would we identify what those small shippers are? What guidance would you give us?

MR. WARCHOT: Well, as I indicated in my statement, I think it would be a combination of the size of the shipper and the annual freight rail revenue, rates paid.

CHAIRMAN NOBER: Well, we'll come back. Commissioner Buttrey, I mean, Vice Chairman Buttrey? I mean, Mulvey? It's been a long morning.

VICE CHAIRMAN MULVEY: I'll see this again. You're basically saying the universe of cases would expand if we did this, because when the contracts expired, they would come to us. But in terms of what we actually would cover would not change, but just we'd be a lot more busy.

MR. HAMBERGER: Yes.

VICE CHAIRMAN MULVEY: A couple of questions, on the exhibit on page five, you have on the vertical axis the number of OD pairs.

That's interesting, but wouldn't there be other more relevant measures for the vertical axes, for example, number of shipments, and how it would look if you changed that axis? Why is the number of OD pairs on that axis as opposed to the number of shipments made in those categories?

MR. ROCKEY: Well, I thought that was most relevant to the definition that was proposed by the shippers. Certainly we could array it by shipments --

VICE CHAIRMAN MULVEY: Well, it would definitely be a different cut on that, if it's quite as dramatic as it is here.

MR. ROCKEY: We can certainly do that, yes.

VICE CHAIRMAN MULVEY: Okay, thank you. Have any of you had the opportunity to look at the testimony provided by one of our witnesses later today, Mr. O'Connor of Snavely King. He has this win-win proposal. Are you familiar with that?

MR. WARCHOT: No, I have not seen that.

MR. HAMBERGER: We have not seen that.

VICE CHAIRMAN MULVEY: Well, that takes care of that question. You say that, in your proposed mediation solution, that it would be confidential, wouldn't that have a precedential effect.

If it didn't have any precedential effect, how would that be useful in helping us establish direction for future dispute resolutions? We would assume that every one of these would be *de novo* and it wouldn't establish any kind of pattern for us.

MR. WARCHOT: Well, I think that would be consistent with the, as we understand, the current 347 Sub 2 requirements, where they current would not have precedential effect.

We think that would work, because again, as you are departing from CMP guidelines, and as you are establishing a rate in the context where it's small enough that it doesn't warrant the full CMP treatment, then that should be the exception rather than the rule, and it shouldn't be relied upon to create a body of case law that isn't based upon sound economic principles.

VICE CHAIRMAN MULVEY: Basically you're talking about people in the status quo, with regard to our mediation efforts?

MR. WARCHOT: Correct.

VICE CHAIRMAN MULVEY: Okay. But unfortunately, of course, we haven't had much success with those. So Mr. Rennicke, a question.

You stated in your testimony that "Anything which increases the risk of exposure and the certainty of the railroad's revenue base is likely to dampen enthusiasm for funding additional investments to expand capacity."

But businesses run the risk of litigation of some sort every day, all of which can impact their ability to raise capital. Can you comment on the relative value of rate litigation to the all the litigation the railroads are party to, such as tort and general Commission litigation? Why is rate litigation especially of concern to the investment community?

MR. RENNICKE: Well, two things. First of all, you're absolutely 100 percent correct, in that we look at a railroad or any kind of company for a credit evaluation, we look at their exposure to all kinds of risks.

Today, history, whether the parties like it or not, has resulted in a certain level of rate matters or rate cases that are in existence. So that if you're looking for a pattern, if you're looking to lend on the basis of a track record, the track record has been that only a certain proportion of the railroad's overall revenue has been exposed to litigation.

When you expand the pot, even though you certainly have, you know, it's been "possible" to be regulated or discussed before, suddenly the probability of revenue loss increases.

It's that measure that the banks are going to start looking at, particularly under the new credit risk. They're going to start doing probabilistic adjustments of how much revenue will still stick with the railroad, and you're introducing another type of risk that was not there prior to the change in practices.

Therefore, they will in essence write down for some period of time, until they see history, how much revenue will in essence stick to the system based on history.

VICE CHAIRMAN MULVEY: Have the railroads had problems raising capital recently? I mean, you have a forecast of this tremendous demand, and there has been this great growth in railroad revenues. Hasn't that offset any potential for expanded --

MR. RENNICKE: In the last 12 to 18 months, I have found, primarily in the debt side of things -- I don't deal much with equity folks -- a very substantial increase in deals being turned down.

People who have lent billions of dollars in locomotives and rail cars, for example, have put a halt on any further railroad equipment financing until they can work through how some of these credit things are.

So it hasn’t closed the system down; it hasn’t closed off some of the opportunities. The loans haven’t stopped. But I would think you will see a progression of these kinds of things, as the credit and risk process tightens. Thank you.

CHAIRMAN NOBER: Commissioner Buttrey? We’ll get it right this time.

COMMISSIONER BUTTREY: We won’t call any names here or anything today, but I think without too much difficulty, we could all think of some large shipper companies that have considerable resources, considerable resources much greater than, say, a railroad. We can all think of those names.

Do you ever, and this is for anyone on the panel, can you think of a situation where you would have a huge shipper, corporate giant in one industry or market, that might end up being able to qualify for these new guidelines? And under what circumstances would that be?

MR. HAMBERGER: Well, I think Mr.

Parsons indicated one, in his testimony, U.S. Steel on his line, and Craig, based on your analysis, most chemical companies, plastic companies would qualify.

MR. ROCKEY: Yes.

MR. HAMBERGER: All of whom are --

MR. PARSONS: In our customer base, ExxonMobil, Chevron, Phillips.

COMMISSIONER BUTTREY: Thank you. Well, let me stick with that for a moment. If we were to, you know, take the view that we should create a distinction based on the size of the shipper, where in the Interstate Commerce Act would we look for support for that?

Where does the statute talk about the relative size of the shipper, and how would we take that into account under the Act?

MR. HAMBERGER: What I think we're trying to say is that the size of the shipper and the size of the shipments allows an inference that the value of the shipment does not yield a stand-alone cost case.

That's how you draw that inference and

that it would be the size of the shipment that would evolve from a small, truly small shipper with not very high rail business.

COMMISSIONER BUTTREY: Anyone else have any thought? What about the -- would it have an impact on the market dominance test, where we try to look at what are the different factors that go into whether or not a carrier is market-dominant, and does size factor into there?

MR. WARCHOT: Well, I don't think we're trying to be inconsistent. I think that the size of the shipper, a truly small shipper, again based upon the annual revenues or the amount of the shipments, we can make a presumption that would be of a value that would satisfy the requirements of the statute. I don't think that would have to really be inconsistent with a market dominance determination.

COMMISSIONER BUTTREY: How would you take into account the market relationship between a carrier and a shipper of any sort? I mean, how would a bright line test account for that, other than size? Is that your proposal? Is there any other way that we could look at that?

MR. HAMBERGER: Well, for the truly small shipper, we're trying to create a safe harbor, trying to be responsive to what appears to be, although Mr. Parsons would, testimony would indicate that maybe there is not a ground swell out there among truly small shippers.

But if there is, then we're just trying to be responsive to that, and create a safe harbor for truly small shippers. Those who are not in that category do have the option of going through Ex Parte 347, Subpart 2.

That does have a series of steps to prove eligibility, and you know, so I've looked at them. They're not particularly onerous. It seems to me that people could decide to come forward and see what the Board says.

COMMISSIONER NOBER: In the past, the railroads have supported a, rather than looking at modifying the existing guidelines, which you have challenged in court as arbitrary and capricious, have instead urged us to look at a simplified SAC.

Have you all given up on that as a view? Is that no longer your position?

MR. WARCHOT: We have not given up on the view that there might be an approach that could simplify the SAC process. We are somewhat pessimistic, in terms of trying to find a way of doing that, but we have not ruled out that as an option.

COMMISSIONER NOBER: Well, how would you square your view that the existing guidelines are sufficient for many shippers, with your view in court that they're illegal?

MR. WARCHOT: Well again, our view was that the guidelines, as they have been stated, are, if you will, vague to the extent that we are not sure that they would be applied in a manner which again would adhere to the Staggers principles of differential pricing and revenue adequacy.

So as we've said in our written testimony, as we've said before, we are not saying that they are necessarily unworkable. It will depend upon how they are applied, what factors are taken into account, and how they are justified in the application in specific cases.

CHAIRMAN NOBER: Commissioner Mulvey?

VICE CHAIRMAN MULVEY: Clearly you feel that the large firms, even if they have small shipments, should not be included in the small rate category. But isn't this somewhat discriminatory against firms, just because they are large? I hate to say it but I am sympathetic to some of these very, very large firms.

But the reality is, of course, some of these relatively firms are broken up into divisions, and in fact some of these very large firms in the past have failed. We all know large railroads, for example, in the past have failed.

So large firms can still fail, and still have very, very marginal revenues and still wind up out of business. Chairman Nober, in his opening statement, pointed out the importance of this issue, because of what's happening to manufacturing in this country.

So there are large manufacturers who

might say “”Well, look, we can’t get relief before the Board. Our rates are too high. We’re going to move our facilities offshore.”

So I question whether or not we should be excluding firms from access to the Board, simply because they happen to be large in some sort of grand overall corporate definition, but may not be large with regard to their rail movements.

MR. HAMBERGER: Thank you, Vice Chairman Mulvey, because you really, sort of I think, lay it out very well. I think we need to go back to home base, and home base is that CMP principles are what govern your ability best to determine what is a reasonable rate.

As you begin to move away from that, you begin to then get, as the ICC has said, into a cruder analysis. As you move away from that, that put more and more revenue at risk for the railroads, under a cruder analysis, then you run the greater risk that the railroads will never earn their cost of capital, and we have the devolving investment spiral that we saw in the 70's.

So there is that balance, and what our argument is, is that the larger firms have market power. They oftentimes bundle their contracts. They do have, although I guess it’s not supposed to be said in this hearing room, product and geographic competition does exist out in the real world.

So those firms have other ways to have leverage, to negotiate with railroads, and that if we’re going to create a safe harbor, that is not going to use CMP principles, we want to do it for those who truly need it, who do not have other options and by putting the least amount of revenue at risk for the railroads.

So the further away you move from the CMP principles, the smaller amount of revenue should be included.

VICE CHAIRMAN MULVEY: Okay.

MR. PARSONS: I would add to that there are about 500 railroads that are very small, whose customers generally speaking are larger than they are and have more power.

VICE CHAIRMAN MULVEY: There may be some

way of taking into account the existence of bilateral monopoly. I know we no longer deal with product or geographic competition, but in case you do have a large buyer of railroad services, versus the railroad being a monopoly seller, bilateral monopoly theory suggests that they might want to come to some sort of arbitrator or mediator, or market-based result.

Let me ask you all another question, and that is the railroad's problems do seem to be clearly related to their infrastructure. It's the only reason for having Ramsey pricing or price differentiation –but the whole reason for Ramsey Pricing of course is to allow the railroads to earn sufficient revenue so that they can invest in what is an extremely high cost to maintain capacity.

Yet on the other hand, the other approach to that, would be to find other sources for investing in railroad infrastructure, which would ameliorate or alleviate some of the pressures on the railroads, and would reduce their need to engage-- –in price discrimination. It's not so much that people disagree with Ramsey pricing, it's the degree and extent of it that some shippers object to.

But the railroads have opposed getting substantial Federal investment. We've talked about this before, things like a rail trust fund. Do you want to comment on that?

MR. HAMBERGER: I'd like to comment on that, and then, if I have time, and then ask Mr. Rennicke perhaps to give an international flavor to the answer as well, by starting out by saying that we do have the world's best freight rail system, and it's not an accident.

The reason that we have not turned to the Federal government for subsidies is because with those subsidies come Federal strings, and we do not want the Federal government back in the business of telling us how to run the railroads.

We do believe that there is room for something called a public-private partnership, as outlined in the American Association of State Highway and Transportation Officials' report last year, called the "Freight Bottom Line Report," where they have concluded that public benefits demand a partnership with the private freight railroads, state and local governments and the Federal government, to invest, to accomplish and get the benefit from a rate standpoint, from an energy standpoint, from a congestion standpoint, from the lower cost to shippers standpoint, more freight moving by rail.

Now we have entered into, as you know Commissioner Mulvey, a partnership with the state of Illinois, City of Chicago and hopefully if there's ever a Federal bill, the Federal government, to fund a project in Chicago, whose acronym is CREATE.

We are not looking for a subsidy. We have put our money on the barrelhead to pay for the benefits, as measured by improved operations in the City of Chicago, in the terminal area.

That analysis has been reviewed by the state of Illinois and the City of Chicago, and has gotten their imprimatur.

So we're not looking for a subsidy, but we are open to other idea of public-private partnerships, where we pay for the benefits that the private sector railroads receive, and the public, quite rightly, recognizes the benefits that the public receives and pays for those.

CHAIRMAN NOBER: Mr. Hamberger, I think the answer you gave at the beginning to Commissioner Mulvey, was what I was trying to get at before, which is when you look at the various sizes of shippers, what are the real world factors that you face, and how should we take that into account in looking at whether or not there really is market dominance?

I was hoping you'd get -- at least I was looking for what are those factors, to try to lay them out.

Let me turn to mediation for a minute, because that is, in something that I hear, that I've heard in my travels all along, from both carriers and shippers is, you know, larger, more broad-based shippers do have a lot of -- and carriers themselves.

There's a real market negotiation that

goes on between the two of them, and I'm not sure how a bright line regulatory test takes account of that. I was asking for you guys' help on what you might think.

In terms of mediation, in your statement you said you that we should only try mediation after we've determined market dominance. Doesn't that -- we don't do that in the large rate case context.

MR. WARCHOT: Well, I think this does --

CHAIRMAN NOBER: It would be acceptable to do it the way we do in the large rate cases, which is when you file a case, we start mediation.

MR. WARCHOT: At the time you file the case. That would, I think, would be an approach we'd be willing to look at. There is no -- it would help to have it earlier to weed out the cases, but I think these are approaches that we'd be open to look at.

CHAIRMAN NOBER: Because in the large rate case, we've only had one that's gone to mediation. But when you file it, you have to make a market dominant showing in that too, and we appoint a mediator.

Although, I think if we went down the mediation path again, we'll have the parties pay this time, because we just can't afford it.

MR. WARCHOT: You know, part of the problem, of course, would be the resources. If it was easy to file a case just to start a mediation process, with the idea of it just going to mediation, that would put, you know, a potential strain on the large carriers' staff in theory. But it's something we would certainly look at.

CHAIRMAN NOBER: What would be wrong with that? Let's just say there's $150 filing fee and everybody who files a case gets mediation, non-binding mediation?

MR. WARCHOT: It would be something we would address, yes.

CHAIRMAN NOBER: Okay.

VICE CHAIRMAN MULVEY: No more.