SURFACE TRANSPORTATION BOARD

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THE 25TH ANNIVERSARY OF THE STAGGERS RAIL ACT OF 1980: A REVIEW AND LOOK AHEAD	STB Ex Parte No. 658

Room 760
Mercury Building
1925 K Street, N.W.
Washington, D.C. 20423

Wednesday,
October 19, 2005

The above-entitled matter came on for hearing pursuant to notice at 9:00 a.m., Roger Nober, Chairman, presiding.

BEFORE:

THE HONORABLE ROGER NOBER	Chairman
THE HONORABLE W. DOUGLAS BUTTREY	Vice Chairman
THE HONORABLE FRANCIS P. MULVEY	Commissioner

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P-R-O-C-E-E-D-I-N-G-S

9:04 a.m.

CHAIRMAN NOBER: Okay. Good morning. The hearing will come to order. 25 years ago Congress passed the Staggers Rail Act of 1980 against the backdrop of the U.S. railroad industry that was clearly in crisis. The plight of the railroads at that time is now documented. Low returns on investment, widespread bankruptcies, insufficient capital for maintenance and improvement and unsatisfactory service.

Now, the five goals of the Staggers Act, as expressed in that legislation, were to assist railroads in rehabilitating the nations rail network to meet the demands of interstate commerce and national defense; to reform federal regulatory policy to preserve a safe adequate economical efficient and financially stable rail system; to assist in the preservation of the viability of the rail network in the private sector; to provide a regulatory process balancing the needs of railroad shippers in the public and to assist in the rehabilitation and financing of the nation's rail system.

Now, we have certainly come a long way in 25 years and I think it's fair to say that the Staggers legislation gets a lot of credit for that. However, it's also clear from today's testimony that significant areas of concern remain. While in 1980 the focus was more on the financial health of the railroad industry, today there are more concerns about competitive climate and service issues.

In many ways, the rail roads have returned to financial health. While railroad revenue adequacy was a distant goal in 1980, today that goal appears close to being achieved for some carriers. At the same time, the industry is experiencing noticeable capacity constraints in some areas and we must grapple all of that -- we must grapple with what all of that means for our regulatory process.

Now, we scheduled this hearing today to explore these issues in an open forum to which all the stakeholders have been invited. I appreciate the widespread interest that this hearing has generated and look forward to the testimony of all of our witnesses. There are some of the most interesting questions facing our agency and the stakeholders that will be discussed today and I look forward to an open and somewhat extensive dialogue on them all.

Now, before we begin, let me just take a few minutes to review a few procedural points about today's hearing. As you may or may not know, we have over 40 witnesses today presenting testimony on behalf of 35 entities. We have split the day into morning and afternoon sessions to give each of the witnesses a better understanding of when they will be presenting. But this is a hearing and it is impossible to estimate in advance how long it will run or when any one individual witness will testify.

I will say that I ask all witnesses to, please, summarize their oral statements in the interest of time. I think I can speak for everyone and say that we have all read each of your full statements and you should not feel obligated to use every second of the time allotted. And consistent with our practice, we will allow all the witnesses on each panel to make full presentations before the

Members ask any questions.

And, you know, we will rotate among the Members by five minutes at a time. Now, finally, as all of you may know, my term here at the Board expires at the end of the year and I announced last week that I will not be seeking another term as Chairman. So while I may be interested in these issues, I have to confess that my views really aren't that important, since the answers to the questions raised today will be faced in the future by my colleagues or by future Board Members yet identified.

To put today's hearings in perspective, it certainly was unimaginable that three years ago we would be having a hearing where the main concerns were that the railroad industry was too healthy and that they were too financially sound. But I'm pleased that we're able to do it nonetheless. So with that, I certainly look forward to, you know a very interesting and provocative day of testimony.

I know I have a lot of questions and I'm sure that my fellow Commissioners do as well. And with that I will recognize Vice Chairman Buttrey for any opening statement he may have.

VICE CHAIRMAN BUTTREY: Good morning. We have got a lot of track to cover today and I don't want to reduce our velocity with a lengthy opening statement. I've read the statements, so I would hope that those who come with oral presentations summarize their remarks, so we can reduce dwell times as well. I have three guiding principles that will govern how I view these proceedings.

Few, if any, really good solutions originate in the halls of Government. Two, any suggestion that all rail resources are being efficiently and equitably allocated will be met with skepticism. And three, the free enterprise marketplace is almost always the best arbitor of all commercial activity.

I had a boss once who was fond of saying bring me solutions, not problems. If we are not smart enough to figure out how to serve our customers, someone else will. That admonition seems to be particularly applicable to our proceedings today. Thank you, Mr. Chairman, and I look forward to hearing from all of our witnesses.

CHAIRMAN NOBER: Thank you. Commissioner Mulvey?

COMMISSIONER MULVEY: Thank you, Chairman Nober. Before I begin my statement, I want to take this time to thank Chairman Nober for his service to the Board, his service to the railroad industry, and his service to the people of America during his tenure as Chairman of the STB. He has done a great job and I've enjoyed working with him tremendously. Thank you very much, Roger.

(Applause)

CHAIRMAN NOBER: I haven't left yet.

COMMISSIONER MULVEY: Oh, I'm sorry, I thought you were leaving.

CHAIRMAN NOBER: Shortly.

COMMISSIONER MULVEY: I want to add my welcome to those panelists who are attending the hearing today. As we debate the impact, the effectiveness, and the future of the Staggers Rail Act, I would like to start off by noting the obvious that the Staggers Rail Act has clearly helped the railroad industry. It has helped the large railroads to rationalize their route networks, reducing substantially the miles of line.

It has helped many small railroads to prosper and grow in numbers. And all railroads are now able to negotiate rates and enter into private contracts with the shippers, making them more competitive with the trucking industry. On the other hand, railroad labor has seen its numbers dwindle over the years, particularly the organized brotherhoods. Many short lines and their customers are limited by paper barriers that restrict their options.

Many captive shippers have struggled with the results of differential pricing, although it's clearly necessary for the railroads financial health. Nearly all shippers are concerned about access to the Board's procedures, especially those tendering smaller shipments. Furthermore, despite the productivity gains that the railroad industry has achieved in the last 25 years, the Class I railroads still do not earn their cost of capital or do not earn adequate revenues, at least as calculated by the Board.

Meanwhile, the system has experienced a serious capacity crunch and we have no national strategy to ensure that railroads meet the capital investment needs of our nation's rail infrastructure. Indeed, our national rail policy has not really undergone substantial change in the last quarter century. By contrast, our highway and transit policies are reassessed every six years through the reauthorization process and our aviation policy is reassessed even more frequently.

Of course, this reflects the fact that our railroads are privately held and that our highways, airways, and transit rights-of-way are publicly provided. Nonetheless, private ownership per se should not be a barrier to establishing a public policy to support rail infrastructure development. With these interests in mind, I am pleased that we have gathered here today to take a critical look at the state of our national railroad system and our regulatory rail policy in this post-Staggers era.

This hearing, I hope, is only the beginning of a larger reassessment effort that will take place over the next few years and will include studies by the General Accounting Office, I'm sorry, the Government Accountability Office and the Transportation Research Board. I'm certain there will also be Congressional hearings on the matter in addition to conferences around the country addressing the rail needs of the nation.

By engaging in this collective endeavor to review our national rail policy, it is my hope that by the time we reach the 30th anniversary of Staggers, we will have a clear and substantial record as to what the successes have been, what challenges remain and most importantly how Congress, this Board and the railroad industry can best meet them. Thank you.

CHAIRMAN NOBER: Okay. Well, thank you very much. And before we begin, just a couple of administrative notes. First off, we'll typically, you know, as is my practice, call the panels and go from my left to my right. So I think where you speak will depend as much upon where you sit as anything else. Secondly, if there -- we have an overflow room up on the eighth floor for extra folks. And I would ask if there are Board staff who are here who could head up there, that would probably be helpful so that we can let the folks who are with the witnesses to sit down in the hearing room.

And I think we are closed-circuit televising it up there as well. But if we need more room for stakeholders, we can put folks up on the eighth floor Board room as well. We'll have a closed-circuit TV to this. And with that, why don't we start? Our first witness is from the U.S. Department of Transportation, Paul Samuel Smith, who is, I guess, in our frequent witness club, speaking on behalf of the Department of Transportation of the United States. Mr. Smith?

MR. SMITH: Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey, good morning. My name is Paul Samuel Smith and today it is again my privilege to represent the United States Department of Transportation. In this proceeding, the Board properly takes stock of the 25 years since passage of the Staggers Rail Act of 1980. The Department of Transportation considers the Act a resounding success.

We do so because in sum the statute did what it was designed to do. It revitalized the railroad industry and by so doing benefitted shippers and consumers throughout the economy. 25 years ago this was an industry, as you have said, marked by decline in all major respects. High rates, low returns on investment, eroding demand, low model traffic share and excess capacity.

Of course, in 2005, all of these factors had been reversed. Average rates are down, return on investment is up, demand is robust, model traffic share has increased and capacity is increasingly scarce. In fact, capacity constraints are no longer confined to cyclical harvest shortages of hopper cars or to the influx of Christmas and holiday goods from Asia.

Obviously, overall, economic growth and other factors have played a significant role in this turn around. But the dramatic overhaul of economic regulation brought about by the Staggers Act has been absolutely essential. Not withstanding these other developments, continuation of the prior restrictive regulatory regime would likely have doomed the rail industry to a much reduced role in today's transportation sector.

A price was paid, of course, in the railroad's reversal of fortune. Some might point to the existence of far fewer railroads or far fewer miles of track or far fewer railroad jobs. We suggest, however, that these reflect considerable efficiency gains that have, in fact, largely been passed through to consumers of rail transportation, the shippers. Others made a cry that captive shippers pay rates based upon their demand, rather than upon average costs.

But rail carriers absolutely must have this ability to survive and compete. Captive shippers overall are better off, because they do not have to bear the entire fixed costs of rail networks. DOT does agree that implementation of the Staggers Act has not been perfect. Major rail cases consume a great deal of time and money and can only be brought by the largest of shippers. Smaller rate cases simply aren't even brought.

We commend the Board for its past efforts to refine its processes in this regard and we encourage continuation of that effort. But the primary challenges facing railroads, shippers, the Government and others today are those resulting from industry success. And since that success is largely owing to the Staggers Act in its implementation, it is the Department's central message in this proceeding that resolving those challenges must not jeopardize that success.

For example, it is clear that capacity expansion is necessary to the continued vitality of rail carriers and to the nation's economy. In this capital intensive industry, that requires returns adequate to the purpose over an extended period of time. But the rate making methodologies now in use were developed for a very different industry of a quarter century ago. They basically attend to assume adequate capacity, rather than recognize the need to expand it.

It is imperative that rate making provisions be appropriate to the industry of today and tomorrow. The Department will certainly participate in such proceedings, which are designed to work within the framework of the Staggers Act to this end. That concludes my prepared presentation. I would now like to try and answer any questions you may have.

CHAIRMAN NOBER: Thank you very much. Vice Chairman Buttrey, do you have any questions?

VICE CHAIRMAN BUTTREY: I would just like to ask you if you boil down all that information into a crucible and you apply the highest possible heat is it safe to say that what really happened in Staggers is that the Government got out of the way and let the private sector do what the private sector does best?

MR. SMITH: I think that's fair in large measure, not completely, of course. There is still a need, in the Department's view, for some federal oversight since, of course, the rail industry is not competitive in the way that industries with much lower barriers to entry are. But where railroads can be and must be competitive, yes, the Government does need to get out of the way.

VICE CHAIRMAN BUTTREY: Thank you.

CHAIRMAN NOBER: Commissioner Mulvey?

COMMISSIONER MULVEY: You have testified about how the infrastructure expansion needed to accommodate DOT's own projections of the growth of rail freight traffic will require substantial investment and that railroads need incentives to expand capacity. Could you elaborate on the incentives that the Administration supports, particularly public financing?

MR. SMITH: Well, the Department, pursuant to Administration, has been appearing in various fora for some time now indicating the Federal Government's willingness to explore public/private partnerships. Obviously, there are some examples of this and we recognize that given the capital requirements and the long lived nature of railroad facilities that purely private sector sources funding may not be adequate to the overall task and so we are willing to explore incentives, obviously, Government areas or Government levels rather over -- other than the federal level or also involve even locally.

For example, the State of Virginia

contributes to local VRE services, which, of course, are run on track, they are owned by CSX and Norfolk Southern, to some extent. So there are certainly opportunities to be had out there. We are exploring them. We recognize that those are kind of beyond the scope of Staggers and this Board as well, but they -- that's just to say that the challenges are not purely regulatory challenges and not purely for any single agency.

COMMISSIONER MULVEY: That's a challenge not only for rail infrastructure, but also highway infrastructure as well.

MR. SMITH: Right.

COMMISSIONER MULVEY: Recently, the House T and I Committee, proposed $375 billion for the highway system and I think we wound up $90 billion short of that. Clearly, if we're going to meet the nation's goals for economic growth and development, we have to have the infrastructure to support it. The question I have is what is the Administration's view of what the federal role should be in developing both public and private infrastructure needs?

MR. SMITH: Well, as someone said earlier, there is -- the infrastructure of the rail network is private as opposed to the other transportation sectors.

COMMISSIONER MULVEY: Yes, I said that.

MR. SMITH: Which the Federal Government plays absolutely a major role. But increasingly, federal highway funds which traditionally, of course, have gone to the roadway literally are available to those state and local Governments that make the decision to spend some of that money for the assistance of rail facilities. So even with the existing legislation and policies in place, that's an indirect federal support, but often has to be agreed upon with other levels of Government. And we are looking to consider more direct federal rail financial assistance, but that admittedly is in early stages.

COMMISSIONER MULVEY: Did the Administration give any thought to an idea that was advanced a couple of years ago about developing a Railway Trust Fund similar to the Highway and Aviation Trust Funds?

MR. SMITH: I know it has been thought about, but I don't -- obviously, it hasn't come to fruition and I can't announce anything like that today.

COMMISSIONER MULVEY: Okay. Thank you.

CHAIRMAN NOBER: Let me ask you a couple of questions. The first is in much of the later testimony this morning we will hear that, I think, the shippers feel that when the Staggers Act was passed there were 35 plus Class I railroads. The number always seems to change a little bit and now there are seven and that services were -- so QED mergers were bad. What's the Administration's view of that?

MR. SMITH: I think although there certainly have been a large, large number of mergers and on each occasion the ICC first and then the Board sought to ensure that no rail shipper that was thereby at least two carriers received less than that, it was conditions. And, in fact, the UP-SP merger was probably the best single example of that where Burlington Northern received roughly 4,000 miles of track rights primarily to serve that need of the shippers.

And so from that perspective, we're not aware of any merger related gain in the number of captive shippers. Obviously, there is continuing concerns about the ability of the captive shippers that do exist to realistically bring their cases, because it cannot be that in 25 years every other than -- major shipper has always been satisfied with her or her rail rate. But that's another problem.

CHAIRMAN NOBER: No, I've spent a lot of time on that in the past three years and we have had one small case brought. But I'm puzzled as to why there haven't been more. Secondly, I think, much of the testimony this morning will talk about the fact that the Board ought to, you know, revisit some of the core doctrines of the Staggers Act, including the bottleneck, the Midtec and paper barriers. What's the Department's view of those calls to change those doctrines?

MR. SMITH: I think it is appropriate as a general matter in light of the very different industry we have today for the Board to consider seriously the major decisions it made in the past 25 years, the ICC made in the last 25 years. Determine if they are still appropriate. We have mentioned specifically in our testimony, of course, rate making, but there are certainly others, such as those. We're not taking any position right now on any of those, but it is fair as a general matter, of course, to reconsider in light of very changed circumstances.

CHAIRMAN NOBER: And on rate making, you know, you indicated that your view is that we should, the Board should look at rate making doctrines appropriate to induce capacity. What would that be? What would a doctrine be that would -- I mean, the carriers would say, you know, what would a rate making doctrine appropriate to induce capacity look like?

MR. SMITH: Well, it might entail, it would entail an examination of whether the current standards and precedent would find reasonable -- the continued historically higher rates, recent historic rates to expand capacity. And whether there would be incentives once those rates were reasonable perhaps whether they would be actually used for the purpose or to extend the use for purpose as opposed to just some other corporate desire. There's also lingering, historically it has never meant anything, but the lingering, as you said, approach or concern that there might be for revenue adequacy and how once the carriers to achieve that which, of course, one can project now with consideration of other conditions, one could project that now, how that would affect the outcome of rate cases.

CHAIRMAN NOBER: That was going to be my next question. If railroads became revenue adequate, how do you think that would affect rate cases, large or small?

MR. SMITH: Well, I'm not sure that I am personally aware that it has ever been spelled out what would happen in that case.

CHAIRMAN NOBER: Okay. That's one of the questions of today.

MR. SMITH: But I believe that it was always understood, if not expressed, that that would be a factor that would weigh in the balance on the side of a lower, rather than a higher, rate in some fashion, very gently speaking. And since it is now in prospect that some of the Class I's will be achieving revenue adequacy, then we have to -- I think it is wise to determine whether that should still be understood or not or even fleshed out as to figure out what exactly that does mean.

Because even with revenue adequate carriers and even with relatively, in some places at least, scarce capacity, it's also discomforting to think that some captive shippers might be forced to pay beyond some unknown level that would indeed contribute to the fixed cost and to the returns necessary for capital investment.

CHAIRMAN NOBER: Well, let me ask one final question, which is something that will be a theme of today, which is we have never had a revenue adequate railroad, at least, not in anybody's, you know, effective lifetimes. What would one look like? I mean, what would you say some of the indicia of a revenue adequate railroad would be, that the Board has never found before? I mean, obviously, earning your cost of capital is a mathematical equation. Being deemed revenue adequate is a legal conclusion.

MR. SMITH: I have been under the impression, perhaps mistakingly, that a railroad that was found to have earned the cost of capital, at least over some time, was very, very close, legally, to being considered revenue adequate. And so I don't know what other factors would go into that legal conclusion. I suppose that it is possible that there are some, because again that has not been the case in living memory that that is another question that the Board might ask is whether -- are there any other factors that determine that? And it may well be that there aren't.

CHAIRMAN NOBER: Well, just, you know, for one year, three years, you know. Somebody once joked to me 22 years, you know, what? That's just something that, you know, a Board will, at some point, have to grapple with.

MR. SMITH: That's right. Yes.

CHAIRMAN NOBER: All right. Anything else?

COMMISSIONER MULVEY: I was just going to add, what Roger was driving at, is that a single year of revenue adequacy of one railroad does not make the industry revenue adequate. How many years must we observe railroads earning their cost of capital in order to declare them revenue adequate? And then the question, of course, is are we accurately and appropriately measuring railroad returns? What is the appropriate measure of those returns?

We use return on investment. There are some who suggested in their testimony we should use return on equity. Others suggest that we should use the cash flow. There are a lot of measures of financial performance and we'll hear from the finance people later on.

Does the Department have any view as to what's an appropriate measure of railroad financial health?

MR. SMITH: We have not to date and do not now. I think that I'm well aware that different parties have championed different indicia of that. That way will, obviously, go on and perhaps you would have more meaning as railroads make more money however measured.

CHAIRMAN NOBER: Yes. And sort of following on to that, I mean, if railroads are financially healthy, what is a fair contribution from captive shippers? I mean, what is that? I mean, I don't know. I don't know if anyone knows, but that's a question that's certainly -- you know, I think everyone is going to grapple with and hopefully will be some good discussion about today.

MR. SMITH: Right.

CHAIRMAN NOBER: Okay. No further questions? Mr. Smith, thank you again for coming and we'll turn to our next panel. We have representing the National -- do we have an extra chair? There is one over there. Rudy, we have an extra chair. Okay. We'll have enough chairs for everyone. We have John Ficker representing the National Industrial Transportation League, Charles Van Vlack representing the American Chemistry Council.

I think it is probably easier if you sit in the sort of left, you know, from your right to your left in the order that you're goinē the panel.

MR. KEITH: On behalf of 900 members of the National Grain and Feed Association, we appreciate the opportunity to be here today to present our views. We think that the Staggers Act has led to many positive outcomes. The railroads have become more profitable, which must continue if rail capacity is to grow. The flexibility created by the Staggers Act gave railroads the ability to better compete for freight, but it also gave the railroads the market power to define the scope of their business and the types of markets that they want to serve.

This has had both positive and negative impacts for our industry. Regarding rail capacity, our members are greatly concerned about rail capacity going into the future. In 1980, the railroads carried 50 percent of the commercial grain movements in the U.S. Today, that number is about 35 percent. While railroads have become more efficient at moving grain volumes between points through shuttle and unit trains, the rationalization of their infrastructure has led to loss in grain volume to other modes, primarily truck.

There is concern in our industry whether ag shippers can effectively compete with other industries for available rail service going into the future. In today's marketplace, this is brought out in rail service trends. Train speeds for intermodal traffic exceed train speeds on other types of traffic by as much as 50 percent. Ag shippers face more difficulty in obtaining predictable rail service.

While intermodal traffic profitability is beginning to increase, we face the situation today where those rail shippers who pay more including some ag shippers are receiving inferior service. This situation confirms that the U.S. and agriculture, in particular, confront a huge freight capacity challenge in the years ahead. To enhance rail capacity, shippers have been required to invest heavily in private rail cars, rapid loading facilities and other equipment.

Today private cars make up 65 percent of the hopper car fleet, 100 percent of the tank car fleet. Owning a private car sometimes can be beneficial in receiving better service commitments.

But if there is surplus capacity that develops, the rail carriers tend to pluck the private cars first, thus creating more ownership risk for the shippers than for the carrier.

Regarding rail rates, the long-term trend in published real freight rates has been declining. But rail rates are only one component of the total cost of transportation. Considering the ownership increase in private cars and required investment in new plants and equipment, the actual trend in total real cost for transportation is less certain.

Over much of the life of the Staggers Act, average grain rail rates have not posed much of a problem, but differential pricing has proven to be a chronic issue for some captive shippers. Differential pricing has been viewed as the appropriate way for railroads to set rates, but just as clearly Congress intended for limits to apply to such pricing in captive situations, and that there be a process established that allows reasonable access to rate relief.

We don't think that exists today for small rate cases. We would urge the STB to provide for a more transparent regulatory system for small rate cases that permits the rail customer to evaluate individual situations and for the carrier to accurately determine the risk of losing a case before the STB.

Next, I would like to speak to customers and carrier's business relationships, which seem to have deteriorated in the last 10 years. We think some of this conflict arises from a carrier's ability to dictate business terms that are costly or unreasonable to the customer.

One example is the grain process, which has been required to purchase tank cars to obtain any kind of rail service for liquid food products. Then when railroad service deteriorates, those same shippers are forced to lease additional cars to make up for the poor performers just to keep plants operating. Then when car cycle times improve, the cars become in "surplus capacity" and the railroad assesses storage charges for the cars. Thus, the shipper is penalized in two ways for unpredictable rail service.

Another example of railroads dictating business terms is rail fuel surcharges. Analysis demonstrates that some carriers' average surcharge exceeds not just the increase in fuel cost, but actually exceeds the total cost of fuel for the average shipment. A carrier's ability to assess exorbitant fuel surcharges is another indication of a lack of effective competition among carriers in the near term.

It also should be noted that there is a wide divergence in railroad policy on fuel surcharges. The BNSF Railway recently announced it would ship to a mileage-based surcharge more directly related to fuel cost. The Canadian National has announced two reductions in its fuel surcharge assessment since April of 2005. These carriers should be commended for making attempts to address customer concerns.

These types of situations that develop, tank car policies and fuel surcharges, are just two examples, but they need some form of oversight system at the STB to provide more effective and timely relief than what we have today.

We have also had some positive business relationships that have developed between carriers and shippers under Staggers. In 1997 the NGFA, the AAR and the major carriers developed a private arbitration system to handle certain classes of disputes. While this arbitration system addresses neither rates or service matters, it has reduced friction and litigation between grain shippers and carriers.

Now, to close, looking ahead. The STB, as the ICC before it, is charged with interpreting the law and Congressional intent. Since 1980, both of these agencies have interpreted the law fairly consistently, emphasizing policy that "enables carriers to earn adequate revenues." As those carriers are now very profitable and nearing revenue adequacy as judged by the STB, we submit that a shift in policy and legal interpretations needs to be seriously considered.

Railroad performance suggests strongly that railroad assets are being concentrated increasingly on the movement of intermodal freight, coal or other hook and haul traffic, such as grain shuttles. This may well be the most profitable business strategy for railroads, but we must ask whether the growing dedication of rail assets to a limited number of rail services threatens to leave many rail customers, including many ag shippers of tank cars, specially covered hopper cars or other non-shuttle movements without a vision of continued affordable rail service.

One reason that NGFA's rail arbitration system has proven successful is that for those classes of disputes that are arbitrable on a compulsory basis, both the carrier and the customer are likely to perceive themselves to be at some risk of loss.

In an era of high profitability for carriers, to the extent the STB could create that kind of balance in STB oversight and proceedings, we think the market would evolve to more self-discipline, improved market performance and the level of friction between carriers and shippers would be reduced. I look forward to questions.

CHAIRMAN NOBER: Thank you very much. Mr.

Van Vlack?

MR. VAN VLACK: Mr. Chairman, Commissioners, my name is Charlie Van Vlack and I am Executive Vice President of the American Chemistry Council.

ACC member companies, representing nearly 90 percent of chemical production in the United States, depend on the U.S. rail industry for the safe, secure and efficient transportation of, approximately, 160 million tons of chemical products each year accounting for about $5 billion in annual railroad industry revenues.

ACC appreciates the opportunity to participate in this hearing on Staggers and commends you for bringing attention to the 25th anniversary of this important legislation. To be clear about our views, however, ACC respectfully recommends that STB reverse a long line of Agency policy determinations that are harming the competitiveness of the U.S. chemical industry and other key sectors of the American economy.

In the long run, unless reversed, those

policies will also impair the ability of the U.S. rail industry to serve all of its customers. To be frank, ACC's concerns is not with Staggers as Congress wrote it, but rather with the way the federal regulators have implemented the law over the past quarter century.

The statute clearly and carefully deregulated those rail rate and service matters that take place where shippers really do have competitive alternatives. Because the marketplace works for such rail customers, Congress appropriately removed the unnecessary regulatory involvement of the ICC. Staggers has been successful in that regard.

But Congress also recognized that railroads have market dominance over certain shippers. In fact, were it not for those situations, there would have been no need to retain a federal regulatory agency with exclusive jurisdiction over the rail industry. As written, Staggers was meant to regulate only those aspects of shipper/carrier commercial relationships that take place in competitive markets. Clearly, this Agency exists today to deal with those noncompetitive situations.

For fully 63 percent of ACC member rail-served facilities, the shipper has access to only one rail carrier. Those shipments are, therefore, captive to a single railroad. For a captive shipper, regardless of its size or location, the efficient movement of its traffic, in some cases even the very survival of its business, depends on the rates and service provided by that single railroad.

In enacting Staggers, Congress wisely left jurisdiction over issues involving railroads and captive shippers with the ICC and now, with the STB. It clearly did not deregulate rail service in noncompetitive situations.

So what has happened in the past 25 years? ICC and the STB interpreted Staggers in ways that we believe deprive captive rail shippers of the protections that Congress included in the law. Since Staggers became law, the agencies have refused to recognize its pro competitive features and have instead erected administrative barriers to competition. Here are just a few important examples.

First, Staggers allows captive shippers with facilities located in terminal areas to seek the Agency's approval for competitive access to another carrier that also serves that same terminal area. But the precedent created by ICC's Midtec Decision has effectively prevented shippers from even requesting, let alone obtaining, such relief.

Thus, despite the existence of this statutory provision, no shipper has obtained competitive access in a terminal area. ACC, therefore, requests that STB overturn Midtec or, at a minimum, conduct a thorough reexamination of its validity after two decades of further consolidation in the rail industry.

Second, STB's bottleneck decisions allow a railroad with monopoly power over a segment of a shipper to consignee movement to extend that power to the entire movement. This Agency-created bottleneck doctrine permits a railroad to refuse to quote a rate over a bottleneck segment as long as it can provide service for the entire movement.

Yet, Staggers neither includes such a

provision nor requires such an interpretation. The bottleneck doctrine arbitrarily denies a captive shipper access to STB to determine a just and reasonable rate for what may be a relatively short monopoly portion of an overall movement. As a practical matter, this nullifies the other railroad's potential to complete for the non-volemic portion of the movement.

STB should discard its anti-competitive bottleneck doctrine. Railroads should be required to quote a rate for service between any captive origin or destination on its system and any point of interchange with another carrier.

should implement a pro competitive policy for short line sales.

Finally, another area of concern is railroad mergers. As ACC has noted in the past, railroad mergers inevitably reduce shipper options regardless of the conditions that are applied by the Agency. Bottlenecks are extended when lines serving competitive shippers are acquired by connecting carriers. Efficient service from independent bridge carriers disappear. Competition for service to new industrial sites is reduced or eliminated.

In conjunction with other ICC/STB policies that curtail competition between railroads, mergers have generally harmed captive shippers. There will likely be only one more round of Class I rail mergers. ACC, therefore, recommends that in any future rail merger proceeding, STB's review should focus on enhancing rail-to-rail competition and improving service to shippers.

These examples illustrate why ACC is extremely concerned about the Agency's past and future implementation of Staggers. Thank you very much.

CHAIRMAN NOBER: Thank you. Mr. Elsea?

MR. ELSEA: Good morning. I'm Chuck Elsea, Senior Vice President.

COURT REPORTER: Microphone.

MR. ELSEA: Pardon me. I am Chuck Elsea, Senior Vice President and Division General Manager of the Flour Mill Markets Division of the Scoular Company. My office is in Salina, Kansas. I am also the President of the Transportation, Elevation and

Grain Merchants Association on whose behalf I appear before you this morning.

TEGMA is a North American trade association that brings together railroads, global grain companies, shippers and receivers, ports, storage houses, inspection agencies and others involved in the shipment of North American grain to customers all over the world. We welcome the opportunity to share our views this morning.

TEGMA believes that the market-oriented approach of the Staggers Act has transformed the railroad industry and resulted in dramatic improvements that benefit the industry, its customers and U.S. global competitiveness. While it has resulted in improvements for the railroad industry, it has not and cannot solve every problem.

As we look ahead, TEGMA strongly supports the continuation of a market oriented approach of the Staggers Act. Agricultural markets are not unlike other markets. They are competitive, dynamic and global in nature. The continuation of reasonable freight charges is an important component in maintaining a competitive position for U.S. agricultural producers.

An efficient, economical transportation and handling industry has kept American farmers competitive in world markets as they face increasing competition from other producers with lower production costs. It's my sense that as they relate to agriculture, transportation costs have remained close to the prices charged in 1980 with increases in rates seen only in the last several years.

When you factor in inflation, this represents significant savings and the greatest beneficiaries have been American farmers and consumers. These economies are the direct result of gains and efficiency due to investment in transportation and handling infrastructure by both railroads and handlers of agricultural products.

Each fall at the TEGMA Transportation Symposium we hear reports from railroads about increased demand for their services as other markets call for more and more freight to be carried by rail. As grain producers continue to realize rapid gains in efficiency, they rely on the transportation industry to keep up and that requires investment.

For railroads to manage volume increases and improve velocity, they need to continue to have the ability to invest in resources such as hopper cars, locomotives and track. It's critical that Government policy continues to promote that level of investment in railroad infrastructure that we have seen over the last 25 years in order for the growing freight needs of our nation to be met.

It's clear then that as we look ahead, rail carriers will need access to capital for further investment in infrastructure, maintenance and expansion. In order for the railroads to attract investors, they need to be able to show competitive rates of return. While we have recently seen calls for re-regulation of the railroads, TEGMA strongly believes that such legislation places at risk the kind of infrastructure investment that has helped keep our industry competitive.

By forcing freight rates lower or forcing inefficient operation practices, re-regulation could restrict earnings, which would severely limit the railroad's ability to invest in infrastructure. If this investment is curtailed, it's likely that U.S. rail carriers will not be able to keep up with the demands placed upon them by the U.S. economy and our agricultural producers will lose their competitive place in a global market.

Rail transportation also must maintain a modern business model. Over time, those that rely on the railroad network will be required to make investments that allow the shipper and the carrier to be more efficient. The Staggers Act gave the railroad industry the pricing flexibility it needed to reward improved productivity.

In return, shippers and receivers in the agricultural industry have made substantial investment to support transportation efficiency. This is an example of how shippers and receivers can work with rail carriers to find market-based solutions that move the industry toward more productive operation.

TEGMA is pleased with the overall impact of the Staggers Act. There are still opportunities for improvement. One issue that TEGMA is working on is fuel surcharge. While we don't dispute the rights of railroads to utilize fuel surcharge to offset rising fuel costs, we support the development of a market-based tool that allows railroad customers to hedge financial risk associated with fuel price volatility.

Establishing a system that allows small shippers to economically challenge the fairness of rail rates is another issue faced by shippers. TEGMA has voiced its support for streamlining the case process at STB, and we believe STB should be given an opportunity to exercise the new guidelines in the substantive case before other remedies are pursued.

Another concern involves resource allocation and utilization. The grain industry continually works to improve efficiency, but if we cannot move our grain to market because rail resources are not available, those gains in efficiency and investment are lost.

We would welcome an expanded commitment of resources to agriculture by rail carriers as they continue to work to improve their performance and create the capacity for better system velocity and infrastructure additions. This will require continued investment in track, rolling stock and personnel on the part of U.S railroads.

In conclusion, we compliment you and thank you.

CHAIRMAN NOBER: Excellent. Mr. Slavin?

MR. SLAVIN: Good morning. I appreciate the opportunity to give testimony this morning. My name is Dan Slavin. I am the Rail Services Manager for Graniterock Company in California.

Graniterock is a 105 year-old family owned construction materials and general engineering contractor. In 1992, Graniterock was a recipient of the Malcolm Baldrige National Quality Award. Graniterock has been doing business with the railroad for its entire 105 year history as the very foundation of the company was first centered around supplying ballast for the railroad's expansion.

Later, construction applications took over as the predominant user of our products. However, these materials are also shipped by rail. Back in 1900 the company's main quarry, now called the A.R. Wilson Quarry, was opened in the town of Aromas east of Watsonville, California on the railroad's coastal main line.

The company has grown to incorporate rail served locations from San Jose to San Francisco. These locations rely heavily on a single Class I railroad for daily rail service as congestion on highways and in surrounding neighborhoods makes delivery of aggregates by truck impractical and undesired by local municipalities. In the peak construction season, rail shipments run between 90 to 115 rail cars daily.

For many years rail service has been adequate with a strong sense of teamwork between Graniterock and the railroad. Recently, the service quality level in our area has plummeted as the railroad has sold a main rail yard in San Jose and rearranged equipment and crews. Although a new service plan developed by the railroad was put into place, it has been poorly executed so that significant delivery problems regularly occur.

It is disturbing to hear from railroad senior management don't expect service levels to improve, as a matter of fact it will probably get worse. Keep in mind that our service route end pattern has not changed since the 1960s. We believe that this problem is more widespread than just to Graniterock.

I would encourage the STB to encourage the railroads to set service standards, such as on time delivery, avoidance of lost rail cars and the railroads to start measuring themselves against these key standards. The rest of America has been doing this for years.

Surely, the concerns about the railroads go far beyond the daily failure to perform for customers. The railroad's position seems to be of driving customers away through some demarketing programs. This really is a failure to perform in support of American business and American citizens in a global economy.

I would also recommend that the STB hold hearings on rail rates and fuel surcharge practices of the railroads. Based on publicly available financial information, we have determined that the fuel surcharge is providing a railroad with a hidden rate increase, because surcharge amounts far exceed what is needed to pay for an increased diesel cost.

Recent rate increases are not supported by the local market and also work to drive freight back on the highways, which is undesirable. Compared to the fuel surcharges of other industries, including trucking, the railroad's practice of charging much more than is needed for diesel fuel increases in their surcharge is a demonstration of monopoly power that is disruptive in the economy.

Finally, there needs to be a better way to resolve the differences between the industry and the railroads. After deregulation, it is now too easy for the railroads to lose touch with their responsibility to their customers and the national economy.

In a market area like Graniterock's where there is no other rail options with only one Class I railroad, I would encourage the STB to facilitate a method of arbitrating differences between a railroad and industry when they arise. For example, the railroad will make operational changes that increase railroad cycle times that are harmful to both shipper and railroad, and at the same time will say that there is no additional equipment.

Over the past 10 years, most of our changes made by the railroad appear to us to encourage added cost with no benefit and improved service. I would also like to say in addition that a meeting last week with senior railroad management has produced a plan to address and, hopefully, eliminate service level issues that have arisen over the last year. Those are my comments.

CHAIRMAN NOBER: Okay. Well, thank you. Mr. Jensen?

MR. JENSEN: Good morning, Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey. My name is Tom Jensen and on behalf of UPS, we commend you for taking time today to consider this important subject.

UPS has a vital interest and what I want to do, as Chairman Nober outlined at the outset of the hearing, we all submitted written testimony. I want to highlight a couple of things and paraphrase what we submitted to you already, key points from UPS' perspective in dealivisit in one of our key intermodal rail facilities earlier this year to see that operation firsthand.

We have done this since the '60s and it has become a vital part of our worldwide intermodal transportation network. You know, today we pick up and deliver more than 14 million packages each and every day and we service almost eight million customers nationwide. It has been estimated that the value of the goods that are transported through UPS on a daily basis is, approximately, 6 percent of the U.S. gross domestic product. So, indeed, we're a major player.

However, in recent years and since the Staggers Act was enacted, we have moved from a domestic focus on certain small package transportation into a variety of other transportation solutions. Today we actively develop logistics and supply chain management solutions for customers around the world, as do many of our competitors.

Service offerings reflect customer demand and new market conditions. A healthy and vibrant U.S. railroad industry not only impacts our customers domestically, but it impacts our customers around the world. Since the passage of Staggers, we initially saw some benefits, frankly. The service and performance enhancements by the railroads were significant and UPS realized those and we continue to work on a daily basis with all our major rail partners.

However, I don't think the issue and we don't think the issue related to the financial health of the railroads still exists. They clearly seem, based on balance sheets and stock market performance, in good shape, at this point, and recently trends have concluded, unfortunately, diminished performance, disruptive service and constrained intermodal operations.

Throughout this period, railroad mergers haven't helped. In fact, we think the railroads have resisted making adequate capital investments, harnessing technology and providing innovative solutions to the very same market conditions we have changed to.

As a major rail partner, as I indicated, we don't believe future railroad mergers are in the public's interest until the service, reliability and performance picture improves significantly. We can look back to the situation with Conrail, which culminated in 1998, and we didn't see the same service, the same service levels, until 2002 and since then they have atrophied dramatically.

Our packages these days that are moving on the rails are time sensitive. We're all about service. We don't make widgets. We got to get them from point A to point B in the time that we have guaranteed to our customers. The notion of urge to merge to potentially two rail carriers controlling the entire United States from supply chains to the manufacturing, from manufacturing source to consumer, is troublesome to UPS.

By any of the statistics, and I have seen several different ones from the Association of

American Railroads, the four major rail carriers are effectively carrying 93 or 95 percent of all U.S. rail freight. Given that scenario, we continue to oppose additional Class I rail mergers.

Time in transit is a significant issue for us. The efficiency and speed of the nation's transportation system across all modes, all modes, has increased except for railroad velocity. We ask the Board and our colleagues today to consider what mode of transportation moves slower today than it did 25 years ago.

We have broad experience in trucking, transportation, aviation. We have seen increases in efficiencies in those modes of transportation and, in turn, we have seen decreased time in transit. This is critical in meeting the demands of our customers given streamlined supply chains, speed to market and adjusted time inventory. *The railroad time in transit* picture puts our competitiveness at risk.

We do recognize, however, the capital intensive nature of the industry and the whole challenge based on capital dynamics of the railroads, and perhaps outside of the purview of the Surface Transportation Board, public policy initiatives addressing infrastructure improvements, capacity, service improvements, enhancing technology should be promoted.

In the spirit of what Vice Chairman Buttrey suggested at the outset, we are the solution and we continue to -- would like to explore the notion of a Railroad Trust Fund. We have a Highway Trust Fund to service and provide for and maintain a safe and efficiency federal highway system. We have an Aviation Trust Fund. There are others.

If these two, the Highway and the Aviation Trust Fund, are deemed to be in the public interest, why not a Railroad Trust Fund? This would represent public/private investment to address the serious challenge we're facing.

Wouldn't improving capacity, safety, infrastructure and technology be in the public interest? From a market perspective, the answer is yes. Frankly, of late we continue to pay more and get less. This year and next year, guess what? Pay more and get less.

Finally, technology, while the railroads have worked to harness technology, we think they can do a better job and we favor policy to stimulate the development of technology that can product tremendous benefits to the network.

We have spent billions of dollars over the last 10 years in information technology and today we wrap all kinds of information, and the market has forced us to do this, around a $6 package or an ocean-bound container of freight. Yet, if we can do that in the market, the railroad still struggles with even basic information about major rail arteries and information on movements.

All this being said, let me conclude where I began. The railroads have made a valuable partner in surface transportation for us. We need to look to the network to be more efficient to reduce transit times, better utilization of equipment and address technology moving forward, and we look forward to unique and creative ways to solve these problems. Thank you again for your time.

CHAIRMAN NOBER: Thank you very much. Mr. Ficker?

MR. FICKER: Good morning, Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey. It's a pleasure to be here. As you know, I'm the President of The National Industrial Transportation League and unfortunately our Vice Chairman, Curt Warfel, could not attend this morning as he has had a family emergency and had to remain at home.

In the last 25 years since the passage of Staggers, the world has changed dramatically. We have seen the industrial sector of the United States decline in relation to the service sector. With a lot of that production moving to Asia, which is dramatically effected the transportation systems, both globally and domestically, and the world has also changed.

I would just point out that in 1980, there were very few PCs. There was no Internet. There was no email and a hybrid was a rose. We are in a different environment and we take the opportunity this morning to touch on a few of those changes. The

Staggers Act had two important focuses when it was passed. One was to allow competition to govern rail rates and services to the maximum extent possible. And second, to stabilize and strengthen the financial condition of the rail industry.

The Act has been an unqualified success in the second, but much more needs to be done in achieving the first goal. But let's be clear, the rail industry is enjoying a financial renaissance. Industry experts, and you are going to hear from them later today, are clearly pointing to the financial success the rail industry is experiencing and the term revenue adequacy seems to be able to be applied to many railroads now and primarily in the future will be applied to more railroads.

I'll quote from a Morgan Stanley report that Jim Valentine put forth, and he will probably be here on the panel later today, that says "There is even greater conviction that the industry will consistently earn its cost of capital over the next year, a feat that it hasn't achieved in decades, led by a secular upward pricing initiative that should continue into 2006 and beyond. If this isn't evidence of a C-change, I don't know what is." And it also points out that it's not a temporary phenomenon, but a true shift in market conditions.

Several factors have caused this: One, the rail landscape has changed. There are a lot less Class Is than there were in 1980. Secondly, the systems have been rationalized resulting in some considerably less track and causing some significant shortages of capacity in key areas. Trucking as a competitive alternative has been impacted by the increased fuel costs and driver shortages. And as mentioned by several panelists, rail customers assumed a greater responsibility for infrastructure such as increased track capacity or car ownership.

And these have affected rail customers. Mergers have reduced the potential for rail-to-rail competition by either creating bottlenecks or reducing routing options. The service improvements promise to this Agency and its predecessor in merger applications have not materialized. Rail capacity has allowed, if not encouraged, the rail industry to move away from individual contracts back to public pricing, which appears to be contrary to the Act. And as this is pointed out by Mr. Slavin, it's demarketing several commodities.

Also, the reduced effectiveness of trucking rates is the real competitiveness of it because of the costs. And finally, as customers who have had to invest more, it's rendering it almost impossible to invest more in rail equipment and rail infrastructure, it's made it difficult for them to move away from rails as Mr. Keith pointed out. And as Mr. Jensen pointed out, today's experience of rail customers can be summed up in a very simple sentence. Paying higher rates for less service.

Now, League Members have not been unwilling to pay more, but it's a question of receiving value for increased costs. We can clearly point out that the opposite has happened, and that is the result of effective competition being gone leaving customers with little alternatives other than to grin and bear it. And the inability to achieve substantial regulatory relief because of the costs or the time constraints has further made this problem more difficult.

Now, the Staggers Act has restored the sustainable health of the rail industry, but now the Board needs to focus on the other policy in achieving the objectives pointed out in the Act itself. The best protection and the best mode of improving financial health and regulation is the marketplace as Commissioner Buttrey or Vice Chairman Buttrey points out. With enhanced competition simply -- when it is not possible, the Board needs to ensure a timely, effective and cost efficient regulatory protection.

In a capacity constrained environment, the Board's regulatory approach should encourage the maximum use of existing capacity in creating incentives for adding more capacity. Enhanced competitive access -- advanced competition advances these objectives by promoting greater collaboration between the rail industry and their customers by identifying the ways to improve.

In addition, competition will reward good service and direct new capacity to its most efficient use. Several mentions have been made this morning by previous panelists and also by Mr. Smith taking a view of some of the rules and regulations that have been put forth and decisions that have been put forth over the last many years with a different rail environment, i.e., bottleneck case and the competitive accessors. We'll call it the reciprocal switching.

The Board should revisit the bottleneck decision. The bottleneck decision was put in place at a time when rail financial health was in serious jeopardy and the Commission at the time viewed it was necessary. The same can be said for the Midtec decision around access. Those decisions need to be substantially revisited by this Board to take a different look and different approach into the future. The League would welcome the opportunity to participate in any such hearing or proceeding opportunity for the rail industry to sustain and enhance its current financial strength is to improve its service.

The Union Pacific Railroad has pointed out in several public forums over the past year that the improvement of one mile an hour in velocity equates to 250 locomotives, 5,000 rail cars and almost 200 employees. That is a substantial reduction in cost and a substantial improvement of service. Think what 2 or 3 miles an hour could provide. Yet, when we examine the service metrics published weekly by the AAR, we find that this has eroded over the last period of time.

Improving service doesn't just benefit the railroads, it benefits the customers, it benefits the country and it lowers operating costs for the railroad allowing them to provide improved service at lower costs and attempt to track more business to their properties and grow their market shares. As our testimony points out, the market share of the rail industry over the past 20 years has been relatively flat, as opposed to other modes. And when you consider the elimination of coal and the non-intermodal freight internationally, it has even declined.

Car load business from 2000 -- excuse me, 1983 to 2000 has been basically flat. And those are

AAR statistics. The Board needs to take leadership in this area as has been pointed out by some of the previous panelists about providing meaningful metrics that get -- to allow everyone to gauge the performance of the rail industry. In addition to the data currently published by the AAR, these metrics should include key traffic lanes and average dock-to-dock performance. A competitive rail market will function more efficiently with such information.

In regards to the shippers taking more ownership of rail equipment, I think, it is important that the Board reevaluate its car supply rules. And this has been mentioned by several other panelists. When shippers acquire cars to meet the ongoing demand of their businesses and markets get soft, then the railroads tell them to park their cars and use our's.

There needs to be balance in that environment. When the markets soften, then everyone should take part of the hit, not one entity have the ability to rule over the other. The Board needs to also take a look at how it can adjust these rules to supply or to provide the industry with some equity across the system.

Finally, I would like to conclude by saying the Staggers Act has been a substantial factor in the recovery of the rail industry in the financial strength that it has today. But there are many changes that face the rail industry that are different from the ones that faced the drafters of Staggers. In particular, the growing capacity constraints is the opposite situation confronting Congress in 1980.

The industry is highly concentrated, motor carriers face increasing difficulties in competing in many markets and shippers have invested an enormous amount of capital in the instrumentalities of rail transportation. These changes as well as the regulatory decisions limiting rail-to-rail competition have increased the rail carrier's market power. These new realities require new responses by our policy makers over the next quarter century.

The nation requires a strong and viable rail industry as shippers and carriers confront the need to move ever increasing quantities of goods in the global marketplace over a domestic transportation system that is increasingly capacity constrained. The needs of all the stakeholders of the industry, rail management and employees, rail customers and rail stockholders must be taken into account.

And the rail carriers and their customers must work together within the structure of the competitive transportation market to build a rail system that will meet the needs of the 21st Century. The rail industry helped build our great industrial economy. Will they play the same role in our new economy? The League stands ready to work with the rail carriers of this country, the Board and Congress in the development of that system. Thank you.

CHAIRMAN NOBER: Okay. Thank you very much. Commissioner Mulvey?

COMMISSIONER MULVEY: Thank you. I want to thank the panel for an excellent group of presentations. Rail rates have been down substantially since Staggers and except for the last year or so it has been down for agriculture as well. But what has been the primary cause of that?

To what extent has the shifting of the

equipment supply responsibity from the railroads to the shippers in the agriculture sector been responsible for the rates going down versus other productivity improvements by the railroads? Have any of you studied that or have some estimates as to the share that's due to the disinvestment in equipment? Anybody from the grain industry?

MR. KEITH: Commissioner, we don't have any quantitative estimates as to what that contributed to the rail rate decline.

COMMISSIONER MULVEY: Because we keep hearing on the one hand the railroads saying they have had tremendous productivity improvements due to Staggers and these have been passed on to the shippers. The shippers say that no, that, part of these lower rates are due to the disinvestment in the car supply. And yet, nobody goes out and quantifies how much of these benefits are due to one or the other action. It would make it easier for us to make judgments about how well Staggers has been performing.

On the issue of the fuel surcharges, the railroads argue that their fuel surcharges while to some extent probably exceed the actual cost of a movement, on balance and in total do not cover their total fuel costs. If the railroads were unable to differentially price their fuel surcharges thereby putting a greater burden on the captive shippers, wouldn't they wind up seeing their returns go down and their movement towards revenue adequacy forestalled?

So doesn't it make sense that they are going to have to charge some of the shippers more than their fuel cost increase if they are going to cover their fuel cost increases in total, John?

MR. FICKER: Thank you, Commissioner Mulvey. Our opinion, and as you know, we have been working on the private side with all of the rail carriers to address this very specific issue along with National Grain and Feed. We believe the fuel surcharges should be exactly what they are to recover that cost. The need for differential pricing belongs in the rate structure, not in the fuel surcharge structure.

In most other modes of transportation, fuel surcharges are relatively transparent. You can identify relatively quickly the current cost and you can estimate the increased cost. We all know what it costs to go to fill up our tanks in our automobiles. We all experience that. We want to know that differential. If the railroads have agreements that do not include fuel surcharges, because they were signed many years ago in a long-term, that's the marketplace working at its finest, which I believe is what Staggers proposed.

COMMISSIONER MULVEY: That gets back to the issue of contracting. Contracting is something that Staggers Act gave the railroads the right to do. It allowed them to better compete with trucking. Of course, on the other hand, these long-term contracts sometimes preclude things like fuel surcharges. Are contracts a boon or a bane to railroad competition? Should there be limits on contracting?

There was an article recently by a professor at Penn State University which suggested that there may be a need to limit railroad contracting, so they don't enter into long-term contracts that preclude them getting legitimate cost increases, like fuel surcharges, and result therefore in the railroad's differentially allocating those surcharges in a way that many shippers feel is unfair. So should we put limits on contracting in order to avoid that in the future?

MR. KEITH: I don't think we would favor that. I think that is really restricting marketplace freedoms to pursue profitability, to pursue business. Yes, people make mistakes in contracting at times, but it's a business strategy that we think rail carriers need.

COMMISSIONER MULVEY: The article, as I recall, suggests that the nature of railroad economics will generally cause railroads to undertake that kind of behavior whenever they have excess capacity, that is, enter into these kinds of contracts, which in the long-term could be counterproductive.

MR. FICKER: Mr. Commissioner, could I take a --

COMMISSIONER MULVEY: Yes.

MR. FICKER: I would agree with Kendell on that. The marketplace should be the arbiter of contract duration, not any regulatory environment. But everyone has to take into account their business structure, their marketplaces. And I think as Vice Chairman Buttrey pointed out in his opening remarks, it's essential that we stand out of the way and allow the marketplace to be the arbiter of these things. And, you know, it's buyer beware.

COMMISSIONER MULVEY: Yes, as an economist.

MR. FICKER: It's buyer beware.

COMMISSIONER MULVEY: As an economist, I have nothing but respect for the functioning of the market mechanism. However, the reason we are here and the reason this Board exists is that there are some circumstances under which the market mechanism might not give the optimum solution and ergo that's why you have a regulatory regime in place.

Now, Mr. Slavin, you mentioned the idea of a trust fund concept and when I was on the Hill we worked with Congressman Lapinski to develop such a concept. Do you want to elaborate on how a Rail Trust Fund concept might work? I'm sorry, Mr. Jensen.

MR. JENSEN: I'm sorry, Commissioner Mulvey.

COMMISSIONER MULVEY: Yes.

MR. JENSEN: That rests with me.

COMMISSIONER MULVEY: Yes, yes.

MR. JENSEN: Well, I'll tell you, this has been an issue that has been talked about in the past and there's been some movement, might be an exaggeration, on the Hill, but we think it's time to go back and look at that and we have seem them in other modes, as I indicated. We are more than happy to pay our fair share and we think that even given the unique situation where there is private ownership in the infrastructure as you alluded to in your opening comments, Commissioner, we think that can work still. So we think we need to go back and look at that. As far as the exact specifics today, I'm not prepared to tell you or to discuss where we go.

COMMISSIONER MULVEY: Yes, the proposal that we had provided several billion dollars a year for railroad infrastructure investment, but it was vociferously opposed by the railroads. I think in large measure because of the concern about what the quid pro quo would be, ergo what would the railroads be expected to do with regard to access if such a funding mechanism were put in place?

So I suppose there needs to be some way of finding a solution that simultaneously involves public support for railroad infrastructure without having a requirement that the railroads would find excessively onerous.

MR. JENSEN: I concur. For what it's worth, Commissioner Mulvey, we concur and we have discussed it with railroads directly.

CHAIRMAN NOBER: Vice Chairman Buttrey?

VICE CHAIRMAN BUTTREY: I would just like to clarify something for my own self here. Several of you seem to be suggesting that the Board order railroads to buy rail cars, tank cars, grain cars, flat cars, whatever. I would just like to clarify in my own mind, is that what you are saying? It seems to me, that you seem to be suggesting that the Board order railroads to buy certain kinds of rail cars and certain amounts at certain times for certain purposes.

And if you are suggesting that, I would like to be cited chapter and verse, if you will, for where that authority would come from.

MR. KEITH: We're not suggesting that. I'm sorry if I misled you on that. What we are saying is that the railroad, in essence, defines the marketplace by defining the set of rules that will govern private investments by rail customers. And we think that those rules mitigates they are very one sided. We think it creates risk, more risk for the shipper than a normal competitive marketplace would allow.

VICE CHAIRMAN BUTTREY: So what form would that risk take?

MR. KEITH: Well, I gave an example in the case of tank cars that, in essence, the shipper has to have the tank cars to get service of any kind.

VICE CHAIRMAN BUTTREY: For coal and oil.

MR. KEITH: There are reasons for that, because you commit things to certain types of products and the cleaning is less onerous and so forth. But, you know, when there are problems and in terms of cycle times, you've got to have plants running. You've got to have cars available to fill with product. And so if the cycle times deteriorate a lot, then you've got to release more cars for a while.

And then when and if the railroad performance improves, you get so-called surplus cars that then you get to pay storage charges for. And the predictability of service in rail is just a major concern. It has gotten much worse in the last few years. The capacity issues are creating more variability in service. And so the total cost of transportation is increasing at a faster rate than the actual rates themselves would indicate.

VICE CHAIRMAN BUTTREY: Yes.

MR. FICKER: If I could kind of echo what Mr. Keith has said? The historic relationship was that the rail carriers provided the equipment to move the goods. That was kind of history. Much as, you know, when you send a shipment on UPS or FedEx, they provide the plane. But in reality, what has happened in the last several years is the rail industry has said, you know, we can't afford this. The price of your product or the rates we are able to charge don't justify our investment, which is the reason, why don't you, Mr. Shipper, invest in your own equipment? So that's what has happened.

The problem is, as I mentioned in my comments, was balance. When the markets do soften, then if both are using at 100 percent in the solid market, then they both should be at 75 or 60 or whatever the market adjusts to, rather than the rail industry being able to say oh, use my cars, park your's and then charge storage for that.

It's not a matter that the industry is saying to the rail industry, you buy the equipment. What they are saying is treat us fairly. The other concern that has been mentioned before by some others is that the rules for interchange and the rules for maintaining equipment are established by the AAR and committees that are developed in that organization. And those committees are made up exclusively with total voting power by the railroad industry without any participation by those other owners. And so far, they have attempted to become part of those committees, but have not been successful.

VICE CHAIRMAN BUTTREY: Is it safe to assume that a lot of the cars become the warehouse, if you will, for product?

MR. FICKER: It happens. I wouldn't say that it doesn't. I think people are becoming more efficient at that, but if a shipper wants to do that, then they need to pay for that. They need to pay for the storage. They need to pay for the equipment or whatever. It's when the service, as Mr. Keith indicated, deteriorates that you have to go out and get more equipment just to maintain your current level of business that gets frustrating.

VICE CHAIRMAN BUTTREY: Is it true that in some of these manufacturing facilities the product tends to show up at these facilities at a time when they can't possibly process it that quickly, and then all of a sudden the reverse of that happens and the plant wants to be open and operating 24/7 and it can't operate 24/7, because it's not getting the raw materials it needs to operate?

Are you suggesting that the Government

intrude into that process in some way?

MR. FICKER: Absolutely not. But what users of raw material expect is a consistent flow. If I release and ship 1 ton, 10 tons a day, I expect that 10 tons will arrive at that other destination within a reasonable -- in five days or three days. Not that I have shipped 10 tons one day and at the other end I get 100 tons at one crack. That's the problem that is faced by many people today.

It's not about wanting the Government to interject in anything. I think these are where the service metrics are so critical and so important. So that people can understand and plan accordingly. The problem is the variability and plan and we have a recipient of the Baldrige Award here, a number of years past, and that's absolutely critical to put processes in place that develop consistency and that same effort needs to be taken in the rail industry.

VICE CHAIRMAN BUTTREY: Let's talk about grain for a moment here. We will have some other shippers, I'm sure, later in the day. There is some argument being made or opinions being rendered that some parts of the industry and some parts of the country have reengineered their systems better than others. And that because of that, they are getting better service and they are getting better prices, if you will, because of that.

Is there hard evidence in your opinion, in the opinion of the panel or anyone on the panel, particularly, Mr. Keith, that certain parts of the country have invested more and are making a greater effort toward reengineering their systems than others?

MR. ELSEA: I'll try that. In the western United States, very clearly, there has been a substantial investment on the part of shippers and train loading facilities and, you know, some of them are shuttle train capable, some of them are just, I guess, what we would call in our company the "big train" model, and that would be a train in size in excess of 75 cars, most of them 110 car units. And we have worked pretty hard to adapt as much of our business model to the utilization of those unit sizes as we can.

And as an industry, yes, there have been substantial gains in productivity that have been made because of that investment. You know, also clearly, Chairman Buttrey, you know, there has been a shift away from grain movements in single cars or movements that go into the manifest model. There has been a move away from that to a move towards these larger, more efficient units. And it works in the west.

MR. KEITH: I might just add --

VICE CHAIRMAN BUTTREY: It works in the west. When you say the west, you're talking about everything west of the Mississippi River or are you talking about part of the west?

MR. ELSEA: West of the Mississippi.

VICE CHAIRMAN BUTTREY: Okay.

MR. ELSEA: And the places where we struggle and places whereas an industry we're working on improving this would be the places where we interchange with the eastern carriers.

MR. KEITH: I might just add there is still a part of the market that really is not conducive to shuttle operations, 100 car trains, and running on a cycle basis. Corn tends to be the easiest one to make work, because it's a very high volume grain. Wheat, especially grains, things like that are less so and they go into some western flour mills that really can't take those sizes of trains. So you've got to break those trains apart to make that happen.

But as an industry, we're always going to have an agriculture, a need for a smaller shipment size than simply shuttle service in certain markets. And those markets are very long distances. Trucks really don't work well for them. And the concern is how much balance do you have in rail service between the shuttle type service and other types of needs in the agricultural marketplace?

VICE CHAIRMAN BUTTREY: What size? What size train are you talking about? When you said smaller trains, smaller groups of cars, if you will. Shuttle trains are very long, lots of cars, 125 or whatever.

MR. KEITH: Right.

VICE CHAIRMAN BUTTREY: Any length.

MR. KEITH: There are certain movements

in, I'll say, North Dakota for special type high protein wheats going into say a Minneapolis marketplace that are may in 10 car lots or something like that or even single cars going in the manifest trains. But those are a fairly small part of the marketplace today, but 25 and 50 car units still could be utilized very easily. I mean, that would work best in some of these markets. Flour mills going into the PMW, for instance.

MR. ELSEA: If I could add to that? There are opportunities, however, to take the business that Kendell is talking about and cause those to adapt to a larger train model and it is going on today in the Dakotas, in Kansas and in Oklahoma. And BNSF has introduced a tool that they call a destination exploiter train that has gained wide acceptance on the Plains. And we have used a model in our company offered by Union Pacific for a number of years where we take, you know, essentially a 100 car empty set and load that, send it to a gateway and break it up into 25 or 30 car pieces to distribute to flour millers.

So, you know, the industry has been able to innovate to some extent to do some of the business that Kendell is talking about, but, you know, again to this point, it can't be the cure all for everything there. But it works. And again, it's another example of the industry trying to figure out how to adapt itself to a transportation model that will serve its customer.

VICE CHAIRMAN BUTTREY: You are familiar, of course, with the feeder airline concept, right? Small airlines, feeder airlines.

MR. ELSEA: Right.

VICE CHAIRMAN BUTTREY: They feed into the greater trunk line system and interface with the faster moving, long haul carriers and freight forwarder model, if you will, where consolidation of freight takes place. Then it is handed off to a carrier to move that over a long distance in a much faster speed. I know UPS certainly is familiar with that.

In other kinds of consolidator type functions, do you see possibly a role, a greater role for short line railroads in that kind of model, if you will, where that model could apply to facilitate, if you will, better service to customers who can't produce and can't consolidate long haul, "fast moving" trains that might be on the long haul routes?

MR. ELSEA: Well, just keeping in mind that once that train goes on to a Class I carrier, it needs to comply with what is going on there, in terms of, you know, what fits in my head is anything you can do to keep traffic out of a manifest model is going to improve the velocity at which it travels. So to the extent that that can happen coming off of a short line, sure. We have any number of members who have, and our company also have, assets located on short line railroads that are aggregating big trains and, you know, 100 car trains.

VICE CHAIRMAN BUTTREY: Yes.

MR. ELSEA: Handing them off to a Class I carrier and serving our customers, you know. And I think if you have got short line railroad activity that can't comply to that business model, it will also struggle.

VICE CHAIRMAN BUTTREY: Yes. Well, I am

not suggesting necessarily that a Cessna 172 follow a 767. What I'm suggesting is that there may be a way to consolidate freight or is there a way to consolidate some of these trains and then hand them off to a carrier that could take them to its final destination?

MR. ELSEA: Well, I think it is taking place now.

VICE CHAIRMAN BUTTREY: Yes. Maybe the industry could do a better job of that.

MR. ELSEA: Perhaps in places. I mean, there are many markets, I believe, where short line railroads are an economic and a viable business model.

VICE CHAIRMAN BUTTREY: Yes, yes.

MR. FICKER: Commissioner, if I can just add a comment to that? There is a lot of freight that will continue to be in a single car shipment. It's just the nature of the commerce, the business transaction between the supplier and the customer generate a certain volume of goods and those volume will probably not be train load volumes. The question becomes and you are asking, I believe, the right question how can we utilize the short line environment to help do what they do, which is gathering and distribution very well and facilitate the Class I what they do best, which is moving trains better.

I think that merits a lot of discussion. I don't think anyone has the answer to that. But it's a question that needs to be focused on by the broader industry segments, users, short lines and Class Is.

CHAIRMAN NOBER: I think our lights are out. Apparently, we're not having the five minutes on, so we'll try to rotate through them and make sure everybody has a chance to ask questions. Starting with me. No, no. I can still do that. Let me just ask for a minute about one of the points that all of you made about the Midtec and bottleneck. I think everybody made that, almost everyone, point in one form or another.

We just spent two days up in Canada with five of our seven Canadian counterparts. And I think they have a similar system in Canada to what many of you are advocating the Board, you know, alter its doctrines to. And we spent a lot of time talking to them about the pluses and minuses of that. Given the concerns that you have raised about adding capacity and ensuring adequate service levels, do you really think that altering the Midtec and bottleneck decisions will -- what do you think the effect of that will be on capacity and service going forward? I mean, if we do what you ask for, what do you think would happen to capacity and service? Anyone? Whoever wants to start.

MR. VAN VLACK: All I can say is that the chemical industry operates in an extremely competitive global environment, not only in this country, but everywhere around the world. And our company has found that in a competitive environment they get stronger. They deliver better service. They have been priced down. They attract capital investment.

We're just unsure why those market rules wouldn't apply in the case of providing competition to captives and that with the drive performance. And, you know, it would allow us to rethink making capital investment at a lot of these facilities right now.

CHAIRMAN NOBER: Why would it do that?

MR. VAN VLACK: Well, right now --

CHAIRMAN NOBER: Because rates would go down?

MR. VAN VLACK: -- the cost of service and the quality of service. Most of our companies operate globally. In other words, they have plants all over the world.

CHAIRMAN NOBER: Yes.

MR. VAN VLACK: They have a choice to where they place their plants, to a certain degree. The rail issue is becoming an increasingly important part of that decision. We have facilities Our companies have facilities outside of the U.S. and inside the U.S. making the same product shipping to a customer in the U.S. Some of them find they can move it more cheaply and more quickly to their U.S. customer by sourcing it outside of the U.S. in their own plant.

Something is wrong with the system when that works. So what we find our members doing is making capital decisions based upon the ability to provide predictable service at competitive costs. So

I think our members would be more inclined to increase capacity, therefore, provide more freight volume to the railroads if they had more certainty regarding how the rate structure was going to operate and regarding the reliability and predictability issues that others have raised here.

MR. FICKER: If I can take just a stab at that? The answer to your question, Chairman Nober, is extremely difficult, because my crystal ball is on the rip track and I don't really know the status of what would happen if that were to take place.

CHAIRMAN NOBER: But everyone is advocating that.

MR. FICKER: I will look north of the border and see that two very profitable and very efficient railroads operate under that environment, at least in the case of what they call interswitching, very successfully. And I think that model could be brought down here. Reciprocal switching used to be a much broader application here in the United States in the '70s when I first started in this industry and it has since declined dramatically.

The opportunity then is for the most efficient mode, the most efficient route to take advantage of that and we are not encouraging that. We are not encouraging efficiency. We are encouraging the status quo. And by encouraging the status quo, there is no incentive to change. There's no incentive for innovation. There is no incentive for improvement. It's just make sure I don't lose what I have got.

CHAIRMAN NOBER: Now, one, as I said, having just spent 36 hours with our Canadian counterparts, one difference is that the two Canadian carriers are national systems, whereas ours are regional. So they don't have the short haul/long haul incentive that we seem to have here, which produces one of the problems that you are suggesting. Not that I'm advocating consolidation. I know all of you feel very strongly about that. I don't think I misinterpreted what anyone said. But that is one difference that, you know, at least thought about. I mean, I'm not sure if that makes a difference or not.

MR. FICKER: I know there is an awful lot of freight that transpires strictly on either of those, in the west and in the east, so I don't think it's that big a deal.

CHAIRMAN NOBER: Let me just ask one more question and then we'll do another round of my colleagues. The second point that I heard a lot of folks raise issues with is demarketing, and that's one that I candidly have been struggling with for the past 15 or 18 months. I have heard a lot about it. And I guess the question I would ask is, you know, you all represent businesses, right?

And when you make investment decisions or decide where to put your resources, what do you look at? What's the highest return part to your business, right? And so if you decide to demarket or, you know, lop off or not, you know, participate in the lowest return part of your business, you do that every day, right? But a railroad can't do that or if they do, you know, we have folks coming in and raising concerns about that. And there is a legitimate balance to that, which is, you know, you don't want businesses that depend on railroads for their livelihood being put out of business. I mean, that's what regulation is there for.

But how do you strike that balance between on the one hand letting railroads act as businesses and focus their assets on the highest return part, which is what everyone of you do, with the need to maintain service to those customers that are captive to railroads? What would you have -- that's what we would have to do. How would you have us do that? What's the right balance to strike there? Does anyone want to try that one?

MR. FICKER: Well, let me take a stab, at least, at addressing the concern. Every industry in the capital economic system that we have in this country needs the opportunity to pick and choose what it will do business as. That's not new to anybody. However, when you look at the railroad efficiency and go back to the comments that I made about service velocity, what would happen if we improved that velocity by 5 percent?

The demarketing effort wouldn't be so significant at all, because the capacity would be there. It's not just about throwing money at the problem. It's about solving the problem by improving service. Capital is needed to, you know, add capacity in certain key lanes, there's no doubt about that. But a slight improvement in the velocity will give the railroad the opportunity to revisit that freight that they think is no longer, you know, profitable or saleable, because their efficiencies will improve, their profit margin is going to improve.

MR. KEITH: This isn't a solution, but one thing that we mentioned in our written testimony that we would favor is for the Board to require the carriers to have metrics that they report on a fairly consistent basis, for the various sectors that they serve. And we're seeing some of the metrics that are being used in the past in terms of performance. The definition is starting to shift and so that the day-to-day are not comparable with the date of history.

And at least you could tell how much of service decline you are really confronting in some sectors. I mean, in the ag sector, we think we've got some movements that are higher return to the carrier today than the intermodal. We think the intermodal is a growth area of the business for railroads. They are going after that. They are more concerned about timely service to the intermodal sector, because that's the way they are going to grow the sector.

And that's fine, but it's really coming at a time when our rates are going up increasingly and the service seems to be deteriorating very quickly, too.

CHAIRMAN NOBER: Okay. Commissioner Mulvey?

COMMISSIONER MULVEY: Let me follow-up on this demarketing issue for a moment. The railroads are somewhat different from other industries. It's not a perfect analogy to say that other industries do things differently. If they chose to cut out a certain line of business, well, that's their choice, but usually the firms that are being cut out would have some alternative.

The argument is that in the case of rail, for many shippers, there really isn't any alternative. There's no substitutability. Which gets us to the question of the common carrier obligation. The common carrier obligation was changed in ICCTA. We have many, many commodities that are exempt from regulation and are not subject to the common carrier obligation.

What is your understanding today, and I ask this of the group as a whole, of the railroads continuing common carrier obligation in light of Staggers and the Interstate Commerce Termination Acts?

MR. KEITH: We think the concept still exists in principle. Reasonable service on reasonable requests. Defining precisely what that is is increasingly difficult, but we do think that railroads are granted a franchise by the Government. They are granted certain legal protections by the Government. Therefore, the maximization of profits regardless of cost to certain sectors or customers that traditionally had service, we think has to be looked at. That's part of the job of the STB. And to decide yes, there are limits, how do you impose reasonable limits without hurting the carrier's profitability? But there are tradeoffs there and we think there is a common carrier obligation under the law.

COMMISSIONER MULVEY: Common obligation for all commodities or just certain commodities?

MR. KEITH: I wouldn't differentiate. I certainly think it applies to agriculture.

COMMISSIONER MULVEY: Okay. And chemicals?

MR. VAN VLACK: And certainly chemicals. We would agree with respect to their being a common carrier obligation. It is the whole basis, you know, under which the manufacturer sector in this country operates. We're a very capital intensive industry. Our investments were made based upon a set of rules regarding access to rail shipments. We have not had a lot of alternatives for shipping a lot of our products and we believe that it's part of the balance that needs to take place. Certainly railroads decrease the returns, but you exist to make sure that those returns are reasonable and not excessive.

COMMISSIONER MULVEY: But does it apply to intermodal?

MR. JENSEN: Yes, it does. Now, you could argue, Commissioner Mulvey, that we have more options than others. I believe that makes sense, but we've obviously chosen the economic -- made the economic decision to invest resources with the railroads to enjoy certain economies and made the business decision to do so.

COMMISSIONER MULVEY: Yes.

MR. JENSEN: Yes, we do believe so.

COMMISSIONER MULVEY: Yes, might it be true that the substitutability of truck for rail may have changed over time given changes in the characteristics of the trucking industry and the rail industry, for that matter?

MR. JENSEN: Absolutely. And we're looking into the basis of today's exercise, look back 25 years, right?

COMMISSIONER MULVEY: Yes.

MR. JENSEN: We see an awful lot of changes in that mode as well.

COMMISSIONER MULVEY: One last question and this gets to the paper barrier issue and it is addressed to Mr. Van Vlack, although you can all answer it. The question of paper barriers, is something dear to my heart. Paper barriers, of course, are something that the railroads require from the short lines when they spin them off to ensure that the short lines continue to interchange traffic with them rather than another carrier. These paper barriers are often in perpetuity. Would you favor some sort of limitation on the time of paper barriers? And if so, how long do you think would be a fair time?

MR. VAN VLACK: Well, I don't have a comment on the specifics, but it's just paper barriers are just another instance of a case where there are artificial barriers to access the competition being created. Our view is that those kinds of barriers shouldn't be there. They impede service. They impede competitive rates. And so I don't have any specific suggestion as to time limits. But again, it's part of maintaining the balance between the return the railroads are entitled to and the competitive access and service that the major shippers need.

COMMISSIONER MULVEY: But the railroads argue that without paper barriers, these short line railroads would never have been spun off and the lines would have simply been abandoned and paper barriers guarantees at least service continues, even if the service is not as competitive. How do you respond to that?

MR. VAN VLACK: Well, in the spirit of today's hearing, I think that's one of those balance issues that the STB needs to look at. Is how do we assure the right balance between securing the continuation of those lines to be able to serve shippers and to be able to provide return to the railroads and the kind of service and rates that shippers deserve in this kind of a regulating process. So I believe that's a ripe subject for further review.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN NOBER: Vice Chairman Buttrey?

VICE CHAIRMAN BUTTREY: A question for Mr. Jensen from UPS. You were talking about you being a very large customer and I was wondering if you are at liberty to say today whether you are continuing to increase your trucks on the rail or whether you have had to reduce that, because of problems with the service?

MR. JENSEN: Well, Vice Chairman Buttrey and Members of the Commission, we have had a lot of challenges as we've outlined and in certain segments, certain lanes we have taken some traffic from the rail back to the road, absolutely. As far as quantifying that, I would rather not get into it, but we have done that based on the issue of service, frankly. We've got to serve those customers, our customers. And we don't make widgets. All we do is provide service, as I know you are familiar with from your previous private sector career. It's absolutely critical. We want to partner with them. We want them to be successful and us to be successful with them.

VICE CHAIRMAN BUTTREY: Thank you.

CHAIRMAN NOBER: Let me go to another subject that folks raised a lot about which is car and car supply, which is something that again there is not -- I think I have been to almost every one of your member's work facilities in some form or another and there is not a visit I made when I did not hear about car supply and the concerns about private car owners.

Some of the issues that you raised about, you know, the shifting of costs and about, you know, some of the rules of post in private car supply. I mean, it's hard not to be sympathetic to that. But what would you have us do about that? I mean, how would we sort of mediate? What kind of rule would make sense to say well, you know, when demand is high and when it peaks and folks buy extra cars and, you know, they will be used, and then when it slackens, what should happen? Who should bear the brunt of the slack?

MR. FICKER: I think as I said and I think others would agree with me, that should be born by everyone, because as the rail industry has shifted, the ownership of cars, other than tank cars, which have always been owned by the shipper, they shifted the ownership of these other pieces of equipment. They have encouraged the shippers to do that. They have made the investment. There is a mixture of rail-owned equipment and privately-owned equipment. And as markets decrease, there should be a balance.

You should be able to report pretty

clearly that we're using 20 percent less and we're both using 20 percent less, rather than forcing someone to say all right, we have a soft market now, use my cars not your's. Park them. And oh, by the way, you know, you don't have enough track space, we'll charge you storage. That just is a matter of equity.

Chairman Nober, I think if you could create some sort of rules that in the downturn those would be effective or if service improves, for example, if service improves to the point where you don't need as much equipment to move the same amount of commerce, then there needs to be a time line when that volume of equipment is extracted from the marketplace, rather than being penalized for meeting your own needs.

MR. KEITH: We would like to see some kind of a rapid procedure at the STB for considering what is reasonable in these kind of situations for rules. And it is the railroads are setting market rules that are fairly one-sided and, in fact, create risk for shippers. And they want the shippers to invest in rail cars for capacity reasons. Shippers are not resisting that necessarily, but when they see the impacts on their business fluctuating, mileage rates and for getting cars parked very quickly, that they own their -- they don't think it is fair. And there should be some kind of a fairly quick process at the STB to review those kind of one-sided rules.

CHAIRMAN NOBER: Now, shipper after shipper I meet with makes the same point that, you know, when we have to evaluate investing in rail cars without, you know, some assurance of turn time, some assurance of the overall total cost, they can't evaluate the, you know, benefit of investing in that. Now, the flip side is the railroad faces the same situation. So if they don't know what the utilization they are going to get out of their cars is and what the kind of rates they are going to get, are they going to invest in cars?

MR. KEITH: Yeah, but they don't face the same kind of risks. They are forcing additional risk on the shipper if they don't incur by their own rules by owning or leasing the cars directly, and that's the problem. The rules are one-sided.

MR. ELSEA: If I may? I think that the industry shippers, receivers and rail carriers needs to focus on the point that John raised a moment ago and that's on improving velocity. You know, if, in fact, we can do that, then we can all operate with a smaller fleet, you know, and take a substantial amount of the volatility, service volatility out of the system. And, you know, whatever our ailments are up and down the table here can nearly all be answered with improved velocity. And so what do we do to make that happen? I think the list is long.

MR. FICKER: If I can just add to that comment? And I think you are absolutely right that it is important though that if velocity improves and the investment has been made in these things, that there be a phased out of the equipment without being penalized for requiring that equipment.

CHAIRMAN NOBER: What if a regulatory body is faced with saying well, the way to improve velocity is to demarket car load business and focus on unit trains? So a couple of you who run unit trains here would benefit and a couple of you who run single car service would suffer from that, and the Agency should stay out of that or be involved in it. What would you have us do in that kind of situation, which I would point out we face almost every day?

MR. VAN VLACK: I mean, again --

CHAIRMAN NOBER: I mean, is Government really the right place to kind of make and evaluate that kind of decision?

MR. VAN VLACK: I think to demarket service to shippers who ship in smaller quantities to many customers, again is a fundamental change in the rules of the game and the balance of the Staggers Act was intended to assure. And again, it's a bit of a broken record for us, but when you are captive and because of the nature of your products you don't have a lot of option and because you are capital intensive and you can't pick up and move your plant to some other place, that would thus be a fundamentally poor decision.

CHAIRMAN NOBER: Well, I agree. It's a very difficult balance --

MR. VAN VLACK: Right.

CHAIRMAN NOBER: -- to regulators to try to look at those and say, you know, if helping one hurts another, you know, that's not the right place, at least in my view, for a Government Agency to be involved. But it's difficult, because what might help velocity for some customers would hurt it for others and vice versa. You know, but that's why we have railroad operating officers, however, to figure that out.

MR. ELSEA: You know, if you start from the concept that there are segments of industry that cannot be served in a big train model, and I believe that's the case and there's nothing you're going to do to change that, you know, but perhaps the goal of the transportation industry is to cause everything that can comply to get closer to improving this velocity. That creates capacity for everyone. Now, you know, do you need to -- is that the role of regulatory body? I don't think so. I think the marketplace is trying to do that and admittedly the marketplace is struggling with it. And I don't know that you help it by trying to regulate it.

CHAIRMAN NOBER: Commissioner Mulvey?

COMMISSIONER MULVEY: I guess it's part of the problem with how some of these metrics are calculated, such as velocity. Is it a nationwide measure? Some of these problems with lower velocity are found in some markets and not found in others. I wanted to ask you what you thought. We heard about the car supply rules and railroad tank cars, in particular. What in our mission, what in our charter would we use to address those problems? What could the STB do?-- -Is that part of our mission to address those kinds of rules or is that something that the industry needs to work out through the AAR by individual railroads as to how to deal with the terms under which cars are supplied?

MR. KEITH: I'm uncertain exactly the direction that should be taken. I think this body, the STB has the authority to make decisions on unreasonable practices. It might be helpful if the car owners had some representation within AAR committees to decide car rules. Certainly, in our industry, when we are moving towards 75 percent private car ownership, it would be nice to have a seat at the table.

CHAIRMAN NOBER: John?

MR. FICKER: I couldn't have said it any better. Kendell, you, as usual, do a fantastic job. A seat at the table is important. Everyone needs to be able to address the issues. It was all still rail-ownership which it was in 1953 or '54, that would be one thing. But today, the ownership is spread across a wide spectrum. The leasing companies, short line railroads, individual shippers, some short line railroads that are owned by shippers, a plethora of people own rail equipment and those individuals need to be represented in the rule making procedures.

COMMISSIONER MULVEY: John, you mentioned about improving velocity and generating stimulating productivity and innovations, etcetera. What one thing drives innovation, productivity improvements in any industry?

MR. FICKER: In a word, competition.

COMMISSIONER MULVEY: Thank you. I am

glad you gave me the right answer. And finally, I remember another question on the issue of captive shippers, the discussion about the number of mergers that took place since Staggers has increased the number of captive shippers and shippers are subject to bottleneck rates, on the other hand, this leaves one individual out there who has argued that, in fact, the number of captive shippers really hasn't changed very much at all in the last 50 or 100 years.

Most shippers have only ever been served by a single railroad and that the mergers have not really increased the number of shippers who are truly captive. Does anybody have any information on how captivity has increased since Staggers?

MR. FICKER: Commissioner Mulvey, if I could take a stab at that?

COMMISSIONER MULVEY: Yes.

MR. FICKER: I don't know that I disagree with the comment that maybe there are not more or less captive shippers than there were many years ago. But captivity is not about one end of the distribution chain. It's about both ends of the distribution chain. It's the origin and the destination, and that's what has happened in this environment. One is now -- if one is restricted, then you are automatically restricted.

The classic example is a company that I used to work for, used to be able to ship out of the south, in a southern state up into the Conrail territory, prior to the Conrail divestiture. They had competitive options at their originating plant. The two southern railroads, Norfolk Southern and CSX. When that merger or demerger took place, which ever is the proper term, they lost that capability, because now if it was a CSX destination in the north, the only viable alternative was via CSX. And if it was a Norfolk Southern destination in the north, the only viable alternative.

So you have lost movements that had captive -- that had competitive options, because of that particular transaction. And so it's not just about who is a captive shipper. It's about what's a captive origin/destination pair.

COMMISSIONER MULVEY: Okay. I understand.

MR. VAN VLACK: I just would like to second that view. I think that's where the increase has been. Our figure is on 60, over 60 percent captive shippers, at least from point of origin, doesn't include the net effect of the customer impact on that.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN NOBER: Well, finally on that, I would just like to offer an observation I'm seeking of NS and CSX. Last spring, I think before my colleagues got here, we did a couple of hearings on the impact of the Conrail merger looking at the end of the five years. And we did a field hearing up in Trenton, New Jersey looking at the impact of the shared assets areas. Now, much of -- I think the closest parallel we have in the country today to the kinds of switch, reciprocal switching and access that some folks today are advocating is what we did in Conrail in New York, Philadelphia and Detroit.

And we had many of the public entities come in and testify in that hearing about the lack of public investment, about the lack of investment and the decrease in rail traffic in those areas. And instead what happened was instead of investing in New York and Philadelphia, we had a lot of -- there was investment in places like Allentown and Bethlehem and Harrisburg, which coincidentally were just outside of the shared asset areas.

And I wonder if when folks think about these doctrines, they look at the experience we have had in three of the 10 largest markets in the country and see how they have worked and what they think that would portend if the Agency, you know, again, it's not going to be me, if some future Agency moved to that kind of a doctrine, what we think would happen to investment in those areas. I don't know that that's a direct parallel, but it's something at least that struck me in the course of looking at it.

Well, again, I just want to thank you all for your time and your testimony. And I'm sorry for the next panel that we have delayed you a little bit. I'm not sure we have the schedule yet, but why don't we -- again, thank you all very much for your testimony. If anyone has any additional questions, we can submit them for the record.

But we'll move now to our second panel, which is not a coincidence, which happens to all be involved in shipping coal. Okay. Are we going to have enough chairs here? Okay. Well, we have Mr. McBride and Mr. Linderman from the Edison Electric Institute, Mr. Richards and Mr. Crowley, again two familiar faces from the Western Coal Traffic League, Mr. Loftus from the Concerned Captive Coal Shippers, another familiar person here.

Mr. English from National Rural Electric Cooperative Association, welcome to the Board, and Michael Nelson from the Arkansas Electric Cooperative Corporation, again, welcome to the Board. I'm going to start with Mr. McBride and Mr. Linderman.

MR. McBRIDE: Mr. Linderman will begin.

CHAIRMAN NOBER: Okay.

MR. LINDERMAN: Thank you, Mr. Chairman. I am Chuck Linderman, Director of Energy Supply at the Edison Electric Institute, and I would like to digress a little bit and go back to what happened yesterday.

Yesterday the Senate Energy Committee held a hearing on the winter fuels outlook for this winter. It should be of concern to every person in this room with the cost of national gas supposed to be rising about 50 percent to each of us in this area who are residential gas users, as well as high costs of all the electric fuels as well as other fuels for our wintertime heating season.

There are two new concepts under discussion in the Senate as they move to think about Energy Bill No. 2. 1 is called Efficient Dispatch and I want to draw the nexus between efficient dispatch and coal conservation programs that have been running by the railroads and the electric industry to maintain our coal piles.

Efficient Dispatch is a term of art that has been developed by the independent power producers as well as, to some degree, with some support from the chemical industry as a way of moving the electric industry to use our most efficient gas powered units, so that we reduce our gas consumption.

The drive by the Senate right now is to find ways for the electric industry to reduce its natural gas consumption as rapidly as possible so as to maintain economic viability for the petrochemical industry and to reduce the pressures on natural gas prices for home heating for this winter. There are very few short-term solutions to this, but nevertheless as much conservation as possible is what is being pushed to the electric industry.

That in turn comes back to this concept of adequate delivery of coal transportation, and the fact that you now have power plants and generators operating in at least three states that I am aware of that have coal conservation programs in place where they have been burning their coal generators during the daytime when demand has been the highest to keep costs as marketable and manageable to the consumers as possible, and then burning their higher cost gas units at night when the demand has been lower.

That is not acceptable in the current kind of economic environment we find ourselves as a nation with national gas prices north of $13 again this morning, and we need to find ways to get our coal delivery system and coal supply system in enough sync, so that we are able to operate those plants without having to turn them down and operate in a coal conversation program.

To further understand that, and Glenn will probably be surprised at me endorsing something from a co-op publicly, but certainly the letter from the Arkansas Electric Cooperative Association Corporation does make that plain and I urge the Board and all of you to take that into account very closely.

The other thing that occurred yesterday was discussion of coal transportation capacity, and we see a nexus between the Hurricanes Rita and Katrina and an action pending at this Board. Hurricanes Rita and Katrina said to this nation we need to diversify our petrochemical base, our refining base and our natural gas production infrastructure.

What do the twin accidents of May 14 and May 15 tell us about coal transportation from the Powder River Basin? That we need to diversify and add to the transportation infrastructure, so that there are alternate routes out of the basin when there is an accident that stops all traffic coming out of the basin.

There is sitting before this Board an application that we hope you can move on shortly and as rapidly as possible to complete the Dakota, Minnesota and Eastern's application, so that it may proceed with financing development as an alternative way out of the basin to give us a little bit more electric reliability or a little more reliability on coal transportation and, as a market solution, I would add to some of the challenges that we as captive coal shippers have faced.

And finally, I would urge you gentlemen to think through your role as carriers of a big stick and ask for reports from the carriers on the number of trains that they are actually loading on a daily and weekly basis, the number of trains that they have been asked to load, as well as keeping the pressure on to get the joint line brought back to full capacity as rapidly as possible.

And in view of the last discussion, we are all owners of major car freights in the electric industry. The electric industry has financed and brought forward the opportunities for the Burlington Northern and Union Pacific and their predecessor companies in the Powder River Basin, because we built and owned the major car fleets out there.

And I would observe in the last panel, for those who are saying they need improved velocity, folks, we all need improved velocity, but there is going to be more heavy coal trains on the system over the next 15 years than you have thought about, too. Thank you. I'll turn it over to Mr. McBride.

MR. McBRIDE: Mr. Chairman and Members of the Board, I just want to emphasize a couple of points that Mr. Linderman already made. Number one, one of the very good things this Board did several years ago during the service crisis on Union Pacific was, at our urging, to require the railroads to report every week the number of coal trains they were loading out of the Powder River Basin.

We were having a coal crisis, at that time, and the problem was over within about a month because of that report. So one of the things that you can do is not run the railroad, but just focus the only place in America where it is believed that there are no revenue adequate railroads. When I go to Wall Street, everywhere else I go, everyone says at least three or four of them are revenue adequate. So the time has come to regulate them differently. Thank you.

CHAIRMAN NOBER: Thanks. Mr. Richards?

MR. RICHARDS: Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey, my name is Duane Richards. I appear today on behalf of Western Fuels Association and the Western Coal Traffic League. Western Fuels is a not-for-profit cooperative that supplies coal and transportation services to consumer-owned electric utilities throughout the west and midwest.

The Western Coal Traffic League is comprised of 20 coal shipper organizations, including Western Fuels, that collectively ship over 140 million tons of Western Coal annually. I am the Chief Executive Office of Western Fuels Association. I do appreciate the opportunity to appear here today.

I am joined today by Tom Crowley. Mr.

Crowley is President of L.E. Peabody and Associates. He also appears here today on behalf of the Coal League. I will try not to take up too much of his time and give him his five minutes of fame here. Also, I know that there is going to be a fair amount of repetitive discussion on some of these issues, so I apologize for that, but I will go through my comments.

As the Board knows, the Staggers Act was a very comprehensive piece of rail legislation, which was designed to balanced the interest of shippers and carriers. On the carriers' side, the Staggers Act contained provisions designed to make it easier for railroads to merge, to ban unprofitable contracts, to enter into confidential service contracts and to freely compete in competitive markets.

By and large, the ICC and the STB have applied these provisions in the manner requested by the rail industry. The ICC and the STB have approved an unprecedented number of rail mergers. Thousands of miles of rail lines have been abandoned and railroads have been allowed to freely compete in competitive markets. The result has been a new era of financial prosperity for the railroad industry.

The Staggers Act also contained provisions designed to protect captive shippers from carrier market pricing abuses, provisions designed to promote intermodal competition and provisions designed to ensure shippers receive adequate service. For this hearing, I will divide the shippers' side of the Staggers Act legacy into three general categories.

The first category includes provisions in the Staggers Act that, as implemented by the ICC and the STB, have never fulfilled Congress' original intent. First and foremost of these is competitive access. The Staggers Act called upon the ICC and the STB to promote competition in areas where competition was lacking via the terminal trackage rights and reciprocal switching relief.

The railroad industry did not like these provisions and succeeded in convincing the ICC to adopt administrative regulations that effectively preclude shippers from obtaining any terminal trackage rights or reciprocal switching relief. Indeed, it is fair to say that shippers are zero for the last 25 years in obtaining any relief under these standards.

The second category is pro shipper developments that fulfill Congress' intent. These developments included the ICC's approval of the Western Railroad properties, entry into the Powder Basin and, essentially, that was C&W and ultimately the UP's access into the PRB, and that area had been previously solely served by the Burlington Northern, an approval that was obtained over the strong objections of the Burlington Northern.

Subsequently, an additional development was the ICC's initial or the ICC's approval of the RCFA, approval that was again obtained over the strong objections of the entire rail industry and that's the rail cost adjustment factor, adjustment for productivity.

The ICC's also additional adoption of the Coal Rate Guidelines in 1985 and the ICC's, as well as the Board's approval, of rail build-out applications by captive utility coal shippers. These are all very important developments that greatly assisted many

Western Coal shippers.

The third category consists of developments in the last few years that are eroding the pro shipper gains identified in my second category. These developments include the ongoing campaign by the duopoly railroads in the west to abandon confidential contract pricing in favor of so-called public pricing tariff authorities.

The evident desire of the nation's carriers is to distance themselves from the Board's RCAF indices with the addition of profit-enhancing fuel surcharge mechanisms and the Board's decision in some of the recent coal rate cases. As the Board looks to the future, Western Fuels and the Western Coal Traffic League ask the Board to fairly balance the interest of shippers and carriers in the manner called for under the Staggers Act.

On the captive shippers' side, Western Fuels and Basin Electric have a major rate case pending before this Board. I am not here today to discuss our case, but I would encourage the Board to take a closer took at the proposals that we have made in the case to achieve a fair balance between the interests of captive shippers and the railroads.

I would further encourage the Board to observe and respond accordingly to the noncompetitive practices of the railroads as they endeavor to reinstate public tariff pricing on Western Coal movements. Thank you. Those are my comments.

MR. CROWLEY: Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey, my name is Tom Crowley and I am President of L.E. Peabody and Associates Incorporated. Our firm has provided economic services for the Western Coal Traffic League since the League's inception in 1976. I am here today on behalf of the Coal League.

As Mr. Richards observed, the Staggers Act has been an unqualified success for the rail industry. Simply stated, since 1980 Class I railroads' revenues have increased significantly. Class I railroads' operating expenses have decreased significantly and Class I railroads' profits are currently at record levels. The Coal League's written statement illustrates these facts through reference to a number of standard industry metrics.

The financial markets have also taken notice. As shown in my first slide, over the last five years Class I railroad stock prices have increased by 133 percent. That would be the red line on the chart. During the same five year period, the S&P 500 stock index dropped by 16 percent. That would be the green line. Obviously, a company's stock price is an important forward looking indicator of the financial health of a business reflecting current operations and the market's expectations of future earnings.

The debt rating agencies are also positive on the railroad sector. In its July 15, 2005 Transportation Industry Report Card, Standard & Poors, the leading debt rating agency stated, and I quote, "The fundamentals in the North American rail sector remain very favorable."

Despite their record profitability levels, the nation's major railroads now frequently claim that they need to raise shipper's rates to fund new rail infrastructure investments. Typically, the railroads cite to the declining average freight rates since 1980 in support of their rate increase arguments. What the railroads never show in these presentations is their declining operating expenses.

My second slide compares Class I railroad revenue per ton-mile and Class I railroad operating expenses per ton-mile from 1980 to 2004 for all rail traffic. This slide shows that railroad operating expenses per ton-mile are consistently and substantially below revenue per ton-mile. This trend is particularly true for coal traffic, as illustrated in my third slide.

This slide compares the average revenue per ton-mile, the green line, the average variable cost per ton-mile, the blue line, and the annual dollar contribution in millions of dollars the railroads receive for handling Western Coal. As shown, the cost for Western Coal moves has been declining significantly since 1980. This makes sense given the large increases in productivity realized by Western Coal hauling role since the Staggers Act.

At the same time, the western carriers'

annual revenues have stayed substantially above their cost of providing service. Overall, the differential between revenues and cost has produced significant coal shipper annual contributions to Western Coal hauling carriers' financial positions. These contributions are, approximately, $2 billion annually over the last 10 years.

Almost all of this contribution is captured by the two major Western Coal hauling railroads, the BNSF and the UP. The Class I railroads' record revenues and profits have allowed them to make significant infrastructure investments in the last several years while, at the same time, permitting them to pay record dividends to their shareholders and permitting them to buy back significant segments of their own stock.

These results are illustrated in my fourth and fifth slides. My fourth slide shows that over the last five years, Class I railroads' capital spending has approximated $6 million annually in 2004 dollars. My fifth slide shows the Class I railroads' free cash flow. This metric measures cash available to the railroads' debt and equity holders after paying for capital expenditures. As shown in this slide, the Class I railroads' free cash flow has been approaching or exceeding $3 billion annually in 2004 dollars.

The record is clear. The Staggers Act has produced significant financial benefits to the railroad industry. It is also clear that in these times of railroad financial prosperity, the railroad industry does not need to increase shipper rates and, particularly, does not need to increase coal shipper rates to fund new infrastructure investment. Thank you.

CHAIRMAN NOBER: Thank you very much. Mr. Loftus?

MR. LOFTUS: Good morning.

CHAIRMAN NOBER: And welcome back to the Board.

MR. LOFTUS: Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey, my name is Michael Loftus and I'm an attorney. I am appearing here today on behalf of the Concerned Captive Coal Shippers.

That is a group that includes American

Electric Power Service Corporation, the city of Grand Island, Nebraska, Duke Energy Corporation, the Intermountain Car Project, Lafayette Utility System, Platte River Power Authority, Progress Energy, Inc., Seminole Electric Cooperative, Inc., South Carolina Public Service Authority and South Mississippi Electric Power Association.

Each of these companies has one or more coal-fired power plants that are captive to a single railroad. As such, they are subject to rail market dominance and face monopoly pricing power from the railroads that serve them. Several have been or are involved in coal rate cases before this Board. This group also participated in the Board's proceedings in Ex Parte No. 657 addressing concerns with the Board's recent application of the stand alone cost maximum rate constraint in coal rate cases.

Concerned Captive Coal Shippers believe the Staggers Act has been highly successful in achieving a number of its goals, in particular those benefitting the rail industry. However, some of the Act's goals that would benefit captive rail shippers have been frustrated and the balance the Act sought to achieve between railroad revenue needs and protection of captive shippers against excessive rates has not been afforded in recent years.

As goals fulfilled, we would include the financial health and stability of the railroad industry, the widespread use of rail contracts, which we view as a boon to the industry and which we believe has had a significant role to play in bringing the industry to where it is today, the rail cost adjustment factor, pro competitive regulatory actions by the ICC in opening the PRB to competition, support by both the ICC and this Agency for construction of rail lines to create competitive access for captive facilities.

As goals frustrated by Agency actions, we would include the Midtec Decisions which, as others have described, negated the pro competitive potential of reciprocal switching and terminal area trackage rights, the bottleneck cases, which deny captive shippers the opportunity to rely on competitive forces where available to obtain reasonable rates, paper barriers, which the Agency has refused to address to date in a meaningful manner to limit their anti-competitive effects.

In the current environment, competitive gains have been reduced through rail mergers. The situations where construction of trackage to create competition could be undertaken at reasonable cost have, to a large extent, been exhausted.

For coal shippers with the benefit of competitive rail service, particularly in the west, competition is diminishing under public pricing initiatives and the duopoly behavior that coal shippers express concern about in both the BN-Santa Fe and the UP-SP mergers, and railroads are raising rates on captive coal traffic dramatically.

As the Concerned Captive Coal Shippers explain in detail, and I will not get into the detail here, in their comments in 657, the goal of the Staggers Act to provide a reasonable balance between the interests of railroads and captive shippers in national rail cases has not been fulfilled in recent years.

Service has been an increasing problem, which is having major adverse effects on captive shippers. Distressingly, it seems that the railroads seem more intent on taking advantage of these circumstances to increase rates than to take the steps necessary to ensure adequate service.

The steps that the Concerned Captive Coal Shippers believe should be taken at this juncture are revisiting, through legislation or otherwise, Midtec and the bottleneck cases to allow the pro competitive policies of the Staggers Act to work through effective reciprocal switching and an obligation to provide rates over bottleneck rail segments, provide greater balance and maximum rate making activities by the Agency, whether in SAC cases or cases relying on revenue adequacy principles, greater oversight by the Agency on railroad service reliability and encouragement by the Agency of competitive rail circumstances and competitive railroad behavior in every element of its responsibilities. Thank you very much.

CHAIRMAN NOBER: Thank you, Mr. Loftus.

Mr. English, welcome to the Board.

MR. ENGLISH: Thank you very much. I appreciate that, Mr. Chairman and Commissioners. I am Glen English. I am the Chief Executive Officer of the National Rural Electrical Cooperative Association. Some of you may not be familiar with what cooperatives are in the electric utility industry, but we have nearly 1,000 that are our members and they are not-for-profit and they are actually owned by the consumers themselves.

That number is approaching somewhere in the neighborhood of 40 million consumers in 47 states across this country, and certainly each and every one of them have a big stake in the discussion today and the actions of this particular Board, given the fact that about 80 percent of all the electric power that is generated by electric cooperatives is coal-fired and much of the rest, of course, is gas power and, as you heard Mr. McBride point out, that has become extremely expensive today.

I want to take a little different approach, if I could, Mr. Chairman. I noted that in your biographies, all three of you served time in the United States Congress as staff people and while I was also there as a Member of Congress, I thought maybe I would appeal to you just a bit on some of the experience that you had during those times.

If you recall, one of the great frustrations staff people and members alike had was when legislation passed in Congress, it wasn't always implemented in the manner in which it was intended. In fact, many times you wonder if a legislative history ever got read by the people who are writing the rules and regulations and carrying that out.

And while I don't believe any of you were there when the Staggers Act passed, I was and I recall the discussion and the debate that took place and, certainly, I would be the first to say that the circumstances have changed dramatically since that time. This is a different time than during that period.

I would say, however, that one thing that needs to be underscored, a provision Staggers put in and what he intended for captive shippers, for those people who could not take advantage of competition that is very real today. It's our estimate roughly 20 percent of all shippers are captive shippers and they are being taken advantage of and they are being abused and they are being used to pay for competition where competition exists.

Mr. Staggers intended that the Interstate Commerce Commission and, subsequently, this Board make sure that those captive shippers were protected and that's what we hope, that you will look back at that legislative history, maybe go back and read a little of it and weigh the impact that the lack of action by this Board will have in protection to captive shippers and what that really means.

This winter we are going to have millions of Americans that are going to have extremely high electric bills and fuel costs and you can do something to help bring a little fairness and equity to the whole electric utility industry by addressing this issue. Thank you very much.

CHAIRMAN NOBER: Well, thank you. Mr. Nelson?

MR. NELSON: Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey and Board staff, my name is Mike Nelson. I am a transportation consultant and, on behalf of Arkansas Electric Cooperative Corporation, I would like to say thank you for this opportunity to provide testimony regarding the Staggers Act.

In the interest of brevity, I will agree with the speakers who have gone before me regarding the beneficial impacts of the Act for the railroads. The big picture is good. Competitive forces have been unleashed and have largely done what they were supposed to.

In my written testimony, I get into some minor detail regarding ways in which, in the wave of mergers that created the current competitive environment, we may have had some unintended losses of competition along the way. On the technical side, the methods used to analyze proposed mergers changed over time and while it was good that we got more refined as we went along, the other side of that is that some of the earlier cases may not have been viewed with the same sensitivity to issues like crossover effects and source competition.

On the flip side of that, early in the merger process you had an environment where there were still many Class I rail carriers and they frequently perceived it to be in their interest to vigorously pursue competitive issues in some of the earlier cases. In some of the later cases, as the number of non-included rail carriers went down, the atmosphere became somewhat more fraternal and there was a tendency for negotiated settlements rather than litigation of competitive issues.

Overall, as a result of those factors and other things in my written testimony, I think there were opportunities for the past merger cases to have sort of let slip through the cracks some elements of competition that may not have been considered at all in the record of the case or may certainly not have been blessed by the Board as being an anticipated part of the merger that was being approved.

Even the important three to two reduction in the number of competitors that was controversial and subject to a lot of debate was ultimately approved on the basis of an expectation that it would not produce competitive harm. So whether or not the Board decides to refine its procedures for regulating the rail industry, there may be some situations from things that have been done in the past where something could be done to address competition that, in specific situations, may have inadvertently been lost.

On the subject of whether there should be a change in the Board's regulatory practices, I think economic theory would suggest that if you get into a mode of having super competitive earnings that you would really expect to be attracting new entry and additional competitors. In addition, I would understand one of the intents of the Staggers Act to be that, as the financial picture improved for the railroads, that you might have less differential pricing.

In deciding, however, when you're at the point of possibly making a change in the regulatory procedures, I'm concerned about the possible reliance on a single measure, be it revenue adequacy or some other comparable measure. It's a natural feature of competitive markets that not all competitors are going to have the same returns.

If you have competitors who undertake bad strategies or make mistakes in their decision making, the function of the market is to punish competitors who make choices like that, and I think we have had a few cases where we have had significant service problems in the rail industry that have resulted in large part from that type of decision making.

So I would be more inclined to look at specific events rather than individual measures alone in terms of gauging when it's time to potentially change the view of the role of the Board in regulating the industry.

As I made reference to, you have disruptive events from things like decisions as to crew hiring practices and maintenance procedures. You have actions by the remaining two carriers in the public pricing area, and people have made reference to the fuel surcharges where duopolists are starting to move in parallel in ways that they have not in the past and in a way that's largely outside of the Board's scrutiny.

There has been reference to the increasing capacity constraints and demarketing issues. Competition provides protection against all of those things, so it would be reasonable for the Board to conclude that the public interest might best be served by sharpening competitive pressures.

CHAIRMAN NOBER: You can feel free to summarize the rest of your testimony.

MR. NELSON: Okay. That is pretty much it.

CHAIRMAN NOBER: Okay.

MR. NELSON: It would extend the view of the role of competition that was originally embedded in the Act.

CHAIRMAN NOBER: Thank you. Vice Chairman Buttrey?

VICE CHAIRMAN BUTTREY: Not at this moment.

CHAIRMAN NOBER: Commissioner Mulvey?

COMMISSIONER MULVEY: I want to assure

Congressman English that we have a copy of the legislative history of the Staggers Act, each one of us here, so we --

MR. ENGLISH: If I could respond?

COMMISSIONER MULVEY: Yes.

MR. ENGLISH: You all have got to be very rare Commissioners if you have a copy of the Act in front of you and if you're really reading the legislative history, I commend you.

VICE CHAIRMAN BUTTREY: And I also carry a copy basically everywhere I go. I have three documents on my desk and that's one of them.

MR. ENGLISH: Spoken like true former staffers. Thank you very much.

VICE CHAIRMAN BUTTREY: I would take some issue with your terminology of serving time in the Congress.

MR. ENGLISH: Well, there are others that have served time afterwards and all have just --

VICE CHAIRMAN BUTTREY: I don't want that to be misinterpreted.

COMMISSIONER MULVEY: I think sometimes

it's not a matter of the law not being followed, but when the law is drafted, sometimes we're rushed and sometimes don't always understand all the implications of what we do.

I think, for example, with respect to the common carrier obligation, I think many in Congress are surprised to know that when they passed the Interstate Commerce Termination Act that, in effect, they may have compromised that obligation for many, many shippers. So I know some in Congress are surprised to hear that when I inform them of that.

I have a couple of questions. One of the things that has been alleged is that some of the electric utilities have, in fact, sold off a lot of their stockpiles in order to take advantage of high prices and that now, they are facing shortages because of that action, as opposed to it being traced to the inability of the railroads to deliver. Can anybody comment on that allegation?

MR. RICHARDS: Sold it to who, how?

COMMISSIONER MULVEY: Hm?

MR. RICHARDS: Sold it to who and how?

COMMISSIONER MULVEY: Put in the market, I assume.

MR. RICHARDS: No. Well, as a utility you're buying coal under your contract to deliver in part.

COMMISSIONER MULVEY: Or sold the contracts, I guess.

MR. RICHARDS: Pardon?

COMMISSIONER MULVEY: I guess the contracts were sold or whatever.

MR. RICHARDS: I'm not -- I'm really not familiar with any of those. I mean, we have an obligation to serve to our customers and to meet that obligation, we have to utilize the coal that we have under our contracts and deliver it. I'm not aware of that.

COMMISSIONER MULVEY: Okay.

MR. LINDERMAN: Commissioner Mulvey, I am not aware of that either, and there are some practical difficulties with even doing that, because most coal plants don't have the ability to reload a train or a truck to take coal off-site. And once you have got the coal on-site, you use it to generate and that is the purpose of that fuel supply that has been brought there.

If you were going to sell off-site, you might generate more power at a given power plant and put the power up on the grid and use the electric transportation system as a way in which to move the power, but that again becomes a matter of what either the local grid operator or the independent system operator decides to -- how they decide to have the plants run.

UNIDENTIFIED SPEAKER: Based on economics.

MR. McBRIDE: And, Commissioner Mulvey, I represent several electric utilities who have had coal stockpile problems for the last few years, and not a single one of them has done what you said. The opposite problem has been true. They have had coal stockpiles reduced to a matter of days. I had a utility in the east last winter that was down as low as six days worth of coal.

I had another that routinely tries for 50 days, was down to 20 days before the worst of the winter hit. The same thing with changes in the number of days with the same picture has generally been true, in my experience, across the country. And people have been trying to get more coal.

There have been problems at the mines, too. This is not just solely a rail issue. I have told the Chairman that and I think the Board could be helpful there as well. Some of the mines seem to think that it's up to the railroads to build storage track on the mine property. It isn't. It's up to them just like it's up to us to build a storage track on our property.

The mines could be more helpful, so this is not just a rail issue, but the utilities are trying to get all the coal they can right now. Nobody is selling it. They are buying it.

COMMISSIONER MULVEY: Yes. My understanding is about half the shortfall of the PRB is due to mine operation problems and about half due to rail transportation problems.

We spoke recently with a major coal producer and they are very, very concerned about the long-term and short-term availability over the winter months, the availability of coal out of the Powder River Basin. And, of course, everyone is looking to the Board to finalize its opinion on the EIS for the DM&E. My concern is that the DME is going to have difficulty in getting financing unless the utilities are willing to sign up for it.

Is it your understanding that there are a number of utilities that will be willing to contract with DM&E, so that they can actually get the financing they need to go ahead?

CHAIRMAN NOBER: I assume in the hypothetical that we approve.

COMMISSIONER MULVEY: In the hypothetical that it gets approved.

CHAIRMAN NOBER: Because it's a pending case.

MR. McBRIDE: Hypothetically.

COMMISSIONER MULVEY: It's a pending case, yes.

MR. McBRIDE: Hypothetically, if you approve it, I think the issue will come down to a simple one and that is will CSX and NS make capacity available for DM&E-originated coal to reach plants served by those two railroads. I think it's unrealistic to expect UP and BN to compete with themselves, if you will, and make such capacity available.

So the key to this is going to be whether DM&E can get the coal to the power plants, because there are relatively few on its system, and there are many people in discussions right now with DM&E and otherwise to try to solve that kind of problem. But it's hard to contract with somebody who can't get the coal to you, so you need the participation of the carriers who deliver the coal.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN NOBER: Well, let me ask a slightly different question. I know many of you at this table are concerned about rates and there is no subject I have probably heard more about in my three years here than coal rates.

Do you think that the -- or at least the methodology by which the Board determines the maximum reasonable rate for coal would change if railroads were found to be revenue adequate and, if so, how would you see it change?

MR. LOFTUS: If I might take a shot at that. I think the coal rate guidelines, of course, identify four constraints and this Board has only dealt with one, stand alone costs. Revenue adequacy is identified as a constraint and although it's not fleshed out in detail, the guidelines certainly suggest that there should be new limits imposed on the extent of differential pricing on captive traffic for a revenue adequate carrier.

And the clearest situation where that would come into play, it would seem, is a rate increase. If a carrier is revenue adequate, and we recognize that is not a snapshot analysis, if the carrier is revenue adequate, it got there with the rates on that traffic at the level they were prior to the increase that the carrier seeks to obtain on that traffic.

And so in those circumstances, certainly, you need to take a hard look. One of the things that has hung captive coal shippers in recent rate cases before this Board has been a very stringent burden of proof in a very complicated case scenario, and certainly you could look at imposing a burden of proof on the railroad in those circumstances if it wants to seek a greater degree of differential pricing on a captive movement as a revenue adequate carrier.

MR. CROWLEY: May I just add to what Mr Loftus was saying? It was a number of years ago when CFI Industries versus Georgia Pipeline came before the Interstate Commerce Commission and offered evidence on the revenue adequacy constraint and the maximum rate was determined using those guidelines. So there is information available.

CHAIRMAN NOBER: Believe it or not, the case is still here.

MR. CROWLEY: Well, not that part of the case.

CHAIRMAN NOBER: Cases, they never die. They just sort of fade away or just stay here forever.

MR. CROWLEY: But there is some guidance available as to how to implement that standard.

CHAIRMAN NOBER: But the question is should it be implemented, because I guess the follow-up is what is a fair contribution from captive shippers in world where railroads are financially healthy?

MR. McBRIDE: Mr. Chairman, the answer to your first question is absolutely yes, because the ICC promised us 20 years ago that the revenue adequacy constraint would be implemented when the railroads got there. I am not going to go over the same ground Mr. Loftus did on rate increases, but I absolutely agree with him.

But now let's look at the issue from the perspective of the carriers. They are going to say we need rate freedom and you can't take that away from us. Well, here is where the Board really could be focused and maybe address the problem. I was looking at data again yesterday from the Public Waybill Sample File, data of this Agency, and consistently over the last 10 to 20 years about 15 to 20 percent of rail traffic appears to be below 100 percent of variable cost.

That was true as of the latest data that is available in 2002 and 2003. Now, either the data is wrong or railroad rate making practices are wrong, and we shouldn't be subsidizing that traffic any longer when there are capacity constraints. It is literally crazy to be carrying traffic in a capacity-constrained environment below the actual variable cost of that traffic.

So the first step of Long-Cannon is to find out why that is happening, if it is happening, and if it isn't happening, correct the data. The second thing to do --

CHAIRMAN NOBER: Hopefully, the carriers can address that after lunch.

MR. McBRIDE: Well, okay, good. I would love to hear the answer to it because, for example, they claim intermodal traffic is much more profitable today than it used to be, but we never see the data.

Now, the second thing in Long-Cannon is the traffic between 100 and 180 percent of variable cost. Again you have to ask yourself in a capacity-constrained environment, why can't we move coal? Why can't the chemical companies move chemicals? Why can't the grain people move grain? And, instead, we're moving traffic that is below average profitability.

It's crazy and that's where the Board could really be focused instead of saying you need to be able to raise rail rates on captive traffic still higher. You don't. In a revenue adequate environment, you should be focused instead on maximizing profitability and this goes to your question, Commissioner Mulvey, about the common carrier obligation. It still exists.

The railroads have to carry everything, except gold and silver bullion and money because of the decisions of this Board, all right, because of Jesse James. But everything else is entitled to a rate, but the railroads can set any rate. Those are the words of the statute on that traffic, subject only to review by this Board.

So there is absolutely no reason, for example, why lines of railroad in this country that carry largely deregulated traffic have demand exceeding capacity, such as was the reference to the Sunset Line in a letter to the Board this summer. Unless the rates are not set at a level adequate to get the return, that that traffic ought to be provided. That's where your focus really could be. Why is this extreme cross-subsidy still going on?

CHAIRMAN NOBER: Vice Chairman Buttrey?

VICE CHAIRMAN BUTTREY: To anyone on the panel. Is it true that there is an inverse relationship between the ton-mile and revenue for intermodal traffic and for coal? I didn't mean to make it that hard.

MR. CROWLEY: That would suggest that, well, the ton-mile --

VICE CHAIRMAN BUTTREY: Intermodal traffic weighs less and pays more.

MR. CROWLEY: Yes.

VICE CHAIRMAN BUTTREY: And coal weighs more and pays less. Is that true or not?

MR. CROWLEY: Yes.

VICE CHAIRMAN BUTTREY: That's true?

MR. CROWLEY: I would say that's a true

statement.

VICE CHAIRMAN BUTTREY: Okay. Wouldn't it seem logical that something that's tearing up your railroad would be charged more?

MR. CROWLEY: Well, it's being charged. I assume you're talking about the coal now.

VICE CHAIRMAN BUTTREY: I'm talking about the coal.

MR. CROWLEY: It's paying rates that cover all of its costs for tearing up the road, as you put it. I mean, all of the costs that are included below that rate level are being covered and then some. The contribution is what you need to look at, not what the rate of the costs are, but how much money is that contributing. That was the focus of the chart I tried to explain earlier this morning.

Coal is paying its share and then some. I think that's the message you want to take away, and I think if you looked at intermodal fairly, it wouldn't be paying its way. I don't think it's making a contribution. I know it's not making the contributions that coal is. I'm not sure it's making any contribution in total.

CHAIRMAN NOBER: Interesting. Frank?

COMMISSIONER MULVEY: Well, presuming the railroads are that irrational, and that is presumption, why would you carry something if you can't cover your variable cost?

Obviously, one of the first laws of economics is that you never price below variable cost unless, of course, you have entered into some sort of long-term agreement, which doesn't allow you to raise rates as your costs go up. And that is getting back to the contracting issue, which I believe everybody has said here, that you have to have long-term contracts in the utilities industry in order to sell the utility bonds and build the utility plants.

So, on the one hand, we need the long-term contracts but on the other hand, there's certainly cases where these long-term contracts have frustrated the ability of the railroads to raise rates in response to increase in demand and causing this problem.

MR. RICHARDS: Commissioner Mulvey, the

long-term contracts were in place when the railroads believed that the rates were going down as they had in the past. And now that they believe the rates are going up in the future, they want shorter term contracts. It's really that simple.

MR. McBRIDE: And Commissioner Mulvey --

COMMISSIONER MULVEY: Well, we're talking here more about intermodal movements and others, as opposed to the coal --

MR. RICHARDS: I was referring to coal history.

COMMISSIONER MULVEY: Okay.

MR. McBRIDE: There are two responses, I think, to your question. Why would they carry traffic below 100 percent of their variable cost?

The first answer you put your finger on. There apparently are historic contracts that are below 100 percent of variable cost. Those should not be the responsibility of the shippers, the captive shippers on other parts of the system. Consistent with your stand alone cost model, we should be responsible for the parts of the system we use not the parts we don't.

And the second answer to your question is, unfortunately, about 20 years ago the ICC addressed this issue in Ex Parte 355 on the subject of directly variable cost, and concluded that it was all right in an excess capacity environment for railroads to be carrying traffic above their directly variable cost, but below their total variable cost.

I would submit to you that is a policy that ought to be relooked at and reconsidered in light of the capacity constraints that we're now experiencing.

MR. LOFTUS: And if I might add to that, Commissioner Mulvey. The costs that are used for regulatory purposes are not necessarily the costs that guide the railroads' business decisions and, in fact, this Board has refused to look into the books that the railroads keep for making their own pricing decisions.

They have been very clear that they don't price on regulatory costs. They have internal management costs and those are probably significantly lower than the variable costs that you would get for regulatory purposes.

COMMISSIONER MULVEY: But directly variable costs, you're referring to what is normally considered to be, approximately, marginal costs, right?

MR. McBRIDE: No, I --

MR. LOFTUS: I think it's below that.

MR. McBRIDE: I think it's even below that.

COMMISSIONER MULVEY: Below marginal costs?

MR. McBRIDE: I think, and Mr. Crowley may recall, but I think there were just a few categories of cost, such as fuel cost, labor cost and some maintenance.

MR. CROWLEY: Yes, line haul cost deleting and clerical, but I think the --

COMMISSIONER MULVEY: It's close to marginal cost, but --

MR. CROWLEY: Close to marginal cost, yes. I think the answer is what both Mr. McBride and Mr. Loftus were talking about. It's the level of cost that we're talking about that goes into the railroads' decision as to whether or not to take the traffic. Is that cost level the same as the level of cost you use in evaluating that traffic? And I think the answer to that is no, it is not, it's different. How do we get those two cost measures in line?

COMMISSIONER MULVEY: One other question, and that is with regard to the stand alone cost process that we use for evaluating large rate cases, it has been charged that the eastern utilities cannot win a rate case today. Western utilities have some chance.

Would you care to comment on the difference between the eastern and western situations and why the eastern utilities would be at a disadvantage given our procedures?

MR. CROWLEY: I would love to. How much time do you have?

COMMISSIONER MULVEY: You have two minutes.

MR. CROWLEY: There seems to be a perception in this Agency that when you move coal in the east, it's different than when you move coal in the west. There seems to be a perception that a trainload or a unit train of coal moving in the east somehow moves differently than it does in the west.

Now, I admit that the geography is somewhat different in the east and it's more mountainous and hillier, but set that aside for a moment and everything else is basically the same. Now, why that translates into such high stand alone costs in the east as compared to the west is --

CHAIRMAN NOBER: Well, there is one difference and this is something that we grappled with, I grappled with in the eastern cases, which is in the west coal is sourced from one place and then distributed out through the network. In the east it's sourced from many places and then funneled into the one plant.

So the stand alone cost, rightly or wrongly, makes you take into account all the fingers sourcing the coal. Whereas, in the west, you know, you only have to look at the one line from origin to destination. That I think would be the one amendment I would make to your point.

MR. CROWLEY: Well, I would disagree with that as well. I think that the evidence that was presented in the eastern cases showed very clearly that coal originated, trainload coal originated at trainload tipples and that was the traffic, the base of the traffic that was moved. There was --

CHAIRMAN NOBER: But there were 40 of them.

MR. CROWLEY: Pardon me?

CHAIRMAN NOBER: There were 40 of them.

MR. CROWLEY: 40 trainload movements?

CHAIRMAN NOBER: No, 40 origination points.

MR. CROWLEY: There were a number of them, but they were all trainload originations.

CHAIRMAN NOBER: I think it was something like 40, if I recall, in all three, as opposed to one in the PRB. Now, that's one, you know, with triple track.

MR. CROWLEY: But the economics --

CHAIRMAN NOBER: I'm not here to argue.

MR. CROWLEY: No, I understand.

CHAIRMAN NOBER: I just think that is a difference.

MR. CROWLEY: But I am here to argue. The economics of coal are such that it doesn't make any difference where all the coal is. It's that train and how that train efficiently moves from origin to destination.

CHAIRMAN NOBER: Correct. But if the SAC test makes you have to build the infrastructure for the 40 different mines, that's why in eastern -- that's the answer to Frank's question.

MR. CROWLEY: Yes. Okay. I thought you were talking about a gathering problem versus a trainload.

CHAIRMAN NOBER: No, it's that you have to build all 40 origination points through the mountains of Appalachia.

COMMISSIONER MULVEY: You have to model that.

CHAIRMAN NOBER: And not --

MR. CROWLEY: Absolutely.

CHAIRMAN NOBER: And it was --

COMMISSIONER MULVEY: And that's the difference between the two.

CHAIRMAN NOBER: No, but that's the difficulty. You can't get the density on the line that you get coming out of the joint line, right?

COMMISSIONER MULVEY: And my question was whether or not there was any way of addressing that, any way of adjusting our processes so we can get around those kinds of problems and make it more comparable across the country. That's where I was trying to go with that.

MR. CROWLEY: Well, I think it's more the amount of investment and the amount of operating costs that came out of those decisions when compared to those same two metrics out of the western cases. To buy a ton of steel or to buy a tie or to buy a ton of ballast costs the same in the east and the west, and we were seeing unit costs at any measure for any component of this infrastructure considerably higher in the east than the west, which was something that confused us.

MR. LOFTUS: Commissioner Mulvey, if I

might add, in the eastern cases the Board accepted operating plans in each of them that were grossly less efficient than the operations in place today for those carriers.

You will recall that the gathering operations that Norfolk Southern and CSX sponsored in those cases has multiple -- very short trains for multiple car movements moving from individual loading points to the gathering yards. SAC analysis is supposed to be a least cost, most efficient analysis, and the operating plans accepted -- I understand, you know, why you defaulted to those.

COMMISSIONER MULVEY: I wasn't here then.

MR. LOFTUS: Oh, I'm sorry. I didn't mean to tar you with that. But the point is that --

CHAIRMAN NOBER: Tar is a strong word.

MR. LOFTUS: -- those operating plans could have been corrected, so that they were at least as efficient as the carriers' operations, but they weren't.

And so it's one of those rare situations where you don't -- in that contested area of the case, which drove a large part of the costs and a large part of the investment costs for the stand alone railroad, the operation that was used to model it was less efficient than actual. And so I would not accept the proposition that you cannot, under stand alone cost, have a winning case in the east.

CHAIRMAN NOBER: Okay. It's more difficult.

MR. LOFTUS: It is more difficult.

CHAIRMAN NOBER: Is that fair?

MR. LOFTUS: Yes.

CHAIRMAN NOBER: Vice Chairman?

VICE CHAIRMAN BUTTREY: Just an observation. There was a suggestion made earlier that, somehow, the information about what is happening on the Powder River Basin is not readily available. That may be true in terms of filing reports or information or whatever.

I would observe that the two carriers serving the Powder River Basin have been very forthcoming with the Board about information about what is happening out there and why, their view of why, and there is no shortage of information to this Board anyway or to this Commissioner, and I presume to the others, about information about what is actually happening out there and what we think the reasons are for that happening.

So just to clear that up from my perspective anyway, there has been volunteer information coming in regularly about what's happening out there.

The other observation is about setting aside the geography or whatever in terms of a SAC analysis or whatever, sort of like the doctor who tells his patient he has cancer, but he has a cure for that and it involves surgery, which may kill you. But setting that aside, we do have a cure. I don't think you can set those things aside. I think those are very real considerations.

CHAIRMAN NOBER: Thank you.

MR. McBRIDE: May I just respond briefly, Mr. Vice Chairman?

VICE CHAIRMAN BUTTREY: Yes, sir.

MR. McBRIDE: Because it was me who, it

was I who, suggested that the Board did something useful by asking for that coal loading information several years ago. And I agree with you. We can find out from UP & BN how many coal trains they are loading in the Basin. But when I ask the question or when you ask the question, it's a great deal of difference. And I wasn't just confining myself to the west. I'm also speaking to the east.

And the point is that the active observation of a regulated entity by the regulator often alters its behavior. Now, if the Board simply signals what its greatest concerns are to the carriers, that may cause a change in behavior.

CHAIRMAN NOBER: Well, to follow-up on Doug's point, a group of utility executives came and met with me in the early part of the summer and expressed concern about the PRB and as a result of that, we did ask for weekly calls and updates with the two western carriers and have been getting that, including having their -- you know, talking to their senior managers and several people in the audience several times about it as well as Mel's shop, talking to them, I think, on a weekly basis.

So we have been doing it. And particularly, when shippers ask, I can't think of a single instance when shippers have asked us to do something like that that we have not. So, you know, I believe strongly in doing it. So I think we already have. We don't necessarily publicize it. But the same with some of the metrics that came up, you know, I spent a long time with the carriers this spring trying to get them to revise their metrics. Some of the voluntary changes made in metrics, somewhat unhappily, but I think ultimately they all came around to some measure.

MR. McBRIDE: Well, let me share with your colleagues what I said to you privately when we last met, which was that in addition to the act of sort of getting that sort of information from the railroads, and I do regret your departure, Mr. Chairman, and that's why I want to make sure they know what I shared with you, which is I think this Board could provide a great service in contacting the mining industry and finding out why we're having these loading problems in the Basin as well.

And why they don't consider it their responsibility to build adequate storage tracks, so that when there is a spot in the queue, they have got a coal train ready to load. And why they are not better able to deliver the coal that the utilities have under contract. This is a three part problem between the utilities, coal mines and the railroads. And we need the mines to understand what our needs are just as much as the railroads.

CHAIRMAN NOBER: Well, let me just make a final point, which is part question, part point, which is, you know, on the one hand we hear the very legitimate concerns of utilities about the increase in coal rates and the impact that that's having on customers and it's hard, you know. As regulators, we have to be sympathetic to those kinds of concerns.

On the other hand, we heard the concerns that Mr. Linderman raised, and we've heard from several other sources about how are we going to meet the increase in demand for coal movements, east and west? And unfortunately, do you think that acting in

Things have changed. But the policies and the actions and the methods in which the, particularly, captive shipper situation is being dealt with is much like it was in the 1980s. And what I'm suggesting is now is the time to go back and look at the intent of the law and balance this out a bit and look at the possibility of shipping some policies to deal more with the reality as it exists today as opposed to where we were 20 years ago.

MR. RICHARDS: Well, I think the policy of increasing competition is where we need to look at. It has been the success on the part of the Basin, you know, where we have had the competition, we have had two carriers, we had the rates that have provided the investment that they needed, you know, in the Basin. So I think as long as the policies move towards increasing competition, whether it is bottleneck or whatever, you know, I think there is advantages. The more we can reduce the number of captive shippers, I think the healthier we'll have the industry.

We, obviously, rely, the three of us, the producers and the utilities and the railroads, we all depend upon each other to be healthy. We don't have any interest in not having a healthy industry of all the parties. But competition has been successful.

MR. LOFTUS: I would just add briefly that, you know, I think, our clients would want us to say that it is critical that the railroads have the capability to provide transportation services they rely upon to get the coal they need to run their plants. You know, there has been a lot of talk about constraints, but I'm not aware of any well-documented analysis as to where those constraints are and how much it would cost to fix them, what cars are effected, etcetera.

But the other thing I would add is, you know, how many coal rate cases have you really had in the last 25 years? I would suggest to you it's not that many.

CHAIRMAN NOBER: Relatively few.

MR. LOFTUS: Relatively few. And, you know, particularly, in an era where you could contract with the railroads where they were responsive to individual companies concerns and wanted to meet those, you know, they were able to work out and work their way around a lot of those things.

CHAIRMAN NOBER: Well, if you look at the case file, I know you do since you are involved in many of them, I mean, it was typically one a year or so for many years and then we had a spate of 8 or 10 in a one or two year span and then it's dropped off to basically one a year again. So, I mean, what has happened the last couple of years, I know is well-documented that shippers are concerned about this are more in line with historical rate filing paces than it has been in the past. Maybe not. Mr. English?

MR. ENGLISH: I would also point out, Mr. Chairman, it's -- for a smaller shipper, this is a very expensive proposition.

CHAIRMAN NOBER: Yes.

MR. ENGLISH: You bring a case here, you're talking about $3 to $5 million and you're talking about two years. And I know many of our members who have had grievances have been reluctant to bring them, just simply because of the fact two years from now what difference is it going to make? And so there is a timeliness and a cost factor that is involved here. There ought to be some way that this can be expedited and those with grievances feel more welcome to bring those grievances forward and can do so without such a huge expense.

COMMISSIONER MULVEY: One last thing. Could you go back to slide 2, Mr. Crowley? Well, if not, if it's difficult --

MR. CROWLEY: No.

COMMISSIONER MULVEY: Whoops.

MR. CROWLEY: This is the operating revenue?

COMMISSIONER MULVEY: Yes, that's the one. Go back to that one. Not that one, the other one. The second slide. That's it.

MR. CROWLEY: That one?

COMMISSIONER MULVEY: Yes. Just looking at that revenue per ton-mile and variable cost per ton-mile. It appears as though the differences is narrowing and that the operating ratio seems to be worsening. Is that what your slide is suggesting?

MR. CROWLEY: No, no. This is just a

subset of traffic. This is just Western Coal traffic.

COMMISSIONER MULVEY: Oh, it's just Western Coal, okay. I see. Okay. Thank you. That was my question.

CHAIRMAN NOBER: Thank you. Well, again, thank you all very much. I know we face some of the most difficult issues of all in dealing with coal customers and I wish I could say in my tenure that we have been perfect in how we have implemented or we tried very hard, I can tell you that. And again, thank you for your thoughts.

UNIDENTIFIED SPEAKER: Thank you.

CHAIRMAN NOBER: And we'll move on to the next panel, which is again some well-known individuals to the Board. James Brunkenhoefer, Jim Stem and Dan Elliott from the United Transportation Union and Mitchell Kraus from the TCU. Gentlemen? Take one of the comfortable chairs.

MR. STEM: I give my time to my boss, Mr. Chairman.

UNIDENTIFIED SPEAKER: The two mouth pieces want to go first.

CHAIRMAN NOBER: Okay. Mr. Kraus, you are to my left, so you draw short straw.

MR. KRAUS: Yes, I did. I got the short straw. I should say good afternoon, Chairman Nober and the other Commissioners. I'm Mitch Kraus. I'm general counsel for the Transportation Communications Union and I'm here today to speak on behalf of a group that has not prospered as a result of the Staggers or at least as a result of the Staggers as interpreted by the ICC and then subsequently this Board.

The result from the perspective waiver of Staggers has been a reduction in jobs, short line sales and for those shots remaining as short line carriers in many instances a reduction in compensation. These transactions were justified under a carefully devised legal fiction that characterized these short lines as being sales involving non-carriers. Notwithstanding that an overwhelming majority of short line purchasers have been fully owned subsidiaries with carrier corporations and numerous short lines.

These transactions do not involve labors of the industry. They are certainly being made by -- not being made by small corporations. These are not the so-called mom and pop types of businesses. While capital has been transferred from the short line purchasers to the Class I railroads, these transactions have not necessarily resulted in meaningful investment in upgrading the purchase lines.

The numbers of jobs have been significantly reduced as a result and those losing employment that entirely now receive only limited separation pay. Generally, as I said, salaries for those remaining employees has also been reduced. All of this has been able to be done by avoiding the protective benefits and regime that was part of the statute and part of what had heretofore been the precedent that the Board had established regarding protective benefits for employees.

What I wanted to do today, all of this is history that has been set forth in 20 years of decisions and there is no need really for me to go into any detailed review and the Board is certainly well aware of it, principally, was to raise certain questions that I think the Board ought to be focusing on for the future. And one would be whether it is equitable to continue this process of short line transactions when the big losers are the employees and the gainers seem to be the Class I railroads, which, as prior speakers have all indicated and as we're well aware, are enjoying record profits.

Second, whether the highly profitable Class I railroads with responsibility to serve the public welfare should be able to continue to engage in the wholesale of abandonment of their rail systems. And finally, whether short line subsidiaries of large corporations should be permitted to buy tracks without any responsibility to invest in upgrading it and whether the Class I seller can sell these tracks ending their responsibility for upkeep.

We think any fair assessment going into the future should include these factors and most particularly, obviously, our concern is the effect on employees and the loss of protection as a result of these transactions. Thank you very much.

CHAIRMAN NOBER: Thank you. Mr. Elliott?

MR. ELLIOTT: Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey, thank you for the opportunity to speak. I'm going to put aside what I planned on saying, because I don't want to be entirely redundant and you've already read the testimony. I'm here, obviously, on behalf of the United Transportation Union. Also, another reason I want to keep it short is because I wanted to allow Mr. Brunkenhoefer, who is much more entertaining than me, to speak.

CHAIRMAN NOBER: He's more entertaining than everyone.

MR. ELLIOTT: Yes, exactly. And I think the audience will appreciate that. Just a couple of quick notes and with respect to the Staggers Act itself, obviously, the United Transportation Union is appreciative of what it did for the rail industry by taking it basically from the brink of disaster up unto what has been stated today as being healthy for the first time in quite some time.

However, what labor wanted to point out, obviously, I'm not an economist, but I just wanted to point out that some of these gains were achieved on the backs of labor. Obviously, the number of employees in rail labor have decreased significantly over the past 25 years. That is, obviously, a grave concern for the United Transportation Union and its members, who have suffered dearly as a result of that.

Also, along those same lines, during this time period, obviously, there have been, as Mr. Kraus mentioned, numerous line sales, short line sales, branch lines resulting in the short lines and the regional railroads and, obviously, that was done originally under Section 10901 and I'm not going to bore you, because a lot of that argument has been changed as a result of the ICC Termination Act.

But the frustration still remains with labor. I constantly receive phone calls regarding these line sales. It's very upsetting. I mean, in the early days the explanation was that this was done based on the Staggers Act with a tenuous interpretation, I say at best, of Section 10901 resulting in these line sales and the elimination of job protection. It was very difficult to explain to our members that result.

And what we were pointing towards, obviously, is there has been some distrust as a result of those decisions and views of the legislative scheme in that manner. What we would like to do is just be more engaged in the process and not to feel blindsided down the road. As a result, we're just here to make that point clear, because without the operating employees and the other employees, these trains would not operate.

And now, I will turn it over to -- oh, I'm sorry, I did that last time. I'm finished.

CHAIRMAN NOBER: Mr. Brunkenhoefer?

MR. BRUNKENHOEFER: I'm James Brunkenhoefer. My nickname is Broken Rail. I work for the United Transportation -- member for the United Transportation Union. I have been told by some I'm the most important guy in the room, because this is Washington and I have the biggest PAC. Based on that, I'm going to talk about what nobody else in the room wants to talk about, which is the big elephant in the room, which is politics.

My cohorts here are exactly right. We made a deal railroads came to us in the late '70s and said we're all going to drown together. Help us. So we formed a partnership, poured a lot of our membership's money into saving the industry. We had 600,000-something people in the industry then. We are down to about 200,000 now and the promise that was made to us was we would have more jobs and we would have more secure jobs.

These nice gentlemen have just told you how secure those jobs are. And it has been the actions by your predecessors that has allowed this game to go on about short lines and about protections. Now, what the result of that has been has been a transference of wealth from our hip pockets into the dividends and the bonuses of others, all in the name of efficiency and deregulation.

What that has spilled over to in politics is what these gentlemen have told you is about a lack of trust. When the railroads now come to us and say let's work together to help this industry, we tell them to go take a hike or go to someplace hot that rhymes with swell and it's not Arizona, because of what this Board did to break that trust in line sales, because what this Board did and using excuses and shams to talk about line sales and talk about releases.

So because we got burned so badly after 25 years, we can barely have a relationship that is very important to the industry as a whole. The politics of reality is that in the political game, we're worth about 200 votes in the House every day, any day of the week. So everybody else in the industry has got to start off and get 218 out of the 235 that's left, because we don't think we can make a deal any more, because after the deal is made, those that we trusted to keep the deal, which is a regulatory body, didn't.

Now, so I don't know how many victories they got out of line sales and out of leases. It's that, I think that there is an economic thing that my economist friend would tell you it's called there is a cost of lost opportunity. So there's a lot of things we didn't do together that we could have done together in partnership, because we had lacked the trust.

So that's all water under the bridge. Those were terrible accusations to make against your predecessors and not against you all, but I hope it's something that you take in in the vision of the future.

Now, it really warms my heart to be here. I'm not used to being in a room where Fortune 500 corporations are calling for socialism or where they come forth and say I want to bring more Government regulation into the deals that we have. And so as those that would call, accuse me of being a pinko commie left wing subversive, to hear a whole group of Fortune 500 corporations talk about using regulatory power to do things, vote me yes, but I have a different agenda.

The first thing I would like to have is something that some of the people complained about, is I wish you would put rules in for staffing levels. I don't think you will ever use them, but because of the strong pressures of the marketplace, in order to make certain targets that Mr. Valentine and others will talk about, Mr. Wadewitz and others will talk about here, is is that they take head counts out.

Well, when you take head counts out because of our terrible, terrible, wonderful seniority rules, they are not taken out the same. So at the time they go to take head counts out to satisfy Wall Street, we may already be short at Kansas City, Saint Louis or Chicago. I picked those locations, so you can't figure out which carriers I'm picking on. I'm trying to be evenhanded, being mean to all of them.

So because you don't have staffing levels at a location, and we may have -- be significantly and severely short of people, then no hiring takes place in order to make the dividends. Then the customers don't get their trains. And all over the United States in the last year we have had trains that, like my friend Fred Emmet said, look like dead buffalo carcasses laying all over waiting on crews to move them.

Now, we have done what we can. The loss is not only the shipper. The losses to us is fatigue. We're not home with our families. We get injured. We make bad decisions. We run trains together. Then the carriers hire an awful lot of young, inexperienced people and they have to learn the hard way and they run trains together. And so because no one has the responsibility or step forth to ask for our staffing, everybody suffers, but then I'm pro-Government regulation. I like to have the Government involved.

Next is competition. I'm married to a strikingly attractive and brilliant woman named Judy Sinkin. We have a basement at home and Judy's basement, my basement, is now an exercise room. We needed a new floor.

Well, we went and, of course, I have the opportunity of going out and sitting in my SUV and reading on Saturday afternoons while we go from everyplace from Expo to Wal-Mart looking for flooring. These are real opportunities of togetherness and relationship I think everyone can relate to.

So she came up with a product that there is no competition for. So since you all can override law, would you all open up the patent and allow some competition, because I don't want to pay that damn high price for that floor. It's unreasonable. It's unconscionable and I am so enthusiastic to hear that the chemical industry here believes in competition, because I can use some in my basement.

And so if we're going to open up the railroad lines and where their franchises are, where they have put their capital cost, and sit down and say in order to get competition, we're going to open it to other people to come in to bring rates down. If it's reasonable for the goose, then the gander is is that they should go over to Omaha or Norfolk or Fort Worth or Jacksonville and hand over a whole stack of patents and to let the railroads make the difference up in competing with their shippers.

I think it's a completely reasonable, balanced situation and if you all will do that, I think that I won't need labor protection. I believe I will be able to get very healthy from money, very healthy money from my members. Now, the carriers don't -- the shippers don't understanding what they are talking when they talk about competition. When you go -- and this is my summation, Roger.

CHAIRMAN NOBER: Okay. I was going to address your floor.

MR. BRUNKENHOEFER: Okay.

CHAIRMAN NOBER: Because I finished my own basement.

MR. BRUNKENHOEFER: Is that what the shippers are familiar with, is a marketplace that allows market entry and market exit. In the railroad industry, market exit is called abandonment. So if you force in competition, and the whole idea of competition is there are winners and there are losers, and the losers in this case would be like when Eastern Airlines went out of business if you took the airport away or one of the 5,000 truck lines went out of business, you went out and ripped up the interstate.

And so if the shippers are correct and they are ready to -- they need to ask am I, as the shipper, ready to live with the downside of competition, and the downside of competition is there will no longer be anyone there to provide you an economically sound, environmentally friendly way of moving transportation, of moving your goods.

I don't think that the shippers appreciate what happens. We lost a great deal of Milwaukee Road. We have lost a great deal of the American railroad system. When we lose an airline, somebody immediately comes in and leases the gate, leases the planes and goes to business.

And so what we don't want to see is in the zest of this wonderful "let's get the Government involved in the free marketplace" is that somehow or another we end up losing a very necessary system of transportation that in many places have already been lost forever. We want a healthy railroad industry.

I want them to make lots of money, so we can take it away from them. I don't want the shippers taking it away from them. We are entitled to it, because we're going to spend it on health care. We're going to spend it on wages. We're going to spend it on retirement.

And so as I have watched these companies fight among each other, I recognize going back to my original point that the only losers in Staggers was our 400,000 jobs who the wealth of those people have been transferred and shared between the shipper and the railroads. And I will shut up.

CHAIRMAN NOBER: Thank you very much. Commissioner Mulvey, can you possibly have any questions?

COMMISSIONER MULVEY: I have only one word. Bamboo. Bamboo flooring is a lot cheaper than --

MR. BRUNKENHOEFER: Can you call Judy?

CHAIRMAN NOBER: Can't use it in the basement. It absorbs moisture.

COMMISSIONER MULVEY: Oh, my God. Now, you tell me.

MR. BRUNKENHOEFER: Would you call Judy and sell her on it? I'm ready.

CHAIRMAN NOBER: Okay.

COMMISSIONER MULVEY: A question to the group in general. The American Short Line Railroad Association points out that more than half of all short lines are unionized. Would you want to address that fact, that unionization seems to be spreading among the short lines, offsetting some of the problem of deunionization of the industry?

MR. BRUNKENHOEFER: We have got 85 percent of the entire membership on our Class I railroads. Now, anybody who wants to do a deal that you end up with half when you had 85 percent. You want to call that favorable, I'm ready to play poker with them.

MR. ELLIOTT: I would also like to add that while we are organizing where we can on the short line railroads, the wage and benefit package certainly aren't at a par with Class I's.

COMMISSIONER MULVEY: One of the issues that was raised by one of you is the issue of sham transactions. The Board in the Sagamore Decision defined to some extent, what a sham transaction ought to be.

My question to you is do you think that the Sagamore Decision ought to be precedent or the Sagamore case was, obviously, a case where the transaction was a sham, but all transactions do not have to look like Sagamore in order to be a sham. Or do you think the Board should be broadening how it looks at a transaction in determining whether or not it's a sham transaction?

MR. KRAUS: Well, my concern isn't so much looking at the concept of sham. I think it's looking at -- and that's not the term I used in my presentation. My concern is really that you have got these short line carriers who are coming before the Board as if it's just this one piece of line that they are purchasing, and the transaction is analyzed from that perspective and labor protection is analyzed from that perspective.

And the reality is in most of these transactions, and you're familiar with the players, they are holding companies. They are major corporations. They own a significant number of short lines and I don't think it's fair to analyze that transaction from the perspective that you're dealing with some sort of mom and pop operation that is a "new investor" in the industry.

These are people who are well-established players in the industry and use that artifice, if you will, to avoid labor protection. So that was the point I was trying to make and not get into the sort of legal definition of what is and isn't a sham.

I don't know whether that technical word fits what I'm saying or not, but the underlying economic reality is these guys own -- they are players in the industry. They own a number of short lines. They are railroad operators and, in my judgment, these transactions employees should be able to receive the kinds of protections that Interstate Commerce Act had historically long established.

And my understanding of the Staggers Act, there is no evidence that the labor protection was supposed to be "deregulated." So I guess that's where I was coming from. That may not be an adequate answer to your question, but it's the best I can do.

MR. ELLIOTT: If I could just add along the line that Mr. Kraus didn't address. Some of the more recent transactions, and I won't get into this in depth, but there appears to be quite a bit of control kept by some of the Class I carriers and that has been quite a concern for our members when they see that there is that type of control. So, I mean, that order is a sham.

Obviously, Sagamore was a blatant sham. In fact, that was my case and I remember the owner of the company, Indiana Hi-Rail, I believe it was, was on the phone with my boss and he asked him who was the owner and president of the new company. He said, of course, I am. So, I mean, that was the affidavit, so that was a blatant sham in that instance.

MR. BRUNKENHOEFER: Just one thing. We're not after -- we're not trying to beat up on the short lines. We're talking about a transaction here and we're talking about the relationship and, although we use short lines, this comes from the Class I carriers who are, essentially, encouraging this.

I wouldn't want anybody to believe that we -- in other words, we recognize those people only taking advantage of the game. What we want to do is stop the game.

COMMISSIONER MULVEY: Yes. I have some concern about the long-term leases partly because of the lack of independence sometimes of the railroad leasing the line and also, of course, the impact on labor and on lost jobs.

MR. BRUNKENHOEFER: We have one Class I that sits down at the table with us and tells us that we are going to make concessions on certain of our collective bargaining agreements, are they going to lease out all their yards, and the yards will all become new railroads and they will do the switching for the line haul carrier.

And they can't exist without those yards. That is like saying I'm going to have -- I'm going to run an airline, but I'm going to lease out -- I'm not going to use any airports. I mean, it's not going to happen. But they use that threat to come to us to make concessions. Now, where do those concessions come from? Families.

CHAIRMAN NOBER: I probably know better than to ask a question, so I will make a statement and people can decide whether or not they want -- which is, you know, obviously, the issues that you raise are difficult ones, because on the other side of it are, you know, shippers and communities that rely on rail service that might not be economical under Class I cost structures or Class I work rules or whatever the case may be and, you know, 30 percent of all traffic originates or terminates on a short line.

So I know you said you weren't here to attack short lines and it's a difficult balance between, on the one hand, you know, wanting to preserve the legitimate concerns that you have all raised and, on the other hand, allowing more marginal service to continue, which keeps the industry healthy overall.

And the good news is for the first time in many years, you all are growing. There are more -- you know, the railroads are hiring, which I think has not occurred for many, many decades overall, that they are actually growing the numbers. So I will quit while I'm ahead.

MR. BRUNKENHOEFER: In the case of the yards and the terminals, that is nothing more than a labor game to get concessions from us. This is not real and so, I mean, nobody is going to come in and use the ABC railroads who are going to lease -- you know, and just throw a name out. Burlington Northern is not going to live without Argentine Yard in Kansas

City.

So it's real simple. UP is not going to live without Neff Yards in Kansas City. It's just that simple, KCSS NOC Yard in Kansas City. Those railroads are not going to exist if you're having a real transaction of where somebody is doing a new railroad, and this case is nothing more than they are leasing off their service company to break -- they are signing a new contract to break my contract.

CHAIRMAN NOBER: Okay. That goes beyond, I think, what I was getting to, of course, but I appreciate that. Anyone else? Okay.

COMMISSIONER MULVEY: Thank you very much.

CHAIRMAN NOBER: Well, gentlemen, thank you all very much.

UNIDENTIFIED SPEAKER: Thank you.

CHAIRMAN NOBER: Appreciate your patience and now, we'll start with our last panel of the morning or afternoon, wherever we may be.

Ken Hoexter from Merrill Lynch, Tom Wadewitz from J.P. Morgan Securities and Jim Valentine from Morgan Stanley. Gentlemen, and then what I think railroads on where they need to be focused.

The second thing you can do, under the statute Congress gave you the authority to report to it if there is a need for change in national freight transportation policy. Even if you don't have the power to fix some of these problems, you certainly have the power to put the spotlight on some of these problems.

And so I think, you know, that big stick you carry that Mr. Linderman just referred to is a very powerful weapon under today's circumstances. We need Congressional action. You have heard this from some people on some of the other panels already on a number of these areas. We don't have to necessarily change the Staggers Act, but we need Congress to focus on rail transportation capacity. That is the single biggest problem that many people in this room are facing.

And with that and the number of people on the panel, I think I will just defer to any questions you may have about rate making, revenue adequacy or the rest, except to say one last thing. This is the one area has an impact on the other if we -- you know, if the Board takes actions that have the effect of limiting rates, that that has the effect of discouraging investment and capacity or vice versa or do you think the two of them could be -- the two of them are consistent with one another?

Can we have an active regulation of rates at the same time while inducing the adequate capacity? Because that's the balance. I mean, I'm not sure, you know, we want to make sure that we don't take an action in one that impacts the other and vice versa. They are both legitimate concerns. Mr. English?

MR. ENGLISH: Mr. Chairman, again, I think this goes back to the point that I made earlier. And that is that things have changed a lot in 25 years. That we have this tendency of policy being built on top of policy. And given -- and from what we have heard today and I think from what I have heard out of you gentlemen, there is an acceptance that the railroad industry is doing far better today than it was in 1980, that we have had great strides and great improvements.

we'll do after this panel, we'll take a brief break for lunch and we'll pick up with the carriers soon thereafter.

Okay. I think we're all sort of shifted over. All right. Sir, if you're ready, why don't we start with you, which is a little off my left to right, but you seem to be ready to go, so why don't we get started? You need to just speak into the microphone.

MR. HOEXTER: I guess I'm not going to use slides then. Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey and my fellow distinguished panelists, my name is Ken Hoexter. I am Merrill Lynch's Senior Airfreight Surface and Marine Transportation Analyst. I have been a research analyst for more than 12 years having worked at Lehman and Goldman prior to Merrill.

And one thing is quite clear. We're witnessing a historic period in the rail industry as rates have increased quite significantly over the past year and a half, capacity is filling up on the rail industry for improved asset utilization and the railroads are improving their margins to the best level in more than a decade.

But the question I believe we're here today to ask is are the rails profitable? And profits can be measured in many ways, such as financial reporting or looking at net income improving from one year to the next, as well as by cash flow measures such as are they generating real cash flow, enabling the stock buy-backs, dividend increases and are their shareholder moves established by different companies over the past couple of years.

A few things to note. Earnings by and of themselves do not send a clear picture. As we have learned from some companies like Enron and WorldCom and a host of others, earnings by and of itself can leave certain statistics to debate in some contrast to some of the true GAAP numbers that we see. We also understand that cash is king, but just having cash flow and increasing or paying a dividend and buying back stock does not necessarily indicate that a company is earning a return on its investment.

To understand returns, we look at after

tax returns on a total capital, after tax returns on total capital. To get there, and just a quick kind of run-through of the actual math of what return on invested capital is, we take a look at in the numerator, you have got your rolling four quarters of net income plus your interest expense after tax plus we take the present value of operating leases and take the interest expense on the operating leases after tax in your numerator.

So we're including every sort of financing in the equation, and then you divide it by the average debt. Inside the debt you have got capital leases along with the total debt, including accounts receivable, securitization and then, again, present value of operating leases. So we're trying to get -- to make the income, the net income, the returns that the rails are actually generating, completely indifferent to how the company has financed itself.

We're aiming really just, again, to derive what the companies' returns are on their entire base of invested capital indifferent to how they financed it, because if the companies don't earn a return, then shareholders should demand that the company not reinvest in the business and instead distribute any cash, because an investor can make real economic profit in other investments.

Investors don't want too big of a dividend, because they are trusting management to earn returns on their investments. It's a lot of background on the equation, but after decades the rails as a group are closing in on earning their cost of capital.

Canadian National has been operating above its cost of capital since 2001. We believe Burlington Northern reached its cost of capital last quarter and that, based on our estimates, Norfolk Southern will reach it by year end 2005 with CP, CSX and UP improving, but still about 150 to 200 basis points away from our cost of capital target.

The whole concept of rails striving to reach their cost of capital is still relatively new coming from the debate from the companies, but quite important to focus on as it dictates the capital spending levels both for reinvestment and expansion for years to come.

Since its scheduled rail focus in the early part of the decade, Canadian National has been keenly focused on earning solid returns even causing Hunter Harrison, the CEO and president, to once ask why. If intermodal is making so little money at that time, why are they even in the business. Either make a return or make the business stand on its own or get out.

And this was a landscape change in thought for the rails at that time. It looked like they were trying to achieve double digit growth and intermodal was the way to beat the trucks at the growth game, returns be damned. This mentality was built during the '80s and '90s.

CHAIRMAN NOBER: Is this an antitrust violation, the two of you?

MR. HOEXTER: So this is just a quick chart. This is the last couple of years of the returns as the rails -- you can see just in 2005 some are actually catching up to their return on invested capital levels and some are still just below the line.

And as I mentioned or I will get there in a second, on the rails, this mentality of intermodal growth at all costs was built during the '80s and '90s when the rails had a tremendous amount of capacity on their networks. Nevertheless, Burlington Northern jumped on board with its diligent focus on yield improvements, recognizing that price deflation would never help it achieve true economic returns and so why invest more capital?

In November 2003 at their Chicago Analyst Day, the company focused its entire Analyst Day on how each segment was going to earn its cost of capital. A year later in Kansas City, Burlington again focused its entire Analyst Day on how each segment could increase utilization without increasing cap ex, because it couldn't yet justify capacity expansion despite its quarterly volumes jumping 10 percent year over year in 2004.

The result industry-wide has been a tightening of capacity as witnessed by Union Pacific's velocity dropping 4 miles per hour after the past two years or 15 percent. With the carriers comfortable that reinvesting in core operations will lead to return on capital, many companies have dusted off capacity expansion plans, something shippers demanded along with better service at the AAR's recent customer forum in Saint Louis, but a move that is not likely to be made in a changing regulatory environment.

With one of its mandates to assure a viable rail infrastructure, the STB has set the environment over the past few years that has encouraged the rails to increase cap ex as a group. In looking at the six largest Class Is, they have invested $7 billion in 2003 up to our target of about $8.5 billion in 2006, a 23 percent increase or a 7 percent four year cager.

CSX, UP and CP have each engaged in significant capacity expansions. These moves to increase long-term capacity are made only because the carriers believe the structure is right to reinvest in a return on invested capital greater than cost of capital opportunity. If that opportunity is removed, which has taken about 20 years for them to achieve again, the desire for reinvestment may disappear.

Thank you.

CHAIRMAN NOBER: Again, Mr. Valentine, we'll go left to right. Sorry, Tom. We'll get to you next.

MR. VALENTINE: I think we need just 30 seconds here to move laptops. Tom, are you going to go next?

CHAIRMAN NOBER: Tom, do you want to --

MR. WADEWITZ: Go ahead, Jim. You're there.

MR. VALENTINE: Okay. Great. Well, first, before I start going through my slides, I want to thank the Board here for giving me this opportunity to speak. By way of background, I am Morgan Stanley's Equity Research Analyst responsible for researching the North American Freight Transportation Sector, which includes the railroads.

As a representative of the financial community, my thoughts today are those from an investor's perspective, as all three of our firms, we have investment banking divisions, but we are here today to talk about it from an investor's perspective.

That's our role as a research analyst.

While Staggers has clearly removed some of the burden of former regulation, we can't call it a resounding success. The long-term success of any enterprise is to ensure that it can regenerate itself, which for a company means that it must generate enough revenue to cover all costs, including the costs of returns for shareholders.

Despite all the benefits of Staggers, the industry still has not consistently earned its cost of capital in the 25 years of deregulation and, thus, shareholders have not been properly compensated for the use of their capital.

The good news is that we forecast this trend to reverse in the next year or two which, if sustained for many years, could be a sign that Staggers is a success. Rather than spend time here dwelling on the past, it's probably useful to highlight our forecast for the future, because that's what we do here on Wall Street, is forecast.

My fairly upbeat forecast for the industry wouldn't be possible had the railroads not been deregulated. As I'm sure we'll hear from the railroads later today, deregulation has allowed them to shed unused assets giving them the freedom to make decisions based on the economic reality of supply and demand that have ultimately resulted in better earnings, cash flow and returns.

It took us about 25 years to get here, but the industry finally appears to be approaching a good financial health. The first slide here of numbers is our forecast for the four major U.S. railroads for 2005 through 2008.

And as you can see in the rightmost column, the compound annual growth rate that we estimate includes annual carload growth of about 3.5 percent. That is about the rate of industrial production so, you know, it's nice, but it's not above a trend line for industrial America.

Yields or revenue per carload, we have it increasing about 5 percent per year, but this is led by a large spike in fuel surcharges in 2005. If you strip this out, the figure would be closer to about 3 percent, which is simply in line with inflation.

Most importantly, we expect operating income to grow at about 15 percent per year over that time period, which is well above most other industrial sectors in the United States. And these trends are much better than anything we have seen in the past 25 years of deregulation.

This success is being led by, we would say, two major factors. First, after about 90 years the railroads have finally worked off their excess capacity and, second, the trucking sector's costs are going up at unprecedented levels. I also work on the research on the trucking side and we're seeing their costs go up at 4, 5, 6 percent a year compared to about 1 percent historically.

That is because of higher driver costs, because driver demographics are shifting. The equipment fuel emissions are causing higher equipment and fuel costs and then just fuel prices in general hurt trucks more than rails, and these higher trucking costs make the railroads more competitive.

Before I go through this next slide, I want to preface that one basic fact in that investors pay for profitable growth. And in this slide here you will see their earnings per share growth rate for four major railroads and, once again, '05 and 2006 are our estimates, that's depicted in blue, and the overall market, financial market, we're using the S&P 500, which is the yellow bars.

And I think it's clear that the recent improvements by the railroads is resulting in better EPS growth in the typical U.S. industry. And if our forecasts prove correct, we'll see the railroads grow their earnings or EPS by about 23 percent next year compared to only about 7 percent for the S&P 500.

Better earnings are leading to better returns, which we show on this slide here. At Morgan Stanley we take the traditional ROI or return on invested capital computation a step further by putting all of the off balance sheet assets back on balance sheet and eliminating the distorting impact of pension assets and liabilities to compute a return on net operating assets or RNOA, as we call it, which is a more clear picture of how management is utilizing the company's asset base.

As you will see in this chart, we have sorted the railroads from left to right based on their current RNOA. If you imagine a line across the chart at about 9 percent like Ken was showing for the assumed cost of capital, you will see that for 2005, the green bars, that four of the six major North American freight railroads will likely earn or even exceed their cost of capital.

This next slide provides a historical perspective on returns, as well as our forecast for the major six freight railroads for 2005 through 2008. If our forecasts prove correct, we'll see at least two consecutive years of the industry earning its cost of capital. Although, I should note that our forecasts are helped by the Canadian railroads, which are at the higher end of the industry.

To help illustrate that Wall Street still doesn't believe that the railroads are going to consecutively earn their cost of capital into the future, here is an analysis that we did. We sorted through 1,600 stocks followed by Morgan Stanley's North American Research Department and we came up with a basket of 12 stocks that our analysts forecast to have similar financial metrics as we forecast the railroads to have over the next three years.

You will see in the top here that investors are currently willing to pay about 12.5 times the railroads 2006 earnings, but only -- but as much as 13.7 times 2006 earnings for companies and other industries with similar financial characteristics. My point here is that we need to see the railroads earn their cost of capital over an entire cycle before they are going to be afforded a higher evaluation multiple similar to other industries.

For anybody who wants some of the details here, I can have a report I can email to you. So in conclusion, our upbeat view towards the earnings and returns would not be possible if the benefits of Staggers are not allowed to continue to play out. We should note for the first 25 years -- for the first time in 25 years, we are hearing railroad investors encourage some management teams to reinvest in the business, because returns have finally reached acceptable levels.

Net reverses trends we saw in the late '90s when investors were beating up management to say cut back, get back. Yes, the industry is generating some of the best returns since at least World War II, but we're still not at the point where the entire industry consistently earns its cost of capital.

And once again, I would like to thank the Board for this opportunity to present our perspective from the investment community.

CHAIRMAN NOBER: Thank you, Jim. Mr. Wadewitz?

MR. WADEWITZ: Thanks. Well, thank you to the Chairman and the Commissioners for the opportunity to testify before you this morning. What I would like to do is take you through some charts and just provide some perspective on where the railroads have come from, what the Staggers Act has done, and I think some important thoughts looking forward for what's necessary for the railroads really to make an effort to invest in capacity looking forward and the type of regulatory support they need for that.

So on this first chart what we have is looking at these charts, the first three are all 1980 to 2004. Based on AAR data, you see that track miles are down, that's in the bar chart. You see that revenue ton-miles are up. It's about 2.5 percent compound annual growth rate over 1980 to 2005. What we see is rationalization of the track infrastructure towards the higher density, higher freight density network. In our view, that means it's a rail system which has a better chance of earning its cost of capital. So that's a constructive trend for the railroads.

The next chart, yes, I'm sure you have seen charts like this, is looking at employment in the rail industry, looking at productivity is the bar chart. That shows you significant gains in productivity for the industry over time. That moves up at about a 6.9 percent cager, that's revenue ton-miles per employee. This is another nice chart for the railroads. And then this third chart, this is a nice chart for the shippers. This shows revenue per thousand ton-miles for the industry.

And what you will note is from the peak in 1982 rates went up slightly at the beginning. Yet, we've got a 30 percent decline in nominal terms to the trough level which is about 2001. So certainly some good news for the shippers on the rate side, but bad news for the rails there. So I think when you look at these first three charts all in, you will say well, deregulation has been good from the perspective that there have been very significant productivity gains for the railroads and then the shippers have participated in this, in some of this good news as well.

This next chart that I have for you looks at the stocks. This is an index of the major rail stocks. In the S&P 500 it is the green line here. What you will note is in the early '90s, through the mid-'90s, the rails generally moved up along with the S&P 500. I think it was a good period in terms of earnings performance, in terms of growth. In the mid-'90s you had a lot of optimism about the potential for if some of these major systems were put together, what would be the cost side opportunities, the cost synergies as well as revenue synergies?

Now, you can see as the rails fall off, it's a combination of two things. Those clearly were not realized. Instead the financial performance fell pretty sharply. At the same time, the S&P was up on a lot of exuberance about technology stocks. As we look to the right of that chart, I think what we have seen is now the railroads have actually moved up above the S&P 500 over this time in terms of what their performance would look like and I think that's largely a function of long-term demand catching up with supply, getting pricing gains, also a function of a stronger industrial economy.

The next chart here, supporting what has been the better performance of the stocks. More recently, this shows for the U.S. railroads, the average year over year yield increase or revenue per car increase on a quarterly basis, we go back to the beginning of 2001. You will note this sharp move up that really started in first quarter 2004. And this, in my view, is the primary driver of the improvement and earnings performance and also the move up in the rail stocks.

The next two charts here, this shows rail average earnings growth. You have pretty good earnings on recovery from mergers in 2001/2002. And then more recently, '04/05, very strong earnings growth for the group. 22 percent in '04 and what we forecast 35 percent on average of the major railroads in 2005. This returns chart also shows some of that positive momentum in the industry that we have. And again, we think that's not only the result of an improvement in the economy in 2004, but more importantly the result of a significant move up in pricing as shown by that yield chart.

Now, the last chart that I want to provide for you here, this is a U.S. railroads, not the Canadians. It's total capital expenditures for the major railroads from 1990 through what we forecast through 2006. I want to note two things here. You see the move up to the stronger level of spending in the mid-'90s. I think was a result of significant optimism with respect to both potential for growth and potential coming out of the mergers what could be done with these properties.

Now, a lot of that wasn't realized quickly. We saw some, you know, struggling on the operating side. We saw the economy weaken in 2001. And so you see those capital numbers fall off really quickly. What I would submit to you is that as the rails improve their earnings performance, as they realize if they have expectations for future profitable growth, then their capital expenditures can rise quickly.

I think that's important, because at the end of the day, we want a system that has the capacity and the investment, so that it can support growth of the shipping community. So with that, what I would say to you, just the last thought, supply and demand and competitive dynamics are really driving much of the total pricing equation for the railroads. But regulatory factors also have a meaningful impact.

In my view, the railroads did produce returns above their cost of capital, which seems to be realistic looking forward, shouldn't be penalized for reaching that. If you go back and then you start to price down their captive traffic, then I think that penalizes the railroads and I think it will actually hurt and work against their incentive to invest and provide more capacity.

With that, I'll thank you for the time.

CHAIRMAN NOBER: Thank you very much. Commissioner Mulvey?

COMMISSIONER MULVEY: With regard to the railroads earning their cost of capital now, in large measure, of course, they have been reducing the size of their infrastructure and cutting back and getting rid of excess lines, et cetera, to the extent that today we now have a capacity crisis. There is insufficient capacity on many routes. This is causing problems for other sectors of the economy. We must remember that the demand for rail transportation is a derived demand, something that serves the needs of all the rest of the economy.

Is there any way of ensuring that we can get investments in the rail transportation infrastructure which might cause it to be somewhat larger and have some excess capacity without Wall

Street penalizing the railroads for doing so? Can we take into account the public needs of the railroad infrastructure.

MR. VALENTINE: Yes, I guess, there is no way to ensure it is going to happen with 100 percent certainty, but if -- I'm kind of going back to one of the points I made that it is stunning, I have been doing now going on 14 years now and only in the last three or maybe six months, I'm actually hearing investors for the first time say I would like the railroad to invest in the business. And it's because they are coming close. And by the way, that's not across the board with all six. You can figure out who I'm talking about in terms of who is earning their cost of capital is where they want that to be spent.

So, you know, you put yourself in the shoes of a CEO or a CFO that has to go to the board and if they say look, we're going to go add some more rail yards and some more locomotives, because we're in a tight capacity situation, and they aren't even earning the returns on their existing capital, it's just not going to fly. So to the extent that for the railroads that are earning their cost of capital, I think we are going to naturally -- the invisible hand is going to work and we're going to see this capital.

In fact, we're seeing cap ex go up on some of the railroads right now to try to increase some of this capacity. But it really comes down to the fact that they have got to be an environment where they can consistently, over an entire cycle of the asset base, generate good returns.

COMMISSIONER MULVEY: Yes. Well, one would hope so. The problem, of course, is that we don't have adequate capacity to move the coal out of the Basin and we don't have the capacity to move containers from the west coast to the east coast to meet Christmas needs and all of that.

MR. VALENTINE: Right.

COMMISSIONER MULVEY: We don't have the capacity to move the grain to ports, to markets when it is needed to meet the farmers' needs, et cetera, and the railroads are making a lot of money. The question is:''is there a divergence between the desirable private infrastructure and a desirable public one?''

MR. VALENTINE: No, I don't think it's divergence. I think the problem is that over the last -- this is -- these are really long assets and this is the one thing I have had a tremendous amount of respect for the Board over the years that appreciates this. That, you know, if you wanted to go put in another, you know, the PRB has 270 miles that are $1 and $2 million a mile to put in, for an increased capacity, we can't do it in a matter of six months. It's going to take a multi-year phase-in program.

You want to expand the Transcon Line from Chicago to LA, but BN and UP, I think, are each putting in 60 to 100 miles of double track this year. That's a major project for them for a 2,000 mile stretch of track. So the point is that, from my perspective, we can't make this happen quickly. And if we are going to have it happen, namely the railroads are going to say we will commit to put in all this double track and buy locomotives and have 20, 30, 40 assets, they are going to make sure they are going to get good returns over the entire life.

MR. HOEXTER: If you take a look at the last couple of years, you know, the move to go reinvest wasn't really caused because they were looking at expansion opportunities. These were solid opportunities, especially with where pricing has gone. Before it was, you know, our philosophy slow down, because we're getting so jammed, so we're just fighting to keep pace and that's probably the worst area. And so that's when investors have punished them for going and making those kinds of long-term investments to keep pace with just the kind of volume levels you were doing.

I think as Jim is kind of highlighting it, if you're going forward now in a different environment, we're now, as they move to earn that cost of capital, you don't want to kind of ring the bell the minute they hit the cost of capital and say okay, thanks for hitting your target and now, we're going to, you know, push you right back under by holding the rates at that level.

So as long as they, as Jim kind of said, through that cycle, can do it, then you've got such a long-term investment strategies. We're starting to see the companies now go out and talk about that expansion that you're looking for, but it's going to be a long process to get that kind of volume commitment in there.

UNIDENTIFIED SPEAKER: There is -- go ahead.

MR. WADEWITZ: Yes, just a short comment to that. I think the most important thing you can do is give the railroads confidence that there is going to be stability, because these investments are very long-term. And if they have confidence that there will be regulatory stability and when they earn their cost of capital, they are not going to have significant downward pressure on rates on the captive business, then I think they will make those investment decisions.

Also, when you look at where they invest over time, if they have expectations for future growth, which they tend to in the west in coal, they tend to overall in intermodal, they will make those investments over time. So, you know, I think stability in future expectations are really critical from a regulatory perspective.

CHAIRMAN NOBER: Let me ask this. When you were going through the presentations from the railroads, at the top end of both, of all the presentations were the two Canadian railroads. Now, this morning several of the shippers advocated making regulatory changes to make the U.S. system more in line with Canada's. And, you know, people have objected to that, because of the concerns that they would have about the railroad's financial health.

But the two healthiest railroads, at least by some measures today, were Canadian, which operate under that system. What is your view of the effect of those kind of changes in the United States or are there differences that would make it inapplicable? Whoever wants to take that one on. I know you -- I'm sure you have looked at this.

MR. HOEXTER: It's a leading question.

CHAIRMAN NOBER: No, I'm not trying to lead. I'm just honestly trying to ask what do you think the effect would be?

MR. HOEXTER: It's a leading question, but it's also a little bit -- it's a tough one for us to answer in front of them. But it's I think a little bit more to do with the way that they have managed technically.

UNIDENTIFIED SPEAKER: In front of us, yes.

MR. HOEXTER: Thank you. I think the way they have managed, the operation is a little bit different. I mean, I guess, if you take a look at the Canadian National, the one that leads all over the charts, with their scheduled rail concept and what they have done since acquiring Illinois Central and Wisconsin Central and kind of sustaining that business plan, it's a different way that they have run the entity as well as, you know, different regulatory infrastructure setup. It's a host of things. It's not just one simple regulatory picture.

MR. VALENTINE: And, you know, I'm not so much concerned about, you know, what the railroad is thinking what I'm going to say, but I think the investors do, and I think -- because they are the ones that ultimately pay our salaries. And so I think we would be a little hesitant to be here saying yes, it would be great to put the U.S. railroads in a situation where they would lose some of their pricing power.

Now, whether they would lost 1 percent of it or 30 percent of it, because of the change in the rules, to make it more like Canada, I don't know. But at least intuitively, I don't know why it would be a positive for the U.S. railroads to have that change. In terms of I don't see how it would increase the returns.

MR. WADEWITZ: I would say in comparing the Canadians with the U.S. railroads, you can have differences in how much traffic overlaps between the two. You can have differences in the type of traffic mix. And so I think it can be a little bit difficult to exactly make that comparison, but I would also have to agree with what Jim is saying. There is -- you know, from an investor perspective, anything that is going to put significant downward pressure potentially on rates, is not going to be, you know, a positive for investors or a positive for more capacity investment as you, you know, appropriately highlight, Roger, with your shared asset area for Conrail example.

CHAIRMAN NOBER: Our Agency's measure of return of the, you know, revenue adequacy is slightly -- or at least return on invested capital seems slightly different than yours and I think we keep coming up with numbers that are a little below what yours are in terms of the railroads return on equity. And, in fact, this year showed at least in a draft decision, which I know counsel will blanche at, it showed several of the carriers going down when your numbers all showed them going up, and it hasn't been published, because I sent it back several times to say that, you know, how can we credibly say the return on invested capital is going down when every public presentation, including the carrier, says it's going up?

We still haven't fully resolved it yet. I think it has to do with asbestos. But even so, I mean, much of the testimony this morning had to do with the fact that the shippers feel the railroads are healthy enough. What's your sort of take on that?

MR. VALENTINE: So the question is are they healthy enough? You know, at Morgan Stanley we've got just teams of people that spend literally thousands of man hours to work on this whole, what we call, model wear initiative, which is to basically make every company anywhere in the world that we follow comparable on an apples-to-apples basis.

And part of the way we do this is go through the, you know, 800 lines of a company's income statement, financial statement to put everything on a comparable basis, taking off balance sheet assets, putting them on balance sheets, taking the assets of the pension or the liabilities and trying to take those aside and say look, that's not -- if you haven't had this gain because of the Wall Street returns in a given year, that's not something management manages.

So ultimately what we are left with is this return on net operating asset calculation that we use. And, you know, as you saw in the presentation that you looked there and you can see CSX and Union Pacific probably won't even earn their cost of capital in 2006 and maybe not even in 2007. And I'm fairly bullish, you know, positive and optimistic about what's happening in the industry. I think a lot of that has to do with some things that have happened on the property over the last few years, as opposed to a lengthy period of time.

But here, you are prone to Northern and Norfolk Southern, at least among the U.S. carriers, we think well-handedly meet and even exceed their cost of capital here over the next year or two. So I think you've really got the carriers in two camps.

COMMISSIONER MULVEY: Yes. Alfred Kahn and others have been critical of the way the STB and the ICC Board have calculated revenue adequacy and cost of capital. I'm sure you are familiar with the way we do it and some of the criticisms Mr. Kahn has made. He suggested return on equity or the free cash flow, which was presented up here, as a better measure of the railroads' financial health. And a lot of, less sophisticated critics sometimes say well, look, the railroads have no problems going to capital markets. They can borrow at extremely low rates and so where is the problem? how can you say they are not profitable, not making their cost of capital? How can they have survived for 20, 30, 40 years and never make their cost of capital. That seems incongruous. Do you want to comment on that?

MR. VALENTINE: Sure. Well, I think there is a difference. Companies can be in this gray zone between not earning your cost of capital, but being able to service your debt. And if you are self-financing, if you're one of these four U.S. railroads and you are self-financing, namely you are able to generate enough return to cover your 6 or 7 percent interest expense, you know, percent on your debt, then you are able to survive and continue. But that doesn't make it to the point where you are actually earning your cost of capital.

Companies, industries can thrive in that gray zone for years and years and years. But eventually what happens is the shareholder base gets fed up and says okay, enough is enough. And, in fact, I remember Rob Krebs at Burlington Northern, who I have a lot of respect for, but back in the mid-'90s he said "If we build it, they will come." And what he meant is instead of spending about a billion of cap ex, which is our maintenance capital expenditures, they spent $2.5 to $2.8 billion for three years in a row and shareholders started getting frustrated.

In fact, they were questioning, you know, should Rob be in this job? What's he doing? This is a dying industry. It doesn't earn the cost of capital. He is spending all this capital. Well, we have Rob to thank in the existing BN management now for the fact that they have been able to take all this intermodal business when these ships are coming into LA and Long Beach. So, you know, I guess, over the long-term, we really have got to look at this over the long-term and realize that if companies don't earn their cost of capital, the shareholders in the boards will go back to these individuals and say no, you can't expand. So, you know, there's quite a wide range between going bankrupt and being able to -- namely, being able to conserve your debt and still not be able to earn your cost of capital.

COMMISSIONER MULVEY: Yes, Rob Krebs was

like Wayne Morse about Vietnam. He was prematurely correct.

MR. HOEXTER: Commissioner Mulvey, if I can just throw in one sentence?

COMMISSIONER MULVEY: Yes.

MR. HOEXTER: Not that what Jim just said -- I mean, I think you don't want to forget about the equity holder. Obviously, there is, you know, the debt holder at the end of the day. It's a lower risk investment, because if the assets get distributed, they are in line to get the assets. So the equity holder is going to demand that higher return. So that's why you can't forget about that. So you can get cash flow. You can have positive earnings at the end of the day, but you can't forget the equity of taking that larger risk to get the return on that investment.

COMMISSIONER MULVEY: Yes.

MR. HOEXTER: And that's the important side of that equation.

COMMISSIONER MULVEY: And, in fact, our calculation, I think, weighs more toward equity than borrowed capital by about 2 to 1.

MR. VALENTINE: We will gladly provide all the detail on how we get to our return calculations, if anybody in the STB wants that to figure out why we differ from at least Morgan Stanley.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN NOBER: Okay. Well, again, thank you all very much for coming. I know you are the subject of a lot of discussion this morning, so we were glad to be able to hear it from you directly. And it's about 1:15. Why don't we break for 20 minutes until 1:35, give folks a chance to run out and grab a sandwich and we will take up only 35 minutes late, so it's not too, too bad considering we're the Government.

(Whereupon, the hearing was recessed at 1:13 p.m. to reconvene at 1:44 p.m. this same day.)

A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

1:44 p.m.

CHAIRMAN NOBER: Okay. Well, I think we are ready to begin. Our side of the aisle was on time. Okay. Well, I think we have a panel again of folks who are very well-known to the Agency. From CSX we have Les Passa, from BNSF Railway John Lanigan, President of UP Jim Young, Chief Operating Officer of Norfolk Southern Steve Tobias, Chief Financial Officer of K.C. Southern Ron Russ, Chief Financial Officer of Canadian Pacific Michael Waites and the head of U.S. operations from C.N. Gordon Trafton.

Okay. Gentlemen, thank you and we'll go from my left to my right as is our tradition.

MR. PASSA: Okay. Thank you, Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey, it's my pleasure to be here to represent CSX and talk about Staggers at 25, a success story. And I might add, I have been in this industry nearly 27 years and I have a maybe somewhat unique perspective in that I did grow up in a pre-Staggers railroad family in the bankrupt Northeast rail system. The experience it has given me is that that is not a place you really want to be, that we have come a long way and that we have opportunity in front of us. Staggers plays a significant role in that evolution.

How has that done that? It has allowed the rail industry to reshape its business. It recognized the need for sustaining revenue adequacy. It promoted differential pricing to the market to allow us to compete. It permitted efficiencies to consolidations and it has resulted in a rail system, a rail freight system that is really the envy of the logistic systems in the world.

Consolidations that we have gone through have led to longer hauls, fewer interchanges and have improved efficiency. On our own network Chessie Seaboard basically allowed us to be more responsive to customers, to provide faster service and really begin to strategically position the company for growth in the Sun Belt. The Conrail split filled in the gaps in the two eastern networks, provided balanced competition to the east and introduced key competition back in key markets in the northeast.

Now, I might add a good example of our ability to utilize these new networks is given the situations we have confronted in the Gulf with the hurricanes and our ability to react and to redirect trains and service with our partners in the industry over alternate gateways in an attempt to continue to drive freight to the customers.

Now, as the vice president of strategy, my responsibilities take a look at really to look forward and take a look at where the industry is going and where our company is going. And I believe that we are at a crossroads here. Transportation demand, as stated by many of the panelists earlier, is really at record levels and it is continuing to grow. The mix between domestic manufacturing and imports and exports is continuing to change and the demographics of the change in consumption markets evolving over time.

That growth is expected to continue. It will come from growth and population. It will come from growth in the economy. It will come from growth in the service and consumption markets. And it will come from growth in imports. If you look at this chart and you even take half the rate of growth, the growth is really stunning.

Despite the rapid growth of service and imports, the industrial production in our economy continues to grow. This is a good thing for the rail industry. Our customers are becoming increasingly competitive in a global environment.

Now, the interesting crossroads is that again this chart reflects the history back to 1980, the date of the Staggers Act. And the bars are really the forecasted changes and the number of miles traveled on the highway, since 1980, and you can see it is about 125 percent basis points above where it was in 1980. And the changes in lane miles on the highway infrastructure. The vehicle miles has considerably exceeded weigh mile capacity. It's pretty obvious highway infrastructure construction is not keeping pace with transportation demand.

We all know that highway infrastructure investment is increasingly difficult and expensive to build. And we are all suffering at the hands of those highways today, whether it be a commuter or rail passengers or our customers who are suffering delays in their own logistic systems.

Now, we believe CSX's market is well-positioned to take care of this demand. The population centers that we serve, the amount of disposable income that is in the eastern territory and the consumption and future consumption which is going to take place. We also, as we look out at the markets, realize that traffic growth is not just at a consistent level across our network. So as we look at our network, in the northern part of our network we see traffic growing at about a little less than a 2 percent compound annual growth rate over the next four or five years. But that's off a very, very large base of traffic we have in the north.

As we look over time, we see rapid growth beginning to occur in the mid-south in the southern markets on our system. With that and with the ability to predict, we believe the look out at predictable ability to market our freight, we have committed to a series of infrastructure expansion projects that we recently announced this past August in New York. That will be a rate of spend which is over the next two years $300 to $400 million per year over the $1 billion in capital investment we put into our planned infrastructure on a normalized basis.

And that expansion will take place across our network north of New York along, what we call, the River Line to get goods in and out of New York along that high dense northern market, between Chicago and the southeast at many points to reflect the changes that have taken place in the vast growth and demographics of the economy and the country's population centers. And you see the little egg over to the left, which is really towards Saint Louis Gateway to accommodate the shift of coal sourcing to the Illinois Basin and the Powder River and Colorado sources that UP and BN serve.

And not only are we investing in this growth, but our customers are also investing in this growth. So that we believe they see things the same way we do. In our merchandise business, which is our batch carload business, new ethanol facilities and feed mills, private investment going into our property along with some investment on our own part to compliment these facilities, such as plastics transit facilities.

In the coal business, for the first time in many years, new power plants actually getting ready to go on-line and more new projects being inventoried. You see the clustering of those in the southeastern United States consistent with our previous slide and the capital investment we're going to be putting into the property.

Intermodal, the growth and intermodal are both important development on the east coast and intermodal logistics centers that our western carriers have been developing in Chicago that we are looking at in the Midwest, in the Mid-Atlantic and in the Florida markets.

And automotive, we just recently in Montgomery, Alabama opened a new Hyundai plant and we expect that the foreign transplant continued growth in the United States in auto parts and plant facilities.

So what is this all about? It really means driving towards the goal, sustained revenue adequacy. CSXT's ability to invest is growing. We have had solid revenue growth over the last couple of years in particular, significant productivity gains and more to come. Our capital structure remains strong. We have solid free cash flow, improving returns enhancing the value of the company, as you heard the financial community talk about the industry in general.

And we have continued investment for growth, recoverability and reliability on our network, because that is what our customers are looking for, reliability and recoverability. Our focus will remain on earning the right to spend. We will focus it around key strategic routes, corridors and equipment and we must earn the cost of capital consistently and sustainably over a long period of time in order to have confidence that we can continue to plow these investments into our company.

In the end, it really starts with the customer, because what we are about is moving freight. We believe there is more customer demand, as we have heard today and as we believe as we look out into the marketplace, and that will mean more volume for our company in this industry. Sustained revenue adequacy is essential for making the long-term capital investments we have to make to be able to accommodate that freight. And that investment and infrastructure will deliver growth for the industry, reliability, safety and recoverability. Thank you.

CHAIRMAN NOBER: Thank you very much.

MR. LANIGAN: Good afternoon, Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey. I'm John Lanigan, Executive Vice President and Chief Marketing Officer at BNSF Railway. And rather than rehash my submitted statement, I would like to touch on a few points that came up during the morning this morning to make it more topical from a standpoint of addressing some of the concerns that the customers and others raised this morning.

First, I think it is clear that everyone of my colleagues that joins me today wishes we had better service today. There is not a railroad in North America that wishes that the service levels were where they are today. But let's talk for just a moment around how we got to where we're at.

If you look over a 20 or 30 year period, and I have a little different perspective in that I spent 16 years in the trucking industry from shortly after deregulation of the trucking industry until 2000. And so I saw a market in the trucking industry that under deregulated environment became easily the most efficient and most effective trucking infrastructure in the world. And I bring that background with me to the rail industry.

And as I think about the long-term volume growth of the rail industry over a 20 or 30 year period, it was more in the 2 percent or so range of annual volume growth. Last year at BNSF, we handled 10.5 percent more units than we handled in 2003. About 5 times what the historical growth patterns were. There was no headlights on that type of volume growth coming our way. But if you think about what has gone on in the economy over the last couple of years, you can understand how it did happen. But you can also understand that you couldn't anticipate it.

Some of those factors included what is

going on in the trucking industry, the industry that I came from, and the difficulty that they are having in finding qualified truck drivers and maintaining an adequate truck driver fleet. Recently, Governor Graves, who lead the American Trucking Association, indicated that the Association believes that the U.S. is 20,000 truck drivers short of needed capacity today and they anticipate that that could go as high as 100,000 over the next five to six years. That's having a direct impact on the demand for rail services.

When you look at natural gas prices in the $13, $14, $15 per mil in cubic feet, for the first time in a generation, coal is becoming the energy of choice or the fuel of choice for the energy industry and has created unprecedented demand for hauling coal throughout the United States. Those are just a couple of examples of things that have happened over the last couple of years that have now put a spotlight on the rail industry.

And with the concerns around service and the absolute service levels, I know at BNSF we have hauled more freight last year, 10.5 percent more units than the year before. And off of that base, we're going to haul probably 5 percent more units this year than last year, somewhere in that range. Just unprecedented volumes historically and we're very proud that we have been able to say yes to our customers a lot more often than we have said no during that period of time.

But it hasn't come without a cost. It has come with a cost of congestion. It has come at a cost of some of the service metrics that we were used to providing. And, in fact, if you looked at the 2001, 2002 time frame, at least at BNSF, those were all time highs in service in the history of the company. And so this unprecedented very rapid build up of demand and volume coming toward the American railroad industry is one that, I think, we should all understand that we have been working hard to handle, but it has not been without its pain.

As we think about these complex networks then, another thing comes to mind and that's the rationalization of the rail network over the last 30 or 40 years, particularly since deregulation. What has been rationalized at least at BNSF is not mainline capacity. It's not terminal capacity. It's not capacity in and out of major metropolitan or major producing and consuming markets. It has been branch lines that are under utilized, under performing and under appreciated.

And as we rationalize those lines, many of the proceeds that were gained from rationalizing those lines were put back into the core infrastructure to build out the infrastructure so that we could handle Powder River Basin coal, for example, or so we could handle intermodal shipments as well. So when we think about the investments that we made, all I have to do is go back three years. Three years ago, we hit the bottom from a standpoint of return on invested capital at BNSF and that resulted in us investing $1.5 billion of capital expenditures that year.

This year we will invest about $2.2 billion, three years later. And the reason that we have gone from $1.5 billion to $2.2 billion is because we are earning a better return on our investment.

It's as simple as that. And the Wall Street analysts showed you some slides today that indicated that not only do they support that, but that the investors are now finally coming to the table for the first time in the generation saying we would rather have you put money back into the infrastructure than to pay us in dividends.

So we may have underestimated in the late '90s, early 2000s what the volumes might be in 2004/2005. Quite frankly, I don't think any of us had a crystal ball to be able to see that we would rise above historic 2 percent or so volume increases on a year over year basis. But we think that we are peddling very hard to take advantage of the opportunities at hand, but also to provide longer term the service that our customers are asking for and the service that they deserve.

So in closing, as you think about future policies that the STB may consider as it regards to the Staggers Act and the anniversary of the Staggers Act and the regulation of the rail industry, I encourage you to think about policies that will stimulate the growth and infrastructure and the rail industry. And it's really predicated upon the rail industry achieving a long-term consistent cost of capital, so that we can gain the confidence of our investors and so that we can put more money into this business. Thank you.

CHAIRMAN NOBER: Thank you very much. Mr. Young?

MR. YOUNG: Don't start the clock yet.

CHAIRMAN NOBER: We'll spot you the extra time.

MR. YOUNG: Okay. Good afternoon, Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey. I think we all agree the Staggers Act has been a tremendous success. In fact, I'm not certain you could find another industry in terms of change that has had this much success in the last 20 or 25 years. But I also agree, I think it is premature to declare victory. Many of the investments that we think about in our business are 20, 25 year kinds of time lines, so time will tell how the success will go.

We all agree capacity is constrained.

There is a chart up here that shows whatever forecast you want to use. The American Truckers Association, DOT, AASHTO all shows volume increasing. We will have a cycle. Commissioner Mulvey, as an economist, it's probably time to come through here, but I think structurally things have changed for us here.

Next slide, Mike. This is a discussion about transportation infrastructure not just the railroad industry. This shows a chart here that says what's happened on the highway system. You've heard it consistently, density has increased here. When you look at vehicle miles traveled per lane mile, you could flip the same chart up there for the railroads and show a huge increase in productivity. In fact, the railroad, Union Pacific, alone in the last seven or eight years has increased its density by 50 percent in terms of gross ton-miles per train mile.

The question, obviously, is one of trucks. I spend a significant amount of my time in front of our customers. What is interesting in those discussions, I see a frustration that truck service is expensive. Truck service in many cases is not available. They want the railroad to solve the problem. That's a great problem for this industry to have in terms of where we're going forward here, but I don't think that in terms of I don't see anything that will change here on the infrastructure side of this that's going to solve this either way.

One of the other things I see in our customer meetings, the logistics piece in many of our businesses now is in the top priority when you think about many of our businesses. I'm in more businesses where the CEO is involved, the president is involved, it's now moved into the top five kinds of issues going forward.

Next slide. This is a chart here that shows Union Pacific's volume. Even with our challenges we've had, we continue to set record volumes every year. I agree with what you have heard up here, we all are focused and need to provide better service. The fact is that we are handling more volumes, even though Mother Nature has hit us a few times, but our ability to recover has certainly been improved over time. You look at the AASHTO report and it's raising a pretty significant issue for all of us which is talking about where will that investment come from as we look forward here?

Next slide. If you look at this chart here, this one to me really kind of tells the story here. If you look at the base case, what's needed in terms of capital investment in the rail industry? If we simply meet what we think industrial production will be over the next 15 years, it says the industry needs to invest $175 to $195 billion. That's greater than the current asset values of the companies today. That's simply to maintain market share with the highway system going forward here. You will also note, if there is no growth, we've got $100 to $125 billion of investment simply to keep up with maintenance.

These are some of the points in our system where you can look at some of the volume. In particular, look at the Sunset Corridor, which we have talked to you about, the acquisition of Southern Pacific. You will note there in 1998 we were running 30 trains a day. October of last year, we were running 45. This year we're running 50. So we have had a huge increase in volume.

You look at South Texas, again, another SP area where we went from 10 trains a day in a corridor and up to 18. You look at the Iowa Corridor, a lot of that handles coal. Our running went from 59 to 69 a year ago. We're running right now about 70 or 75. So clearly, volume has been increased in our business.

I have used this chart several times in terms of when we look to the next five years, these are the major areas in our network that we have some very critical decisions to make about investment. Sunset Corridor, I'll tell you, the demand there far exceeds the capacity. It's a thousand mile railroad. A third of it is double track, two-thirds single track. The price tag for investment there is $2.5 million a mile. So we have a major decision to make about how fast we want to invest in this business.

If you look at total capital expending, the numbers are pretty big. There is no industry that spends capital as a percent of revenue. This is UP here. We've been running 18, 19, 20 percent of our revenue over time. I think the next closest is probably about 7 or 8 percent, if you look it across the board here. We're going to spend record levels of capital this year. Part of that commitment of capital is we are seeing our ability to start to improve our margins and give price in the marketplace.

If you look here, this is the issue for us. The returns aren't there. UP is lagging. Many of our partners here, in terms of where they are going in returns, we will come around. But the real fundamental issue here is one on what's happening with returns in this business.

This is a pretty straightforward chart. It talks about where do you want to put the capital? Where do you want to focus your returns here? We are seeing a significant amount of focus in the areas where the most efficient customer base is where scarce resources are allocated in terms of hauling goods.

Next slide. This slide here is a view from the rating agency and I think it's important to keep in mind here while this industry shows that we are above investment grade, it doesn't take much to move us back below. The margin for error when you look at cash flows in this business, the huge amount of capital, it can quickly deteriorate as well as it has moved up.

To wrap it all up here, demand for transportation is growing. We all agree with that. I see that is going to be satisfied in several areas. We have to get the returns up and this isn't just about pricing. This is about efficiency in our network. This is about good industrial engineering that you look at processes. This is about efficiency in our network, investment and technology going forward. Adding capacity is expensive. A price tag easily is about $2.5 million a mile right now to put new railroad in. So it's a real challenge.

When you look here, item 3 here, expanding the rail network will require higher earnings, not regulation that reduces earnings. We have had this discussion. Investment is only going to come from two places, either from our shareholders in the investment community or the Government. And I don't see the Government actually bailing this industry out in terms of putting significant capacity in.

Scarce capacity must be used efficiently. One of the things we are seeing and it really varies with each customer base, as I said in many of these areas the strategic focus on transportation has been raised in many of our customers we deal with here. One of the things we are talking with and we've partnered with a lot of our customers, we can sit down together and look at how do we get the most out of the train station infrastructure?

And some of those solutions are simple. It's work seven days a week. Operate 24 hours a day. Many customers work Monday through Friday and it does restrict capacity going forward here and we see a lot of our customers that are committed in working with us to increase through efficiency. So the bottom line, how large a rail network do we want?

The industry when you look at it, as I said, it's not -- I think it is healthier, but we have a long ways to go before we declare victory in terms of the state of this business. Thank you.

CHAIRMAN NOBER: Thank you very much. Mr.

Tobias?

MR. TOBIAS: Thank you, Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey. It is my pleasure to represent Norfolk Southern at this proceeding. I started with Norfolk and Western and had the pleasure to migrate in '80 to merger with -- consolidation with Southern Railway and had that experience and have put in 36 years of principally operating line duties and currently serve as chief operating officer of NS.

I think the successes of the Staggers Act have been widely recognized here. And there were certainly many discussions and publications that attest to that. The contrast between the pre-Staggers rail industry to the post-Staggers demonstrates how significant the regulatory regime is to the success or failure of this particular industry.

I'm struck by the fact that many of the comments that you are hearing today are similar in context. It's not verbatim, but it's not something that we sat and contrived. Not the least of our commonalities is our gauge which is 56.5 inches. We share many other similarities and many other issues for the successes that we have had of late. We still have a very long way to go.

Freight volumes are increasing at Norfolk Southern as they are in the industry. NS is focused on what we must do to provide the safest, the best rail transportation and service to our customers in the face of a very large increasing demand. Running the scheduled operation and reducing variability are the two major focus points for NS in this particular environment.

We are focused on serving all of our customers and by doing what is best for the network, making decisions that impact the complexity of what we do across the broad spectrum of our system and not just moving problems around. We invest heavily to be prepared to handle more freight and provide better service to many different customers who have many different shipping patterns and different requirements, many of which shift and ebb and change on a daily and a weekly basis.

The investments that we make are again

based on the overall health and benefit of the network in total. They don't come cheap. They fall into areas of track investment, much like our Heartland Corridor, which is a corridor investment and projected somewhere in the neighborhood of $300 million. We invest in locomotives, both from an acquisition and a leasing standpoint, rail cars fall in the same category, crew hiring and training of our people.

We invest in information technology. At NS we have invested heavily in our thoroughbred operating plant and our operating plan developer which allows us to model and respond in a very short period of time to "what if" scenarios. What if Hurricane Katrina does strike? What should our response be? What will our service configuration be and what adjustments do we need to make in our network that allow us to respond to that type of an event and bring our service back to a standard that meets the need in an emergency situation or some other non-standard event?

All of these things require a lot of money, and probably more importantly, they require a great deal of lead time and they are long-lived assets. We try to be very judicious in the application of that money and that spend, because the long-lived tenure of those assets has far reaching impacts if we make a significant mistake.

Rail investment is critical to our future. The Staggers Act was critical. It created the best rail system in the world, in my opinion. Our system is a competitive advantage for America. I really don't think we can afford to lose that. We must have the resources to continue to improve, encourage growth and reach the potential over the much longer term. Thank you.

CHAIRMAN NOBER: Thank you. Mr. Russ?

MR. RUSS: Chairman Nober, Vice Chairman Buttrey, Commissioner Mulvey and Members of the STB staff, good afternoon. I am Ron Russ. I'm the Executive Vice President and Chief Financial Officer of The Kansas City Southern and it's wholly owned Class I subsidiary, The Kansas City Southern Railway Company. I joined KCS in 2002. I have spent 28 years in the rail industry, including service at Wisconsin

Central, the Sioux Line and the Milwaukee Road when the Staggers was enacted.

I would like to thank the Board for allowing KCS the opportunity to provide its input on the Staggers Act and it's implementation. As an overall comment, it has been my observation that without the Staggers Act and the way it was implemented by the Board and its predecessor, the industry would not have survived as we know it. In KCS' opinion, the Act should not be changed in any significant way nor should the Board change its precedent implementing that Act.

In explaining why and how KCS has come to that conclusion, let me share a brief history of KCS and the role KCS today plays both domestically and internationally. Then I would like to discuss the importance of attracting sufficient capital in the rail industry, the role capital plays with respect to the rail industry's infrastructure needs and why Staggers is critical to that role.

In 1980, when Congress passed the Staggers Act, all railroads were struggling to survive. The

KCS was no different. With the passage of Staggers and the deregulation of the rail industry, KCSR, like the industry as a whole, was able to adjust its revenues to market conditions, increase its investment and infrastructure and improve service. As we approached the 1990s, massive consolidation of the industry left Kansas City Southern, the smallest of the remaining Class I railroads.

Kansas City Southern was either going to be acquired, continue to shrink or going to grow. Under the leadership of our Chairman, Mike Haverty, Kansas City Southern decided to grow. Kansas City Southern did so through a series of mergers, acquisitions, alliances, marketing and haulage rates with many of my colleagues here at the table.

None of these franchise strengthening actions would have been possible in a pre-Staggers regulatory structure nor would Kansas City Southern have been able to undertake these actions if the ICC-STB had implemented Staggers in a different way or taken a more activist role in the marketplace.

Today, Kansas City Southern remains the

smallest of the Class I railroads. Nonetheless, it plays a significant role in providing shippers with an independent competitive presence in the marketplace. The Staggers Rail Act along with aggressive and focused management has allowed Kansas City Southern to become a critical alternative for rail transportation, both domestically and internationally.

For example, The Kansas City Southern's Meridian Speedway, which is what we call a rail line between Meridian, Mississippi and Dallas, Texas, holds great promise for the movement of intermodal freight in the Transconscontinental market, that is the most direct connection from the U.S. southwest and west coast to Atlanta and southeast U.S. markets.

Likewise, NAFTA holds great promise for our company. With our ownership of Kansas City Southern Railway, the Tex-Mex Railway and TFM under one single holding company, Kansas City Southern now presents the best competitive alternative for the movement of NAFTA traffic to and from Mexico and it presents the greatest opportunity for growth in the future. Most of the growth will come from increased projected trade between Canada, the U.S. and Mexico. Some will come from the development of a port at Lazaro Cardenas.

However, most of that growth will come from our ability to move traffic from other modes, including off our highways and onto our rail system. Most of the overall NAFTA trade is transported by other modes. Of the overall cross border traffic between the U.S. and Mexico, rail represents only a 20 percent share. We intend to change that. We will do so by providing the most cost effective, safest and most environmentally responsible way to move the ever growing volumes of freight that will be required along the NAFTA Trade Corridor in the future.

However, we cannot do this if Stagger changes and the industry is re-regulated. This Board and Congress must resist the urge to change the Staggers Act in a way that would hamper efforts of the rail industry to better compete with the other modes in the NAFTA Trade Corridor. Calls by some for the regulation of rate making freedoms, such as the requirement to establish bottleneck rates, both domestically and internationally to and from our borders or for this Agency to be involved in setting the divisions to and from gateways should be rejected.

Such regulation would eliminate the railroads' ability to achieve adequate returns and price according to the market. Perhaps the most critical component to Kansas City Southern's ability to continue to provide an effective competitive rail alternative and to increase the rail industry's share of the overall NAFTA trade market is the need for the railroads to achieve adequate returns.

In spite of the successes of the Staggers Act or perhaps I should say despite the successes of the Staggers Act, the nation's railroads both large and small are at a crossroads. KCS like the other railroads is finding it more and more difficult to replace, improve and expand its infrastructure in order to keep pace with the increased traffic growth. We are very close to being completely capacity constrained. Yet, capacity can only be increased with new capital.

As you know and like the trucking

industry, railroads finance virtually all their own right-of-way, both in terms of maintenance and improvements. KCS like the other rail carriers must increase its revenues and raise sufficient capital to not only maintain an existing infrastructure, but at the same time plan for and build for future traffic. This is a challenging task. This year domestically in the U.S., Kansas City Southern will spend, approximately, $65 million for maintenance cap ex, $56 million in rolling stock, IT and other assets just to maintain our existing infrastructure.

That's about 17 percent of our operating revenues. On top of that, Kansas City Southern will spend yet another $42 million more to expand the capacity of our rail infrastructure and $60 million more for new high horse powered locomotives. KCS could easily spend 100 percent of these amounts and more to accommodate all the capacity expansion projects necessary for KCS to truly build for the projected growth of the system.

Obviously, that would be unrealistic. But we do need to do revenues, so that we can raise the new capital needed to expand our system and meet the demand of rail transportation for the future. To illustrate the challenge we face at Kansas City Southern, for example, within the confines of our existing revenue base, both The KCS and Tex-Mex are undertaking a significant number of capital projects to expand capacity for the future, from yard expansion in Shreveport to adding CTC at several locations on the Meridian Speedway to putting new sidings and double tracking at numerous locations.

Recently, Tex-Mex obtained a $50 million RRIF loan from the FRA to rehabilitate the Tex-Mex Line in south Texas. These projects are necessary for KCS to remain competitive for the existing traffic dates. But that is not enough. KCS must plan for the future and we are doing so. KCS is working with third parties to arrange for the necessary financing to rebuild and rehabilitate the Victoria to Rosenberg, Texas Corridor, so as to free up capacity on the UP Lines used by Tex-Mex by its trackage rights.

KCS is also funding existing rate crossing relocations, closures with state, federal and private dollars as necessary to improve safety and eliminate congestion. All of these projects require significant funding strategies, funding that is many times difficult to come by in the capital markets witness the RRIF loan for the Tex-Mex.

The bottom line is that the railroads like KCS and others continue to prosper and plan for the future. We need to have access to capital for the capacity improvements that we must have for the property to grow. KCS can raise revenues and improve capital picture by cutting costs using Government funding mechanisms and in public/private partnerships will find significant benefits to improve the railroad and improve the railroad in the public interest.

By looking at ways to improve productivity through technology investment and through items such as federal capital investment tax credit for Class I railroads like those granted to Congress -- to the short by Congress, to the short line railroads, would also help. But all these options have limits. The best way to ensure the necessary capital continues to remain available is for the STB to ensure railroads like KCS can earn adequate returns.

We urge you to not tamper with the Staggers Act going forward. Thank you.

CHAIRMAN NOBER: Thank you very much. Mr. Waites?

MR. WAITES: Thank you very much, Mr. Chairman, Vice Chairman Buttrey, Commissioner Mulvey. We are pleased to be here this afternoon. Allow me to say that Canadian Pacific conducts its operations in the U.S. through subsidiaries, Delaware and Hudson Railroad in the U.S. Northeast and also the Sioux Line Railroad in the U.S. midwest. That ties together the twin cities to Chicago up to Detroit with running rights and also tieing into the west to CPR's western Canadian Lines to border crossings.

I think it's also very helpful to note that of CP's total revenue is about $4.5 billion Canadian, about 30 percent of those revenues are transborder revenues and so we're very much talking about a system of transborder shipments about $1 billion in U.S. dollar terms and also we're talking about global traffic movements and supply chains and rail, obviously, is one part of that overall system.

I would like to abbreviate our comments. Much has been said by my colleagues on the success of Staggers, so I'm not going to repeat that. What I would like to do is just draw your attention to this slide. It's towards the end of our submission. And this is really our picture of what is happening at CPR and I think it draws a picture of what perhaps might be happening to various degrees at other railroads.

But you can see this is entitled "CPR Network Holiday Ending," and what you have here is on the top you have a line running from west to east and that line depicts the physical capacity of the track and road bed capacity of our railway and this is an illustrative depiction, but you might think of it as an index spaced relationship. The histograms and the why excess talk about the amount of that capacity that we are utilizing.

So, for example, in the early 1900s, at the far left, you can see that we had excess capacity, but you can see in terms of number of trains versus that capacity that the excess was moderate, but it nevertheless existed. The top part of the histogram is passenger trains. And, obviously, as we saw the development of roads and highways, the amount of capacity dedicated to moving passengers declined over time, as something we have all seen.

And as you see that come down clearly, there were movements on the freight component, but as we move to the right, you can see that, in fact, that capacity crushing got even greater and that was not a sustainable proposition for railroads. And so railroads did what they only could do, that was to ration capacity and to rationalize systems. And so what was happening was we shrunk the railroads so that the revenue adequacy was not there. We had to get rid of the capital base and that's how we did it.

As we move to the right you can see we removed double track. We abandoned parallel routes. We moved to fewer longer sidings. We went to centralized traffic control, today the equivalence of that of positive train control and so on. As you get into the '80s, we had a lot of improvements, productivity improvements in terms of rolling stock, improvements in car fleet, car utilization, locomotive technology and so on.

But the key take-away here is as you move to the right hand side of this chart, we're moving from an era of surplus capacity to an era of surplus demand. And clearly price signals have to reflect that kind of movement. And I think the question as we started our submission by asking the questions did Staggers work? What worked, what didn't work? I think the question here is as we go forward, do we think that Staggers is what we need to go forward?

And we believe the answer is very much yes. So let me try and explain that. Maybe we could take this slide down, at this point, if that could be done. But as we move forward, what do we see? We see increasing trends to containerization. We see increasing short line roles originating traffic. We see increasing trends toward coproduction with our colleagues up here in short lines. We see more opportunity for collaborative demand management working with shippers and this includes things like 7 x 24 loading schedules and so on.

We think that we have to look at the entire supply chain. This includes ports, terminals, mines and other pieces of infrastructure that fit into that overall chain. And I think there will be an emerging and increasing clarification around the world of trucks, which certainly with the current fuel price differentials trucking plays a key role in terms of originating and distributing traffic. But railroads do the best job moving heavy tonnages long distances.

And a consequence of that, which you have heard about this afternoon, is, obviously, a huge demand for investment in railroads. And the reason we believe that Staggers is still very much applicable is because it plays a market based solution to those challenges. So to Vice Chairman Buttrey's comments earlier this morning, we don't believe we need regulatory help to work on those opportunities as we go into the future working with shippers on demand management coproduction and so on.

We think those opportunities are there for us to have. And that the marketplace and the value of proposition will be there if it is allowed to work.

What that means fundamentally is our ability to price, our ability to generate a return on assets, it enables us to access capital markets, so it's critical for us to do that.

There is one other point that I would really like to stress here is when we look forward to these types of investments, the investments we're looking at are different types of investments to what we, I wouldn't say typically done, but more recently done over the '80s and over the '90s. A lot of those investments are investments in rolling stock. And they have some fairly unique characteristics in contrast to what we're looking at here.

But for example, in cars and locomotives they are more physically discrete. You can put them in. You can take them out. They come in smaller divisible increments. So if the demand isn't there, you can try and match those leases if, in fact, that's the way you acquire them and finance them to those various levels of demand. They are easier to redeploy on a sublease as an example. There is a different risk profile around that type of investment.

The investment that we're looking at here, this is an investment in physical infrastructure. We can't move that. It can't go anywhere and so what we have to have in order to do that is we have to have revenue adequacy over the investment cycle and that will enable us to invest. And I would suggest to you that if we have that over the investment cycle and we're looking for sustained investment, I think we have to have sustained revenue adequacy. That is the only way that this will move forward.

And so I wanted to highlight that key distinction. We do need stability. We need the commercial incentive to improve the productivity. And the way we do that, obviously, is to go back to those capital markets that we heard about about midday today and we argue for that capital on a risk adjusted competitive return basis. And that, in fact, or those, I should say, are, in fact, the rules that we have to deal with going forward. That concludes my comments. Thank you.

CHAIRMAN NOBER: Thanks. Mr. Trafton?

MR. TRAFTON: Chairman Nober, Vice

Chairman Buttrey, Commissioner Mulvey, thank you for the opportunity to share with you my perspective on the 25th anniversary of the Staggers Act.

It was through a summer employment improvement that I landed a job with a Class I railroad a few years before the enactment of the Staggers Act. When I made my decision to go to work for a railroad, there were those who questioned why, after earning a college education, I would want to work for a company that is in a regulated industry that then and now is not well-understood by the general public and the shipping community.

Their view was if you were going to do that, you might as well go to work for the utility or a Government. I'm sure that there are many factors that contributed to my final decision that I no longer recall, but the one I do remember was a transportation professor. He described to me the potential and the likelihood of a renaissance in the railroad industry when, not if, the industry became deregulated.

With a view and some additional research, I took a leap of faith that has brought me here today.

I can tell you from my own personal experiences how accurate my professor was in describing that renaissance that has occurred over the past 25 years. Much more is still to come.

Seeing it as a business and as a business, we have to produce a service that attract customers. Without them we have no business. In order to compete with other transportation companies, we need to assure investors that we have an opportunity to earn our cost of capital. Finally, we must pursue efficiency and innovation in product and our practices. I believe that the Staggers Act has given the CN and other railroads the opportunity to accomplish all three of these objectives.

As a business, we have to reinvest in our plant. Hundreds of millions of dollars each year are spent on maintaining and renewing our equipment and facilities. CN will spend, approximately, $1.6 billion this year. New rail, new ties, new ballast are added each year as we maintain and expand our network in addition to many other items that include IT services and the like.

As a practice, we do not seek Government funding in our day-to-day operations. We spend additional millions each year recovering from such events as hurricanes. Also as a business, we must innovate and continually improve efficiency or fall by the wayside like many others in the past. Peak and off-peak pricing by day of the week, intermodal reservations, routing protocols are examples of our efforts.

We at CN are here for our customers. Why? Our customers' success assures shareholder and employee success. We are, therefore, always looking forward to new ways to provide value to the customers in order to secure the profits available when we create that value, and we need a regulatory system based on market principles like that provided by the Staggers Act to assure that we can keep creating new value.

The difference between the Staggers Act and other regulatory approaches is that other such approaches impose inefficient and uneconomic regulation while Staggers imposes efficient and economic regulation.

Now, there are those that talk about re-regulation and the need to "fix" the railroad industry, but I would suggest to you that it isn't because the railroad industry is broken, but that change has been hard to accept for those in today's world that continue to view the railroads as a utility.

Instead, the Staggers Act has provided us with the ability to operate as a business by giving us the opportunity to earn our cost of capital, create the desire to compete by offering better and better services and has generated the need to innovate and improve safety, efficiency and service.

At CN we have five core principles we live and work by each day, service, cost control, asset utilization, safety and people. These five principles are all interrelated and not one more important than the other.

Service, which is to us doing what we say you will do all the time. While we're not perfect and we do fail, our service goal is always 100 percent every day. Cost control. It's not about cutting cost, but about a cost effective and efficient operation. Asset utilization. They are not free. We are a very asset-intensive business and we must maximize their use. Safety. Don't get people hurt and don't have accidents. No job is more important than safety. People. Recruit the right people. Develop them with the right skills. Motivate them to do the right things and provide leadership.

I believe all five of these principles are aligned with what the authors of Staggers had in mind. We cannot thrive with a system that will limit our ability to achieve these goals and principles. I know the Staggers Act works and I will leave it to the lawyers and economists to tell us whether there is any way to improve on that Act. So far I have not been shown one. Thank you.

CHAIRMAN NOBER: Thank you very much. Commissioner Mulvey, do you want to start?

COMMISSIONER MULVEY: Sure. In the past, the Class I railroads have been opposed to virtually every form of public spending until the era of public/private partnerships was ushered in by the Alameda Corridor and up until recently, hopefully, now the CREATE project.

And I applaud the willingness of the railroads to work within the PPP model, but you really shouldn't be waiting for an authorization bill, they roll around every decade or so, to support public funding. You should have partnerships with every state department of transportation, city council, even the Federal Government, and work with them to help expand railroad capacity.

I would like to ask the railroads how successful they have been in implementing public/private partnerships especially on the state and local levels. Anybody care to start with that?

MR. LANIGAN: We have had varying degrees of success. A lot of it has had to do with things like commuter rail projects and things along those lines that are local projects, not necessarily Amtrak related, like the Sounder System in Seattle, but it has been somewhat limited.

I think there has actually been greater

success with short lines, because they are considered to be local companies and, therefore, attract a different level of understanding or interest from local and state Governments.

COMMISSIONER MULVEY: Anybody else?

MR. YOUNG: I would say for Union Pacific, we look at it, we really don't have a choice. Many of the communities we operate in, we are part of the community. We get to know the local officials very well. The most successful projects that we see are ones that are realistic in nature. They can have more immediate benefits.

It's a partnership where the economic value we are willing to put in, where there is a benefit for our shareholders, we will put that capital in and then the communities will fund where they see the environmental benefit for them. You know, there are a lot of ideas out there on public/private partnerships.

Unfortunately, when you look at the amount of money that's on the table, they are never going to happen probably in our lifetime. So we're very active with them, trying to keep it realistic and get benefits as quick as we can.

MR. PASSA: At CSX I think we see the same thing. This really seems to be in many ways in its beginning form and we have got active discussions going on in a couple of states, and I believe the states are all getting themselves to different levels of competency on that as well. So it's something that we expect quite a big role in the future and along the lines of benefits that both Jim Young and John have spoken about, so we see that as a part of the future.

MR. WAITES: I would like to add, I think it is in a stage of evolution and I think, candidly, railroads have been apprehensive about getting into those transactions for fear of losing control of assets. And I think, candidly, public officials have been concerned about being involved in projects, working with railroads and perhaps being perceived as putting public funds into privately owned assets.

I think CREATE is a good example of where that is evolving and some of the fundamental principles there include complete transparency as to what those project costs and returns are and, very importantly, funding in accordance with the benefits that each party derives. Now, that's not an easy one to solve, but I think it is evolving.

COMMISSIONER MULVEY: The CREATE project, of course, is one that right now is on hold because of insufficient public funding. Do any of you care to speculate on the future of the CREATE project now that we only have $100 million in the Highway Bill for it?

MR. TOBIAS: Steve Tobias, NS. Commissioner Mulvey, my sense and the sense that I have gotten from the representatives on the CREATE Project is that all of the roads are uniformly still engaged and behind the CREATE Project. We have put a tremendous amount of work into this effort over the last six years.

It's probably a landmark point from the standpoint of the roads that are involved and the communities that are involved in a commitment to a project that brings great benefit both to the freight application here, but also the public sector.

MR. LANIGAN: I do think that when you

think about how these sorts of projects slow down though when we think about overall capacity additions to the network, this is one of the primary issues. We're involved at BNSF Railway in a project in southern California right now where we have been selected by the Port of Los Angeles to develop a new near dock intermodal facility.

From the time we first approached the port to the time that we believe our best guess as to when that facility will be up and running will be somewhere in the range of seven to eight years, only one of which is construction.

And so when we think about this rapid need for capacity in the rail industry, we need to think through the fact that many of these projects take a long time to get off the ground because of local regulations, environmental regulations, things along those lines and, quite frankly, I think that's something the Board can help both educating and also helping to push policy in those directions as well.

COMMISSIONER MULVEY: One last question before I pass it on. When we look at the numbers that everybody presents, whether it be AASHTO or whether it be ATA or DOT, and then your own forecasts for your own spending for capital needs, it does fall short. You just don't get enough money spent on capital investment, including maintenance as well as expansion, to meet the projected forecasts and demand. So, there is this gap.

It was suggested by somebody earlier today that maybe a Railroad Trust Fund similar to the Highway and Aviation Trust Funds might be in order. And I understand your concerns about what that might entail for you in terms of the quid pro quo, but do you see any way in which something like that could be developed so that monies could be made available for rail capital infrastructure without the railroads losing control over their operations?

MR. YOUNG: I think our best bet here, trust funds do concern Union Pacific, because the question becomes one as to what strings go along and what part of that trust fund gets committed to community projects versus projects that actually expand freight capacity?

You said earlier CREATE is several hundred million dollars short. I think when you think of the concept of a trust fund, everyone will have their eye on that transportation dollar. I think an alternative, and we have had some discussion, there is talk about the concept of an investment tax credit for rail infrastructure.

I think that is something that really needs to be considered going forward. It's a partnership with the individual railroad and the Government to apoint, but there is incentive there and it could be very much targeted on freight capacity going forward.

MR. TRAFTON: I share Jim's concern on the trust fund in the sense that our company in particular, I think, stays away from dollars from the Government or local funding because of the strings attached. My concern would be similar in that you never know in these trust funds where the money is going to go, and I think there's enough trust funds out there to show the history that they don't go to what they were designed to do initially.

But I think there's other alternatives and one of which has to be the marketplace. The marketplace has to dictate what happens and where. A lot of our capital investments are in the main line. They are our main corridors. They are our main yards. A lot of what you see, and not unlike what I think Mr. Lanigan had indicated earlier, is that what you see are the reductions in areas that are the branch lines or areas where six cars a week may be going out.

The real question is how do we survive in those kind of lines, and those are the kinds of situations that you have seen over time, that short lines have sprung up. Other people have come into the business and serviced those properties. In some cases states actually buy the property and operate the railroad.

The only concern I have when a state gets involved, again, is you're taking taxpayer money to operate that railroad and, again, there is enough, I think, companies out there to operate and look at it from a market standpoint.

MR. PASSA: I guess the last point is

wherever this takes us, the idea of sustained revenue adequacy comes with sustained public policy as well. So as we go forward trying to develop public/private partnerships, the rules and the players can't keep changing their mind and changing their ideas, because then we end up with stops and starts and we don't have a continuous process, because these things do take a very long period of time, as John pointed out.

COMMISSIONER MULVEY: Well, surely no one is suggesting that trust fund monies would be earmarked for uneconomic projects. That doesn't --

CHAIRMAN NOBER: It never happens.

COMMISSIONER MULVEY: It would never happen.

CHAIRMAN NOBER: Commissioner Buttrey?

VICE CHAIRMAN BUTTREY: Thank you. Someone referred this morning to -- I think they called it the elephant in the room idea. I was sitting here trying to think of something a lot more scary than an elephant, and I came up with dragon. Dragons are kind of scary to me, so I wanted to speak for a moment or talk for a moment about the dragon in the room. It might not scare anybody else, but it scares me.

If you read through all of these statements, there is a common thread that runs through there, and one of those common -- there are several common threads, but there is one common thread that runs through there and it's not a general thread. It's a visceral thread. And when you meet that visceral claim, if you will, you get it in very impressive terms and that is the subject of fuel surcharges.

I don't know how we got to this place, but there doesn't seem to be any feeling anywhere in the shipper community, I think to a person, that there is virtually no credibility that attaches to the methodology or the practice of fuel surcharges in the railroad industry right now.

Now, I don't know how we got to that point and I'm not saying, I'm not claiming personally that there is no credibility. I am just saying that that's what the community is saying and I would be interested in knowing what the responses are of the Class I railroads to that situation.

I am one of those people who likes to believe everybody, but sometimes it's hard to do, especially when the claims are so opposite, so disparate, and I just wondered if any of you had any comments about where we are and how we got to where we are on fuel surcharges.

And I'm not talking about the accepted fact that fuel has gone up in price and that people expect to pay for those kinds of increases. I would just like to see if anybody has any comment about that.

MR. YOUNG: I will give it a shot here. Yes, you go back in time where this industry passed very little fuel on and I think in the inception when fuel jumped $35 a barrel, $40 a barrel, most views were it's temporary, it will come back down again.

We know what the trucking industry does in terms of when you look at their fuel surcharge programs. We have looked at many different models. We know our partners have put a new proposal on the table. We believe the way we approach this thing is fairly reasonable.

We have looked at different segments. We have cut it by length of haul. We have cut it by the weight, the type of train, and it comes reasonably close. It gets more complicated. You think of manifest service and you start thinking of applying a mileage-based comparison on a manifest train. Well, where does the fuel come in that is consumed in the terminal switching the engines or switching the cars? There is a huge fuel consumption factor that is at the local terminals.

Much of that could be reflected in the rate, because it can be a higher cost business in terms of the service. So we're very much aware of it. We have sat down regularly with our customers to walk through what we see in the fuel surcharge, but I don't again see a perfect model here going forward.

MR. LANIGAN: I think the Board is aware that in March BNSF announced that we are going to move to a mileage-based fuel surcharge program starting January 1st of next year.

When I joined the company three years ago with my trucking background -- as an aside, when I returned from serving in Operation Desert Storm to my job at Schneider National, my second day back the Chairman said you're in charge of our new fuel surcharge program, because we got killed while you were away at the war.

And so we embarked on implementing a fuel surcharge program, which was mileage-based. And in my first couple of years at BNSF we looked at the program that we had in place, which was percent of revenue-based, and it really came from an historic base, the fact that for the most part in the rail industry there is not a mileage-based revenue program, so it was not easy to correlate to a mileage-based fuel surcharge program. We don't charge for our services that way like the truckload motor industry does.

But in the end, as we analyzed it at BNSF, we felt that we could implement a mileage-based fuel surcharge program and have a more direct attachment or corollary to the actual usage of fuel on a train-by-train basis. And so we have been preparing to do that now all year, systems changes, etcetera, educating our customers.

What is extremely surprising is in the last 30 to 60 days, the number of customers that have come forward and have asked us not to go forward with this program because of the change that they would have to go through.

Either they cannot acquire IT resources or the complexity of having one system with us and another system with other railroads, but you would be shocked at the number of customers that, on face value, agree that this would be the way to go, but are not currently prepared or want to move in that direction.

MR. WAITES: I might add, if I can tag onto Jim Young's comments, you know, not so many years ago we were buying West Texas Intermediate for $30, $35 a barrel. That was about three or four years ago. And not so many years ago you were seeing cracking, distillate margins from refiners on a good year at $1.50 a barrel, perhaps a little more.

Today you're seeing those numbers at $8, $10, $12 a barrel on cracking margins. We're seeing crude prices in the $60s, and I think what we started with in a well-intentioned way was to put in place proxies to be fair to recover the cost.

Given the magnitude of the change, there needs to be more transparency on the exact match, and I think all of us are looking at those things to explain it, but a very large change in a very short period of time, which is part of what is manifesting itself and how it's playing out at this point.

VICE CHAIRMAN BUTTREY: Thank you.

CHAIRMAN NOBER: Well, let me ask this. We heard a lot of discussion about this this morning. You know, I know that there is a mathematical equation to determine when you're earning your cost of capital, which is something that you all spend a lot of time thinking about, but then there is a legal conclusion that we would have to come to, which is when is a carrier revenue adequate.

When do you all believe a carrier crosses the line from earning your cost of capital to being legally revenue adequate? Whoever wants to -- don't everyone speak up at once.

MR. YOUNG: Well, I will give it a shot again here. We go back to my CFO days. You know, at the end of the day the market is going to determine revenue adequacy. I mean, we can crank through formulas.

The formulas are all pretty directionally correct, but I will tell you there is nothing magic about hitting a number, because at the end of the day you still are going to look your board of directors in the eye, you are going to look your shareholders in the eye and you're going to have to justify growth investment.

And while you may have a company that is deemed revenue adequate today, when you're making 30, 40 year types of investment decisions, double tracking the Sunset Corridor, there has got to be sustainability there. There has to be room when you think about that revenue adequacy. Again, I think it's not a point here that all of a sudden that this industry is healthy.

It's sustained over time and, in fact, I think we want to look at -- as we think about it as

UP, going beyond revenue adequacy or going beyond your basic cost of capital, to us would drive even more growth investment.

MR. LANIGAN: I think the financial community certainly focuses on return on invested capital and similar types of metrics. But to Jim's point, if we believe that this demand environment for rail services will sustain itself over a longer period of time than just one or two or three years, then we need to continue to improve our returns and keep them at a consistently high level, so that we can take investments to the level at which we can then ultimately be much closer to satisfying market demands.

And I think that that's -- the part of the disconnect right now is the fact that with this rapid run-up of demand over a relatively short period of time, the perception is is that we don't want to handle the freight or we can't handle the freight. It really was more of a case of having inadequate returns for such a long period of time that we could just not afford to be ahead of the game at all as an industry.

And so when the tidal wave came, we weren't prepared. We weren't prepared for these kinds of levels of freight to be able to sustain service and volume at the same time, and so a longer term for us to get back to the service levels that we had in the early 2000s when freight volumes were much, much lower, the level of investment is daunting required to handle that.

MR. RUSS: At Kansas City Southern we have been constrained by our balance sheet in terms of growing our top line and getting revenue adequate. We're a little different than my colleagues here at the rest of the -- at the panel here.

With our investment at TFM, we believe that we're going to make the investment now, because it will come, because we believe that the growth prospects of the combined network will get us to that point of being revenue adequate. But right now we're still playing a catchup game in trying to be in a position to be revenue adequate at some future time.

CHAIRMAN NOBER: Well, many of the carriers, many of the shippers this morning expressed the view that at least in certain -- you know, they expressed two views. One is that the carriers are healthy enough, they are financially healthy enough, and that you ought to change your doctrines to take that into account. And secondly, they said that to explain why that is, that some of the carriers just have too much market power. They are too strong and they are utilizing it in ways that are harmful to customers.

How do you respond to some of those contentions that were made this morning?

MR. WAITES: I would maybe try and lead off on that response. I think that in terms of our financial position today, bear in mind we have been as an industry revenue inadequate for some considerable time. Following along with the discussion we have just had, for us to invest going forward, it has to be there for us to have an expectation of revenue adequacy and it has to be on a sustained basis.

And so in terms of our financial position now versus moving forward, there is a very strong correlation between our ability to invest, so I do not agree with the position that we're sufficiently strong and we don't need further price increases and so on, which is what I had interpreted from some of the messages this morning.

I think that is the key point that I would like to make on that. It has to be there for us to invest or else we can't do it.

MR. PASSA: Just a note on the investment that we're going to make in our corridor between Chicago and, basically, the southeast, that is to accommodate the growth of a very diverse customer base from the agricultural industry to the coal industry to the intermodal industry.

And our ability to look out and be confident that the ban will be there long-term and that we will be able to earn sufficient earnings to make that investment and further investments is part of the formula that we have to look at.

MR. TRAFTON: We are in a situation where we have done well in recent years, recent times, and at the same time though we have got -- as you know with our railroad, it has been a patchwork of a lot of other carriers that have made up CN here in the United States. We're in the midst of some expansion, but also some significant investments, particularly in the yard side, tens of millions of dollars in the near future in terms of expansion and additions to our yards in the U.S. property alone.

I think from a revenue standpoint, you know, to think that you're there today and you won't be tomorrow, you just don't know. The history is such that it's not proven that is has been sustained over time and I think it's also indicative, as my colleagues have already mentioned earlier, that you don't build that capacity overnight. You don't train train crews overnight. You don't build the railroad capacity. You don't get a locomotive overnight. Getting signal systems is at least a year out.

All those things take time and it's like anything else. The process is much longer for a lot of reasons, but to believe that we're there and it's time to change and do something different, I think, is way premature.

MR. LANIGAN: Clearly, there's different

markets that we serve that have different dynamics from a standpoint of the modes of transportation they rely on, but in many of our markets the customer has the ultimate market power. You heard from UPS today who said that on certain moves, they have actually moved freight off the rail back to over the road.

That's the ultimate market power. If we don't prove ourselves on a day in and day out basis to be the value that the customer is looking for, then they will seek another solution, and that is where the balance comes in the equation between the power of the customer who has the ultimate decision as to how they move their freight and who they move their freight with.

And again, granted, we have some different scenarios with different types of customers, but we do have a large number of customers that have equal or more power when it comes to market decisions.

CHAIRMAN NOBER: Commissioner Mulvey?

COMMISSIONER MULVEY: Returning to the fuel surcharge question, some of the shippers have suggested that the fuel surcharges have become a profit center for the railroads. My understanding is that the fuel surcharges are designed to be cost recovering.

And my question is do any of the railroads right now cover all of their increased fuel costs through the fuel surcharges? Is anybody covering the total cost of increased fuel?[panelists No] So fuel surcharges still fall short of the cost.

They should be based on cost, agreed. And, obviously, one based on mileage is probably more closely related to cost than one based on the waybill. But it would even be better if they were ton-mile-based taking into accounts such things as terrain.

Has anybody looked at a ton-mile-based fuel surcharge taking into account terrain differences?

MR. LANIGAN: What we have done with our fuel surcharge program, the mileage-based fuel surcharge program, is it inherently takes that into consideration. We have different tables for the different types of commodities, which take into account the average tons per train, the number of locomotives per train, etcetera, so we believe that we have built that into our mileage-based fuel surcharge tables.

COMMISSIONER MULVEY: So it's not simply mileage-based?

MR. LANIGAN: That's correct.

COMMISSIONER MULVEY: Okay. Positive train control is something that has been looked at for quite some time and many have suggested that positive train control, if fully implemented, would greatly improve railroad safety but, almost as important, also improve railroad productivity. One recent study by Zeta-Tech out of Philadelphia suggests a payback period on positive train control of less than two years, about 18 months, and that's not even taking into account the safety benefits.

I know the industry historically has pooh-poohed the idea of positive train control as being cost ineffective based upon earlier studies, but has the industry or any of you as individual railroads looked again at positive train control today to see whether or not it may make more sense for the industry?

MR. TOBIAS: Commissioner, I'm sure you're familiar with the --

COMMISSIONER MULVEY: Illinois?

MR. TOBIAS: -- Illinois Dock Project, which was supported and funded by the AAR along with the FRA and a number of different contributions from appropriate suppliers. Have we looked at it? Absolutely.

NS most recently announced a pilot project. Actually, it's more than a pilot project. It is an implementation roll-out of a PTC-based application in South Carolina, and we're excited about it actually. As to the Zeta Tech findings, I'm not familiar with that particular study, so it would be inappropriate to comment, but technology is alive and well here.

COMMISSIONER MULVEY: Yes. I mean, it has made a lot of progress since it was looked at the first time. I think costs have come down. GPS is becoming more widely available and it is ever growing more precise every day.

Did anybody else look at the Zeta Tech study or are any of you familiar with it?

MR. LANIGAN: I haven't seen the study, but we have a system also called Electronic Train Management System that we have been piloting in Illinois, as well, a separate system from the industry, and we're lining up the stars and moons from the standpoint of the timing and the funding and the paybacks as well. So I think, ultimately, we're all looking at these sorts of systems and, ultimately, they will be part of the infrastructure. It's just a matter of timing and funding.

MR. YOUNG: I was going to say we actually, as an industry, have committed to a common functionality, because whatever the Burlington Northern puts in or Norfolk Southern puts in, it's going to have to operate on our individual railroads. So there are a lot of different terms, but it is a form of positive train control.

And we are running a pilot right now. In fact, I think -- I know CSX, we're all looking at the same concept, but the key was functionality here. And we went through some good benefits there from a safety perspective.

MR. RUSS: Kansas City Southern is currently involved in a PTC project on its property in Panama on the 47 mile railroad parallel in the canal.

COMMISSIONER MULVEY: One last question, and that is the CN and CP both operate under a slightly different regulatory regime and interswitching or reciprocal switching, is required up in Canada and you are two of the more profitable railroads of the seven Class I's.

Do you find the interswitching to be a burden on you or does it improve the competitive situation in Canada for shippers?

MR. WAITES: That is correct. We have interswitching in Canada. I think, you know, the general comment around the profitability of Canadian railways versus U.S., there are, as you might expect, a number of reasons why that could be different, things like health care costs, traffic density and different types of traffic and so on and so forth.

You're correct. We do have

interswitching. However, in Canada, interswitching has a long, long history. It has been around a very long period of time and sufficiently long whereby capital investment decisions have been made understanding that interswitching is in place. And I believe you know that in Canada the interswitching rate is set by the Canadian Transportation Agency --

COMMISSIONER MULVEY: Right.

MR. WAITES: -- on a variable cost function relationship, but I think that's an important distinction. If we know what the rules are prior to making capital investment decisions, that is one set of circumstances I think in Canada, if we found out after the fact, after making capital investments, that the rules were different, I think we would have suffered more.

Having said all of that, I think the net effect of interswitching is to push the rates down candidly. But at the end of the day, if we can't recover those revenues from other shippers, it's less revenue and that means less investment and less capacity, but we have grappled with that.

So I think there are separate issues in terms of profitability versus a regulatory environment, although they can be related.

MR. TRAFTON: I would have to second Mr. Waites' comments. And in addition, I think you have to take it in the context, too, as he has indicated, these rules and regulations that we have in Canada versus what we have in the U.S., and I am no expert on Canadian rules and regulations, but the fact is is that they exist up there for a lot of different reasons.

And I think that whether interswitching works in Canada or it doesn't and whether it works here, I think it has to be applied and looked at to see what kind of fit it would have or application it would have here in the U.S. Personally, I don't -- again, from a regulation standpoint, I don't view that having somebody else involved in setting those rates is the right thing to do.

That is my personal view and that's our company's position. But from the standpoint that we live with it, because that is the way it is, and it's not unlike some of the other legislation that is in place in Canada or the regulations that we have in Canada that are different here.

To think that we can cherrypick certain things that fit in Canada or look like they fit in Canada or maybe somebody thinks works well in Canada and to put it in place here in the U.S. and say that's the fix, you wouldn't have to go too far to look at health care and a few other areas to say that no one has ever found that silver bullet, and I would question whether or not we would actually be harming ourselves in the long run.

CHAIRMAN NOBER: Commissioner Buttrey?

VICE CHAIRMAN BUTTREY: Just to touch on fuel surcharges one more time. It's my understanding that some customers pay fuel surcharges and some customers don't pay fuel surcharge.

Is that true across the board or is that limited to a particular type of customer or is it limited to a particular geographic area or a certain commodity or how does that work? Is that true and sort of how does that work?

MR. TRAFTON: At least at CN it's due to contracts. If we have a contract in place, and I suspect it's the case with most railroads, that does not allow for it until that contract becomes due or we can renegotiate or in some way instil a fuel surcharge, that is what prevents us from applying it across the board.

MR. YOUNG: It's similar at UP if there is a contract in place, but we do now have -- as the contracts roll off, we're all going to a standard fuel surcharge across all the business groups.

MR. TOBIAS: I think you will find that it's similar for all of us.

VICE CHAIRMAN BUTTREY: Okay. Thank you.

MR. TRAFTON: I think one other thing to point out there, too, is what we have also learned, I think all of us over time, is that these long-term contracts of 5, 10, 25 years in some cases don't work. Obviously, in the case of fuel surcharge, nobody ever envisioned probably back five years ago when they signed a 25 year contract that fuel would be what it is today.

And I think what you will find over time, too, based on these contracts, as they are renewed, at least in our company, they won't be renewed for a long, long term. I mean, two to three years may be an exception to the rule.

VICE CHAIRMAN BUTTREY: Two to three years would be an exception to the rule?

MR. TRAFTON: Right. Anything beyond that would be an exception. Excuse me. That would be more the norm in what we look at today.

CHAIRMAN NOBER: Well, let me ask. Again, many of the customers this morning were concerned. You know, they claim that they are captive shippers and that they have seen their rates go up and up and up and their service go down.

First of all, do you all agree with that, I mean, agree with those assertions that were being made this morning?

MR. TOBIAS: I don't particularly agree, at this point in time, that NS' service has gone down. We are certainly consistent within parameters that, from an operating perspective, we find acceptable.

MR. YOUNG: From a UP perspective, you know, I would agree. The service has gone down when you look backwards. Part of it is our own doing that we're correcting right now in terms of hiring, buying more locomotives, putting capacity into our network. We are the highest density railroad in North America and we're working very hard in terms of improving those service levels.

I have said all along what comes with price, service has to be there for the value at the end of the day. One of the things I do see happening though in the network and with a lot of our customers is because of the scarcity of transportation resource, the inefficiencies are starting to show up in the network when you look at it.

And our only tool today, it's rough, is price to try to manage flows in a very, very difficult one called embargoes. But you bring an industrial engineer outside of this industry and have him sit down and look at what you deal with in a capacity constrained corridor, he will tell you 9 times out of 10 you're going to fail, because you don't have an efficient mechanism of controlling flows.

And we have used pricing to try to do that, to try to manage flows long-term. But I would agree our service has deteriorated, but it is moving back up right now.

MR. TRAFTON: Chairman Nober, I think you have to also define what service is, because I suspect that as you hear it when you're out and about, service isn't just transit. It's car supply. It's cleanliness. It's a lot of other factors when it's all said and done.

I would suggest, at least at our company, we have seen improvements in transit time performance, and our overall trip plant performance is in the 92, 93 percent and at least in the U.S. properties, consistently around the 95 percent. But at the same time, I can tell you that I know of car shortages we have in the U.S., car shortages for a lot of reasons.

Grain this time of the year, what tends to happen, happens every year. Nothing is new and there are backups due to a lot of factors this year that have not been the case in the past, the hurricane being one of them, but also crops that were not expected to be good turned out to be excellent. At the same time, you have other commodities as well. Log cars in some of our locations are in short supply, but the demand has changed.

And at the same time what is not understood by a lot of folks is that the distribution system, for instance in the case of logs, that used to be between Point A and Point B is now triangulating between -- because customers in the log business are exchanging logs for whatever, for reasons that have to do with the quality of the product, and as a result lengthening the length of the hauls.

That requires more equipment. The more you lengthen that length of haul, which we like, the more you're going to have to add more equipment over time. Those things were not forecasted or communicated ahead of time enough that we could do something about it. And in the short-term, at least what we see in the case of cars is a potential shortage.

MR. WAITES: Now, I would like to add one comment. I mean, maybe I can use an example. We had a large bulk shipper come to us about a year ago and on very short notice wanted to increase the tonnage 40 percent over a base level of tonnage in the contract and on very short notice, and we did a lot of things to move that tonnage. Clearly, we're incented to do so. We moved an increase of 26 percent not 40 percent and we were declared a failure by our customer in that example.

And I use that to illustrate the fact that on a given shipment, what is service, we are moving a lot more tons and I think that is, Mr. Chairman, an opportunity for all of us working with shippers to improve service.

MR. PASSA: And also the reinvestment in rolling stock that needs to take place across each of the business areas, so being able to price to the market, to be able to reinvest in different types of equipment is something that, as we talk about earning the right to invest, we look at each of our equipment types and our customers, in many cases, want us to continue to provide that rolling stock.

CHAIRMAN NOBER: Let me ask one last question. One of the most difficult sort of challenges that we face or at least that I faced in my three years here are customers coming to us and saying our service is a problem, our rate is a problem, X, Y or Z is a problem, the carriers are demarketing us and balancing, on the one hand, the legitimate concerns of a captive shipper who may not have alternatives with, on the other hand, the legitimate, you know, concerns of the railroad to try to allocate their resources and put them to the highest return and the most -- you know, to the most efficient usage of their network.

As we go forward this is going to increase and not decrease these kinds of conflicts, and how should the Agency look at those? I mean, that's what I do every day, is try to look at those and every one of you have heard about that in one form or another.

MR. TOBIAS: I'm not the marketing guy, but I will make a simple run at this. To me many of the things that crop up as significant issues between our customer base and ourselves really need to be addressed on a bilateral basis, and to the extent that they will come to the table and sit down so we can have a meaningful discussion rather than, and I'm not casting any aspersions here, a political posturing, we might find that we get a better resolution and a better solution.

MR. TRAFTON: I would agree and at the same time I would also suggest that better communications, forecasting ahead known volumes. Not unlike my friends in the CP, we have had several, numerous cases actually, over the past year where volume that no one had ever anticipated is moving for a lot of reasons that have to do with the world market.

But I think when you look at it, communication sometimes is broke, the process is broke, and if anything else, what I would suggest that this body do is to encourage that more between the two parties, as opposed to getting involved in the political ramifications that sometimes come out of this.

MR. LANIGAN: I think demarketing is an interesting word in that it implies that you are trying to chase something off or push something away or what have you, and it's really -- you know, if you look in the current environment, it's really not a demarketing issue.

And when I listened like the coal panel this morning talk about their perception that returns on intermodal are so far below coal, one, it's false and second, they made the direct suggestion that we demarket intermodal to the benefit of coal when that really wouldn't solve anything.

These are big networks that rely on the interplay of the various commodity types that we haul to position equipment, to position locomotives, to position crews, etcetera, and it's not as simple as saying -- it's kind of like you look at your children. Do you love one more than another? The answer is no, you love them all and, you know, we really want to serve our customer base across its breadth and provide the type of service that they deserve and that they are paying for.

COMMISSIONER MULVEY: You answered my question as to why you're carrying traffic that doesn't cover your cost like intermodal traffic, so I won't go on with that.

I will ask though, to stay along with the demarketing idea, it has been also alleged that railroads are picking and choosing winners and deciding who they are going to carry and who they are not going to carry, who they are going to serve and who they are not going to serve. This is contrary to the old notion of the common carrier obligation.

What do you see is the common carrier obligation of the railroads today and the future?

MR. YOUNG: I believe the obligation here is one that we have a right to, to some extent, choose and the market is choosing. When you look in the transportation sector today, it's not a function of winners. It's a function of when you have a scarce resource, it's going to flow to the most efficient producer and consumer and that is going to be a function of return. It's going to be a function of investment and customers.

I have customers today that believe they have a strategic advantage, because they have made investment in highly efficient load/unload. They have committed to work 24 hours, seven days a week and we're partnering with them. They also look at us to say should I subsidize the less efficient customer? And what is happening again when you look at it overall -- and we have the largest manifest network out of all the railroads, and it's probably one where you look at that has the most opportunity for efficiency improvement.

But I have a real divergence of customer groups that recognize strategically that we need to work together to improve throughput and their concern with me again is one on are they being penalized because they are willing to make the investment.

COMMISSIONER MULVEY: Anybody else on the common carrier obligation? Thank you.

CHAIRMAN NOBER: Well, I would just ask finally, I know everybody wants to wrap up, but just one last question, which I can ask, because I'm a short timer, which is what is the right role of regulation for captive customers?

I mean, what do you all think a regulatory body like ours should do for customers who are captive who don't have alternatives in a world where you're, you know, financially healthy?

MR. YOUNG: Well, you have tools in place today. When you look at our customer base, I look at maybe 70 percent or so have competitive options. That can be a geographic substitution. It can be competition with another railroad. It can be the trucking industry coming through. Then there is another 30 percent that fall into the captive area and there are mechanisms out there today that, I think, offer some protection when you look at it.

I have seen many cases and what is happening here in many cases, again, the more efficient and the higher return business will get the scarce resource. In many cases where you compare a captive customer to an open customer, there is no secret. There is a rate differential that has been out there for years, but that rate differential is shrinking in terms of the spreads and, in a lot of cases, the captive customers are the first one where we're going to commit the resources.

CHAIRMAN NOBER: Anyone else? Well, again, thank you all for your patience and for your time and sitting through the questions.

And we will turn now to our next panel, which is Larry Parsons from the Wheeling & Lake Eerie Railway Company, Roger Bell from the Columbus & Greenville Railway, Charlie Marshall from the Genesee & Wyoming, Reilly McCarren from the Rail Industry Working Group and Charlie Swinburn from RailAmerica.

Are we ready to go? Okay. Well, once again, I know they set you up in order, but I usually start from my left, so Mr. Swinburn, you draw the short straw.

MR. SWINBURN: Thank you. Mr. Chairman, Vice Chairman Buttrey and Commissioner Mulvey, thank you for allowing me to present my views today on the Staggers Act.

By way of background, RailAmerica is a large short line holding company operating in North America. We own 47 railroads operating over 8,900 miles of track in 27 states and six Canadian provinces.

Our company exists because of the Staggers Act. Our employees have their jobs because of the Staggers Act. Many of our shippers receive railroad service only because of the Staggers Act. Many of the small and rural communities in which we operate are far better off because we are there because of the Staggers Act. All that is because the Staggers Act streamlined the procedures governing the abandonment and sale of non-economic rail properties by the Class I railroad industry.

Since 1980, the number of short line and regional railroads has more than doubled from less than 250 to 550. One out of every four carloads in the United States originates or terminates on a short line or a regional railroad.

We short line and regional railroads have succeeded by offering our customers a higher level of service at lower rates than they were able to get before the Staggers Act. The shippers we serve are disproportionately located in rural and otherwise under-served areas of the country. Our employees often live in the communities we serve. Our trains link these small communities and their shippers to the national and international transportation networks.

Short lines often provide their communities with the first real opportunities to grow that they have seen since the middle of the last century. In my submitted testimony, I give three examples of how short line railroads in our RailAmerica family have provided significant stimulus for renewed economic growth in communities that had gone stagnant.

Importantly, the examples I give are not isolated examples. Short line railroads elsewhere have similarly succeeded through a combination of customer-oriented philosophy, lower cost structures and aggressive marketing strategies.

As to where the short line and regional rail industry will go in the future, my expectation is for more of the same. The industry will continue to grow. Shippers and communities will continue to be well-served. From my point of view and that of my company, no changes to the Staggers Act or to the Board's administration of its provisions are necessary.

Before closing, I would like to share two observations about the more general effects of the Staggèrs Act. I do so from the perspective of one who, as a much younger person working in the Department of Transportation as the Deputy Assistant Secretary for Policy, managed many of the Department's efforts in response to the railroad industry crises of the 1970s, as well as the Department's efforts in support of deregulation of the industry and, specifically, in support of the Staggers Act.

First, those few who call for re-regulation of the railroad industry are simply not mindful of the lessons of history. When I joined the DOT in 1971, the railroad industry was reeling from the shock of the bankruptcy of the Penn Central. By 1980, 20 percent of the system's route models were operated by bankrupt railroads.

Congress had been forced to pump money into the industry and the specter of nationalization was real. There is no question, but that the sorry state of affairs that the industry had reached by 1980 was directly traceable to 93 years of failed Government regulation. The Government cannot successfully replace the marketplace in controlling decision making in the railroad industry. Nothing has changed in the last 25 years to cause me to believe differently.

Second, the Staggers Act has worked even better than those of us who argued for it in 1980 expected. I testified then to Congress that deregulation of the industry would give well-run railroads a shot at returning to a reasonable level of profitability and that safety and service to shippers would improve. However, I never dreamt that the results would be as dramatic as they have been.

Data in the Association of American Railroads comments sent to you before the hearing show almost a threefold increase in rail industry productivity in the past 25 years while, at the same time, rail industry traffic rose by 80 percent.

Yet, even while the industry was benefitting from those accomplishments, the shipping community also benefitted from significant decreases in rail rates, as shown by the fact that inflation adjusted revenue per ton-mile fell by 60 percent through 2004.

I conclude that the Staggers Act has worked phenomenally well. To retreat now from its basic premises would be folly That completes my testimony, Mr. Chairman. Thank you.

CHAIRMAN NOBER: Thank you very much. Mr. McCarren?

MR. McCARREN: Yes. Thank you very much, Chairman Nober, Vice Chairman Buttrey and Commissioner Mulvey. While my paycheck these days reads the Arkansas and Missouri Railroad, I am here representing the Rail Industry Working Group of which I am the short line co-chairman.

The Rail Industry Working Group was organized in the year 2000 to interpret and administer the Rail Industry Agreement. It's comprised of representatives of the seven Class I railroads operating in the United States along with seven Class II and III representatives, the AAR and the American Short Line and Regional Railroad Association.

While originally an ad hoc group, it is now chartered under the revised Rail Industry Agreement. The most important thing about the Rail Industry Working Group is that it is a private sector solution established to administration of interline relationships in an evolving and increasingly complicated industry. The number of short lines has more than doubled since Staggers and the complexity of the business relationships and the amount of traffic they handle has increased geometrically.

The Rail Industry Agreement was adopted in 1998 with substantial urging from the STB and then Commissioner Linda Morgan or Chairman Linda Morgan to address concerns of the Class II and Class III railroads about maximizing their potential under the new arrangements that were just really becoming revealed.

The agreement addressed access issues, notably paper barriers, interchange service, car supply, reciprocal switching and heavy axle loads, and its general intent was to maximize the ability of short lines to gain new traffic and handle it efficiently.

But the RIA evolved. As any time when there is a significant change in the terms of trade affecting a broad swath of an industry, there is a break-in period. And after a few years, we determined that some of the language was ambiguous. Some of the original intent may not have fit changing circumstances. In any event, the railroad industry had transitioned in those ensuing five years.

Consequently, after a long process of examination and negotiation, the rail industry has updated the Rail Industry Agreement. We have improved the definition of new business, established some bright lines and new clarity. We continue to focus on maximizing short line traffic potential without cannibalizing existing rail system traffic.

This mechanism improves the public utility of the rail system by allowing the system to handle more traffic than it otherwise could. In the terms of an economist, of which I am not, but we have certainly well-represented on the Commission, it is a movement towards what might be called Pareto efficiency in the short line/Class I relationship.

Our philosophy to this day continues with the Rail Industry Working Group to maximize short line opportunities to gain new traffic in an interline environment and to keep existing traffic on rail. We promote short line service as a solution to first mile/last mile issues that have gained publicity recently with respect to the merchandise carload network, and we strive to maximize network efficiency through the utilization of both large and small railroad assets.

Specifically with respect to paper barriers, which have been an issue and the subject of another proceeding, the nature of paper barriers has changed over the roughly 20 years since the modern short line era began. Originally, short line sales were predominantly lines that were abandonment candidates and would otherwise have been bike trails had not short lines come along to take them over.

Over time, substantially larger branch line opportunities have become available to short line companies, and the issues for the Class Is have been less ones of outright abandonment than return on invested capital and ability to reinvest in the fringes of their network.

However, many of these lines still have profitable traffic for their Class I owners and without some sort of paper barrier or access restriction, many of those lines would not, could not be sold due to revenue or contribution risk and, thus, the lines would remain in a sort of limbo, unable to warrant reinvestment, unable to warrant marketing effort but, yet, too valuable to exit the Class I fold.

Whereas, in short line hands, what we find is these lines experience traffic growth almost uniformly. Customers returned to the rail system who had forsaken it years earlier and infrastructure investment increases in almost all cases from what it had been in the Class I environment.

In summary, there is a large public benefit associated with the transfer of these lines to the short lines. In today's climate, frankly, the formal RIA applications on paper barrier waivers are scarce. Only one to two a month generally come on our agenda.

However, many informal resolutions are achieved because of the terms of trade set forth by the RIA while other issues have assumed at least equal importance and the RIWG has moved on to address car supply and interchange service as the next challenge if improving the overall interline relationship. That is the end of my comments. Thank you very much.

CHAIRMAN NOBER: Well, thank you. Mr. Marshall, welcome back.

MR. MARSHALL: Thank you.

CHAIRMAN NOBER: You have been a long time member of our Outside Advisory Council of the Rail Shipper Transportation Advisory Committee, and we thank you for your service on that and welcome you today.

MR. MARSHALL: Well, thank you, and it's a pleasure to be here and it's a pleasure to have seen 25 years of the Staggers Act at work. I am Vice Chairman of Genesee & Wyoming. We're a short line holding company. We have about 3,300 miles of track in the United States and similar or somewhat larger holdings in other countries.

I am here really in the context of being the ultimate captive shipper. Short lines, if you think about it, can't make their product somewhere else or use another mode of transportation. If we're going to succeed, the Class I railroads have to succeed and then we have to live with them as partners. And so that's the way we try to think of our business and that's the way we think of the Staggers Act.

Now, if you take it one step further, for us to succeed in this joint product that we make between short lines and Class Is, the traffic, the merchandise traffic, the retail traffic that we tend to handle on short lines, must compete on the Class Is, must compete for capital and must compete for track space. If our traffic isn't as good as other kinds of traffic, we will in the natural course of economic events be forced out and we don't want that to happen.

So that leads me to three points I want to make today. First of all, the Staggers Act is wonderful in our view. It has been a big success and one of the reasons that it has been successful is that it has let normal economic forces play in the railroad business, which had never happened before.

Now, there are problems. Yes, there are capacity problems and there are service problems, but those in my view aren't ones that can be fixed with regulatory adjustment. They are ones that are going to require economic adjustment, commercial adjustment, and they are something that, I think, everybody in the business is focused upon.

The second point I want to make is that paper barriers, much criticized, are also much misunderstood and are not susceptible to regulatory adjustment with constructive effect. If you think about it, paper barriers are just like requirements contracts in any other business. A supplier says to a buyer if you will buy everything you need from me, I will give you a break, and that is really what paper barriers are.

They are an agreement between a Class I

and a short line that the short line will favor that Class I with all of the business or pay a penalty. And, generally speaking, there can be a negotiated change in those paper barriers for a price and the short line either decides to pay that price or not. But we think that the creation of short lines, as Reilly just said, is very important to increasing the efficiency of the railroad business overall and to increasing the competitiveness of the merchandise freight that we handle.

Anything that takes money away from the Class I, and thereby makes our business less competitive and shifts that money to us, is not in the long run good. That might surprise you, but unless our joint product with the Class I succeeds competitively, we're going to fail. So we don't want artificially to take money from the Class Is and transfer them to the short lines or the shippers, because it will make the product less competitive and that is not good.

Finally, the third point I want to make is that there are some residual regulations on Class II railroads by statute, but the size of Class II railroads is now out of proportion with the size of railroads in the industry. In my written testimony, there is a graph at the end of it and it shows a number of big bars, which represent Class I railroads.

And then there is a tiny little green spot over on the left side, which is the maximum size of a Class II railroad, and that just to us doesn't make sense and I am suggesting that we all get together and find a way to redefine Class IIs or the division between Class IIIs and Class IIs to a higher level.

The reason for that is to make short lines even more competitive, to make it easier for the Class Is to create short lines, because short lines, we think, make merchandise traffic, make the product of many shippers much more competitive against those unit trains that we heard about this morning.

So we support the Staggers Act. We think that paper barriers should be adjusted by commercial means and not regulatory means, and we would like to see the line between Class IIIs and Class IIs redefined to a higher level. Thanks.

CHAIRMAN NOBER: Thank you very much. Mr. Bell?

MR. BELL: Thank you. Thank you for the opportunity to be here. I am here today representing the Columbus & Greenville Railway and to go along with Charlie's graph here, we're probably that little green dot compared to everybody else who have been up here. We operate about 75 miles of railroad between Columbus and Greenville, Mississippi.

I want to begin by giving just a sketch of a history of our railroad prior to Staggers, some examples of some positive effects that we have had and conclude with a couple of thoughts and some subjects of concern as our industry looks to the future.

Our railroad, like a lot of railroads, goes back into the late 1800s. Its predecessor struggled for some 50 years until the mid 1920s when it finally became consistently profitable. In many years it carried in excess of 200,000 passengers even in a state like Mississippi, but by the late 1940s passenger trains had to be discontinued.

But to give you an idea of the financial wherewithal of the C&G, back in 1946 it purchased five new 1,500 horsepower diesel locomotives and was one of the first short lines to completely dieselize its locomotive fleet. Throughout the '50s, the railroad traffic basically was stagnant, showed little growth, and that continued through the '60s and the '70s.

Declining traffic and deteriorating track conditions took train schedules down to one train a day, one train each way each day, and poor service and derailments commonplace as track and bridge maintenance continued to be deferred. In 1972 it became part of the Illinois Central Gulf. Through the merger of the IC and the GM&O, conditions only worsened. Three years later the line was saved from abandonment when a small group of local shippers and railroaders purchased the line.

Like many small short lines or branch lines of that era, the C&G had been stymied by the burdensome and regulatory environment of the period, absent of incentives or a chance for progressive and value-enhanced service. Once a profitable and successful operation, the C&G had been unable to adapt or benefit from those changes for decades and, almost after 100 years of operation, it was on the verge of collapse and headed for abandonment.

With Staggers, small rural carriers like C&G now have the opportunity to publish rates specific to customer needs on a one day notice, issue quotations and contracts and negotiate divisions with our Class I connections.

Small carriers learned to effectively utilize the benefits and exploit those efficiencies made available through Staggers. Those benefits kept C&G operating, allowed new efficiencies and provided optimism. Some traffic was lost due to the poor service and competitive disadvantage, but new opportunities developed. It was a period of transition.

One particular success story that I want to share with you began in the early 1980s with the development and growth of aquaculture in the State of Mississippi, farm-raised catfish, and grow it did with total feed production exceeding 850,000 tons annually by the late 1990s, now estimated to be a half billion dollar a year industry.

Two of C&G's largest customers are fish feed mills using rail to transport the vast majority of their 350,000 tons of grain and feed ingredients annually. This is significant to C&G, but the greatest value came through an innovative three party agreement, which included a customer, C&G and our Class I partner, Canadian National.

Our track and bridges were not safe to handle 286,000 pound loads nor the unit trains the customer needed to penetrate preferred grain markets in the upper midwest. In return for a volume commitment by C&G and the customer, a 10 year agreement was reached whereby CN provided funding to complete the upgrade of C&G's track and bridges, increasing capacity to accommodate heavy loads and unit trains to those feed mills.

The value to the customer was far more than the improved efficiency or the higher track capacity, providing an option to buy large quantities of grain from abundant supplies throughout the grain belt dramatically reduced its feed cost. For the CN, they got increased revenue and improved utilization on its equipment with efficient long haul service, and the C&G's lightweight rail was replaced and the bridges rebuilt.

Safety and efficiency were vastly improved. Customers gained confidence in rail. Reliability and traffic to the feed mills continued to grow, and none of this could have happened or would have happened without the enactment of Staggers. I believe the C&G story has a common thread with many short lines serving rural America today. Our greatest asset and our opportunity to succeed lies in our ability to provide quality service and to work with our Class I connections.

The advent of Staggers has given short lines the opportunity to provide such a service, but equally important is the inert medium that allows individual railroads and railroad operators to exercise the flexibility and the creativity to adapt and develop the specific service needed and required by our customers to comply with their needs and compete for their freight.

In conclusion, I believe today the STB reflects on our industry with a great degree of satisfaction, pleased in large part with the results of 25 years of Staggers, however restrained with a degree of caution and prudence as we enter into an era of great demands on our nation's transportation industry.

The STB, keeping an ever watchful eye on the new challenges brought about by Staggers, the issues of capacity, aging rail car fleet, increased rates with add-on surcharges and the areas most in need of investment to keep our industry fluid and in good fiscal health.

The creation of short line railroads all across America under the vigilant oversight of the STB has offered competitive value to a significant portion of the shipping community and the transportation industry, and our entire nation recognizes and depends heavily upon this tremendous benefit.

The STB is the gatekeeper, the helmsman standing guard with the power, the authority and the acumen to act and respond to the new challenges as they develop, a position I endorse and urge this Board to maintain. Thank you.

CHAIRMAN NOBER: Thank you very much. Mr. Parsons, welcome.

MR. PARSONS: Thank you. Larry Parsons, Wheeling & Lake Erie. We're a 750 mile region or Class II railroad, 400 employees, and we exist first off to operate safely for the benefit of our employees and customers. I want to thank the staff and the Commissioners for reading my testimony.

I can summarize it by saying I came over 25 years from disliking the Staggers Act to admiring the wisdom for where it has brought our industry. Having sat through the hearings today, I would like to make three additional points if I may.

CHAIRMAN NOBER: Please.

MR. PARSONS: I am quite discouraged to hear customers say now that our nose and toes are out of the water, that is far enough and probably ought to go back under.

We are embarking on a four year project aided by the RRIF Program and the investment tax credit to put far more capital into our property than our book value, and that is because we believe in this industry and I think this century, given what we have seen from the Surface Transportation Board in the past, will make this century better than the last one. If that were to reverse, I think we would change course.

CHAIRMAN NOBER: Okay. Well, thank you very much. Vice Chairman Buttrey?

VICE CHAIRMAN BUTTREY: Yes. I posed a question some weeks ago to a member of the short line family, shall we say, to help me understand better what the capacity, the unused and under-utilized capacity of the short line railroads is right now. That is a subject that really interests me a lot.

It seems like every time the subject of short line railroads comes up, everybody stands up and applauds, because the sentiment out there seems to be that the short line railroads are doing a spectacular job and have done a spectacular job and I think you are to be commended for that.

But having said that, until somebody

proves otherwise, I am convinced that there is a lot more you could do and I'm wondering if you could estimate for me or take a shot at estimating to me what the unused and under-utilized capacity of the short line system is right now.

MR. PARSONS: I'll take a crack at that.

VICE CHAIRMAN BUTTREY: Good.

MR. PARSONS: I would say close to zero. We are -- part of a capital projects, we're adding sidings, upgrading track speeds and yes, we could, you know, help here and there, but you got to remember the capacity has to fit in a network and most of our capacity does not fit into a network. That is why it has been short lined.

MR. MARSHALL: On our railroads we --

VICE CHAIRMAN BUTTREY: Let me follow-up on that if I could. What is it that's keeping you from fitting into the network?

MR. PARSONS: Well, you know, we, for example, have detour agreements and occasionally, in the case of an emergency, we'll detour a CSX or an NS train between two points, but it's not a good way to do it and it's only in an emergency and we don't have the capacity to do that on an ongoing basis in terms of siding capacity or track structure at today's date.

VICE CHAIRMAN BUTTREY: Someone else was going to --

MR. MARSHALL: Yes. I was just going to say there is a great deal of capacity within the limits of most short lines, but we don't provide a complete product and unless there is connecting capacity on the Class Is, we can't get the freight all the way to where it wants to go.

The significant limitations on short line capacity are in the weight, which the track structure will carry. Cars are getting heavier and so we need heavier track. Some lines can take the heavier cars and some can't. The other limitation at the moment is that there is -- the locomotive supply in the entire nation is very tight.

MR. SWINBURN: I would add, Vice Chairman Buttrey, that the capacity question varies significantly across our 47 railroads determined in large part by the nature of the commodities carried and the demand for capacity.

As an example, we have got a railroad in the midwest, in Kansas, that primarily carries agricultural products and during the agricultural season is full, could not carry any more than the trains we're running back and forth. For large parts of the year it's empty, not really empty, but it's not very utilized.

What we try to do is maintain all of our railroads on what we call fit for purpose spaces. We put the investment into the railroad that is needed to match the traffic that is available. That railroad, for example, because it's carrying grain, can carry it at pretty slow speeds and large parts of the railroad are limited to 10 miles an hour and that's fine.

Other railroads that are primarily carrying industrial products we're moving at 40 miles an hour and they take significant capital investment to keep them there. It is generally true that if there were more demand across the entire system, we could find more capacity to meet that demand, but it's a demand and commodity type situation.

CHAIRMAN NOBER: Commissioner Mulvey?

COMMISSIONER MULVEY: Thank you. Thank you for coming today. I have been a long time fan of the short line railroads and some of you may know, I worked very hard while I was on the T and I Committee to secure the investment tax credits for the short lines to deal with the 286K problem, and I'm glad to see that those funds are being used and that short lines are continuing to serve many, many shippers who otherwise would not be served.

I want to address this question of paper barriers, because it is one that is of particular interest to me. I did not accept the analogy about the buyer and the supplier, simply because most buyers will have an option to go to another supplier. As one of you pointed out, you are the ultimate captive shippers. You really don't have any other options to go to another supplier. Therefore, you must negotiate with the railroads.

And secondly, most suppliers and buyers do not enter into contracts that go on in perpetuity. There is some limit as to how long those contracts go on and, at some point, when the parties feel that the value has gone out of that contract, they can go elsewhere and contract anew. That is not the case with paper barriers, which do go on in perpetuity.

I find the perspective interesting that you are better off or you're happy with requirements that restrict your ability to negotiate. In general, the more negotiation positions you're able to take, the better your hand in negotiations, the better off you are in achieving what you want. This is interesting in the sense that because you have these paper barriers, you really have no credible threat to the Class I railroads and you are pretty much price takers and service takers.

I would like to get your perspective on this, because I hear from a number of railroads and shippers and we have even had testimony before this Board in cases where paper barriers really have frustrated operations.

Unless paper barriers go on in perpetuity I am not opposed to the notion of paper barriers, per se. I think sometimes they are a legitimate part of a sale or a lease, but when they go on forever and ever and cannot be sunsetted, then I think there is a problem and you don't have the ability for the short line to eventually bring competition to the Class I railroads in those markets.

Anybody want to comment on that?

MR. MARSHALL: Let me try, because I realize this is unpopular and counterintuitive, the position that I have and am convinced of. Forever is a long time and we have seen railroads buy out paper barriers, railroads like Reilly's, and we have negotiated our way out of paper barriers on some of our railroads on commodities that the Class Is aren't interested in handling.

But the issue about should we put some sort of sunset on paper barriers will have a chilling effect on the willingness of Class Is to create short lines, and if there are not to be more short lines for merchandise handling lines, I think that that business, which today is less competitive than the unit trains, will be in danger.

I think it is in the public interest to

have as much of the retail railroading in this country in the hands of short lines as possible, and to monkey with paper barriers is to jeopardize that short line growth in my view.

COMMISSIONER MULVEY: We agree that there should be more short lines and that short line should prosper. I would disagree or I would question the notion of the Class I railroads creating the short lines, and it strikes me that the short lines should be firms that are independently created and come to operate these lines, as opposed to being the children and the controlled children at that of the Class I.

So that is my concern, not that the short lines don't grow and prosper, but rather that they be truly independent entities at some point.

CHAIRMAN NOBER: Do you want to follow-up?

COMMISSIONER MULVEY: Well, I only have one other question, and that is with regard to Mr. Swinburn. I noted in your testimony that you said that the Staggers Act worked even better than you expected in 1980 and you mentioned the teachings of the staff economist at DOT combined with common sense told you it was going to be a good thing.

And I just wanted to say that I was one of those staff economists, not one of the ones who taught you, obviously, but nonetheless I was associated with those individuals, and I just want to say that that group who consisted of Jim Hagen, Dave DeBoer, Gerald Davies, Jim McClellan, Bill Loftus, and others, was truly one of the most talented groups, that has ever worked in the Federal Railroad Administration, at least in my memory.

So I was wanting to give credit to those people who helped create the Staggers Act. I'm sorry, and also Ed Hamburger, who is sitting in the audience.

MR. SWINBURN: I certainly agree with your evaluation, Commissioner.

CHAIRMAN NOBER: Let me ask you all. Some of the testimony this morning raised two issues. One was paper barriers, which Commissioner Mulvey has already asked you about. The second was concern from our labor representatives this morning for the Board to take a more -- to give more scrutiny to purchases or change the regime for purchases of short lines by, essentially, holding companies.

What is your reaction to those comments that were made earlier?

MR. PARSONS: I can sympathize, because I was the Operating Vice President during the first 15 years of Staggers, and it did force us to rationalize what was going on in trains. And when Staggers was passed we had four and sometimes five people on a train, a caboose, and it was comfortable. Everybody was happy, but it sure as hell wasn't efficient.

We have still got two people on trains and that is not efficient. In most cases we can do it with one. So change is painful, but I don't think Jim's characterization of how ill-treated the employees were in the process is accurate. I think attrition has taken care of most of them.

The Railroad Retirement Act has just accelerated the retirement process, which is hurting us, and I think one of the challenges we have in this industry is finding people to work in it that are dedicated to it. And even though we're -- I look at our employees and it's not unusual to find people in train service making over $70,000 a year in our employ and, you know, we consider that a decent wage. It's not as good as a Class I, but it's certainly nothing to be ashamed of.

So I think, yes, his membership has gone down and I hate to say it, but it's going to go down a hell of a lot more, I think, and I don't think anybody in this room can change that or should.

MR. SWINBURN: One point of clarification in case there is some confusion. We don't, and I think it's true of most short lines, have any problem being unionized. About half of our railroads are unionized and I would have to say that there is really no difference in operating or financial performance between those that are unionized and those that are not.

It's true, as Larry said, that the transition to our industry of many of these lines did result in personnel dislocations for the employees who previously were on those lines, but it's also true, and if you get a chance to look at the three examples of communities that we think we have revitalized with our operations, that we have brought a lot of additional jobs to those communities, people that were not working in facilities that were moribund and in places where there was simply no rail activity.

And you also have to think about the alternative to the short line industry. A lot of the lines upon which Jim's members were working probably would not be operating today if it wasn't for the short line industry and I don't know where those jobs would be.

MR. MARSHALL: Just something on the holding company point. Most of our railroads of any substantial length are unionized either by Jim or the engineers, but the railroads are very different and they have very different agreements even where the same union is involved. We have some coal railroads where labor makes a lot.

We have some light density railroads where the agreements are much thinner. They comport with local wages for doing other kinds of work. So if you look at this from a holding company perspective, do you want to assess the higher wages against the light density railroad and have it probably abandoned or do you want to bring down the wages of the home railroaders where the railroad is a little richer and can afford more?

I think the present system of differentiating railroad by railroad according to the local circumstances that serves labor well. We think we build jobs not only locally, but also for the Class Is that we feed and this, the present system, is working.

CHAIRMAN NOBER: Well, let me ask one follow-up on a point Charlie made, Mr. Swinburn made, which is how are you able to operate properties efficiently that the Class Is couldn't make, you know, couldn't either find -- either couldn't operate efficiently and wanted to abandon or were kind of in that netherworld that you described in your testimony?

What is it that you all or your properties do that a Class I can't or doesn't?

MR. PARSONS: I will give an example. We're 15 years-old. The original investors didn't get a lump of coal. The current owners have had it for about 12, 11 and a half, 12 years and I found more money on the sidewalk leaving the airport last night than we have taken out of it.

So you won't find many Class Is that are willing to live with that equation. Every penny that we generate, the cash flow goes back into the property and we give attention to detail, to the customers, at a level that a Class I cannot and we can make decisions very quickly, and those all bode well and over that period of time we have doubled our revenue through a lot of good luck and hard work.

MR. BELL: Our operation, obviously, is much smaller than Larry's and those same things apply at our place. In addition to that, our employees I think have somewhat of what you would refer to as a family type attitude and the train crew on our railroad doesn't mind doing locomotive start-up work that maybe on a Class I would require more than one craft to get the job done. So it's a lot of flexibility and a great attitude from our employees, which I think is a great thing for us.

MR. MARSHALL: Local management. The same guy is in charge of marketing and operations, so we promise what we can deliver and we deliver what we promise.

MR. McCARREN: I will comment in my capacity as the Chairman of the Arkansas and Missouri Railroad since the Rail Industry Working Group doesn't actually operate railroads of its own.

I think one of the most fundamental principles is the organizing principles of a local railroad are very different from that of a transcontinental line haul railroad. And our whole business model is built around pickup and delivery service, short line hauls, and our labor hiring, our labor agreements if we have them, the equipment we use, the way we maintain our track, everything is built around that organizing principle.

A Class I railroad is built around the organizing principle of hauling large volumes long distances on high density track. It's a very different principle. It's very difficult for them to be good at what we do. It's equally difficult for us to be good at what they do.

CHAIRMAN NOBER: Anyone else? Do you want to comment?

MR. SWINBURN: I will say that all of those apply to us, Mr. Chairman, particularly as with Charlie's company, which is also widespread, local management makes a big difference. Our general managers are entrepreneurial in nature. Their employees are all willing to pitch in. Even though, as I said, half of our railroads are unionized, again, there is no difference in the willingness of the employees to take on multi-tasks, do things that probably in Class Is the craft system would not allow them to do.

And finally, I would say you would be surprised to get out there and see that a lot of the rail we use is secondhand rail. A lot of the locomotives we use are locomotives that have come down through the Class I system and we bought them out the bottom. You learn how to do that and make it safe and successful when you have got the kind of local management that we do.

CHAIRMAN NOBER: Okay. Well, thank you

all very much and for your patience sitting through eight hours of hearing to get here, but we appreciate it.

And our last panel of the day. Okay. Our first panelist is Tom O'Connor From Snavely King, Sandra Dearden from HIGHROAD Consulting, Curtis Grimm from the University of Maryland, Art Scheunemann from Northwest Container Services, Michael Sussman from Strategic Rail Finance and Paul London. I'm not sure he's here. If he's not, we'll end five minutes earlier as well. So Mr. O'Connor?

MR. O'CONNOR: Thank you so much. Thank you so much and thank you for having us here today. If I had to sum up my remarks in three words, it would be Long-Cannon and mediation.

UNIDENTIFIED SPEAKER: Somebody might have kicked it out.

COMMISSIONER MULVEY: Well, the light is on.

MR. O'CONNOR: Here we go. Okay. How are we doing?

CHAIRMAN NOBER: Excellent.

MR. O'CONNOR: Okay. To begin, if I had to sum up the remarks in three words, it would be Long-Cannon and mediation, and we'll be showing you some data today that support the advisability of mediation and, arguably, the benefits that will flow from it as well.

The experience since Staggers clearly, and we have heard practically no dissent on this, market solutions are preferred. Rail regulatory assistance is needed in some situations and we believe that's primarily in captive situations. There is some discussion around that, but there was no discussion really that denied that captive situations exist.

The most effective form of assistance, it seems to me anyway, in captive situations is mediation facilitated by the STB. We have applied that formula with my company working on behalf of BP-Amoco with Mike McBride whom you have heard already today from New Bethlehem and I think all -- and working with NS, I might add, in that, and I think all of the parties would regard the outcome as successful, including the STB.

And the basic formula is it combines the strengths of all of the parties at issue in a flexible way to use all of the knowledge that is available and to focus on the issues that count deferring, if you need to discuss it at all, peripheral issues for later.

Now, we heard a little bit about the legislative history and you have it, I have it. Many of our careers have intertwined around the Staggers Act, certainly mine has. And one of the primary add-ons to the Staggers Act was Long-Cannon. And basically, Long-Cannon 1, 2 and 3, which I have got up on the board there and appeared in my testimony as well, is basically talking about being fair and equitable and being efficient about the production of revenue, broadening the revenue base. That is really what it amounts to.

Here I'm looking at Long-Cannon 1 and I'm using a metric that is available. It comes out of the STB waybill sample, so these are STB data or, basically, the same data I have shown you from time to time in prior appearances here.

What we have up here is the percentage of rail freight revenue, which is moving at rates below variable cost. We're leaving off to one side for the moment whether this is the measurement of variable cost, but this is standard or x, is what it is, as implemented by the STB staff and before them, the ICC staff. And what you see, basically, is that anywhere from 15 percent to as much as about 20 percent and, most recently, about 18 percent of the revenue is moving at rates below variable cost, just a fact. Okay. We'll come back to that.

Long-Cannon 2. Here what we're looking at is the amount of traffic, which contributes only marginally to fixed cost and the extent to which, if any, rates on such traffic can be changed to maximize the revenues from such traffic. And here what we're looking at, again, this is the STB waybill sample and ICC before it. The graph covers the entire span of years. And you can see that in the high year, 1987, the average revenue cost ratio on the waybill sample was 139 percent and, most recently, 133 percent. And Long-Cannon 2 is are we maximizing?

Long-Cannon 3. Long-Cannon 3 mandates consideration of the carrier's mix of rail traffic to determine whether one commodity is paying an unreasonable share of the carrier's overall revenues, and I have showed you this graph before in prior appearances. Again, it comes from the 2002 waybill sample.

We see that chemicals had 61 percent of its revenue above 180 percent, coal 44 percent, overall 31 percent, that's all traffic taken together, has revenue above 180 percent. And 5 percent, by the way, that's where the intermodal would fall in, in that category there. And intermodal, we could debate about whether intermodal is cost precisely -- correctly in the waybill sample. I would not assert that it is, but it's cost uniformly throughout the time period. That's the key point I'm focusing on here.

What do we recommend? What do we support? We support private commercial negotiations and a primary approach resolving rate reasonableness challenges unequivocally. We recommend STB-assisted mediation for small shipment rate cases as an effective and efficient addition to STB services and it worked quite well in BP-Amoco, I thought.

A minor technical point just as I'm going by here. We will need, of course, to access and verify the underlying data. We're working right at the moment with staff doing that, with STB staff, and we'll continue to do so. Is it going to cause a broad impact? I don't think so.

What we have here, recall now that if the commodity revenue is below RCR 180, it's exempt. And as you can see here for most of the commodities that we're talking about, including chemical, a significant portion of it just drops out right on that characteristic alone. So it's very unlikely to unleash a wave of cases toward you, and that concludes my remarks. Thank you so much.

CHAIRMAN NOBER: Okay. Well, thank you very much. Ms. Dearden?

MS. DEARDEN: My name is Sandra Dearden. I am President of HIGHROAD Consulting, which is a full service transportation and consulting firm, which means we consult on all modes for domestic and international traffic. However, it seems that rail has become our niche. About 60 percent of our firm's business is on rail-related projects.

We have a diverse client base that includes shippers and railroads, including Class I railroads. Today I am representing the views of some of my clients that are rail customers. Prior to starting HIGHROAD, I spent 26 years in the railroad industry. My most recent position was General Manager of Marketing and Sales for a Strategic Business Unit at Chicago Northwestern Transportation Company.

In this verified statement, I would like to discuss the impact on businesses in the United States since Staggers has been enacted, and I would like to offer some suggestions for changes to be considered, which I think could enhance the current system.

Rail customers and the railroad industry have realized significant benefits from the Staggers Rail Act. We gave the railroads the right to establish rate and service agreements with rail customers. Railroad marketing personnel, including myself, responded enthusiastically to the opportunity to work in partnership with customers to develop markets and on supply chain initiatives.

High volume business with major customers was confirmed in multi-year contracts, some with terms as long as 20 years. Because of the long-term contracts, rail customers initiated long range planning and committed capital to their transportation and supply chain infrastructures feeling confident that they were assured certain rate and service levels.

At the same time, the railroads also invested capital for equipment, track and yards knowing the business would be there to cost justify their investments. This was good for the railroads, the rail customers and the economy.

Post-Staggers was really fun to work in. We were operating in a new entrepreneurial business environment and we formed cross-functional teams that applied out of the box thinking to our planning processes. Examples of team initiatives included alternative route analysis and strategic allocation of assets.

These initiatives, in addition to new labor agreements negotiated by the railroads, resulted in new, improved productivity and reduced cost, enhancing the railroad's ability to compete. The primary focus of railroad management personnel was on contribution growth and today, while there is significant room for improvement, the railroad industry is healthy and profitable.

I believe that many of the problems we face today have developed because the rationalization of the rail infrastructure has simply gone too far. The super-sized railroads are so big and bureaucratic, it seems they cannot respond quickly to problems and opportunities. Railroad operations are sluggish, which contributes to increased cost.

This has also impacted on the rail customers operating in supply chain costs as customers have realized increased costs due to plant shutdowns, labor costs associated with service failures or from emergency trucking required to keep plants open. Some railroads have increased the size of the private rail car fleets, which increases their cost but, more important, it also contributes to the already congested system.

One of our clients has 3,500 tank cars. Although his company's increased car costs associated with inefficient rail operations was documented and significant, two railroads declined his company's invoices to recover some of the costs on the basis there were no service commitments in the contracts.

Shippers are not allowed to function on a level playing field. While they are required to pay demurrage when cars owned by the railroads are not unloaded and released on a timely basis, there are no measurements or processes in place that allows rail customers to collect when railroads do not handle their equipment with reasonable dispatch.

Currently, the STB has a new process to arbitrate disputes between shippers and carriers on service failures. However, the STB does not currently have the authority to mandate and enforce solutions. The term "reasonable dispatch" needs to be defined and a process developed that is fair, but not administratively burdensome giving the customers recourse in those situations where abuse of the private equipment has been repetitive and significant.

Another problem that contributes to the cost increases incurred by shippers that move their products on private cars is out of route movement of empty cars, which results in charges for excess empty miles. Mileages for some of the empty moves are more than 200 percent higher than those for the loaded moves due to the railroad's choice of the return route for the empty car.

These problems are compounded by a high incidence of railroad reporting errors. One example was an empty move from Chicago to Joliet, Illinois. The mileage reported for that empty move by the railroad was 444 miles. When challenged, the railroads have worked with us to address these problems, and we have succeeded in mitigating charges for excess empty miles.

However, it has been our experience that we're required to call their attention to these moves even though they often present opportunities for the railroads to improve their own operating efficiencies and to free up capacity. While this is not a problem to be addressed in the legislation, it is a symptom of an even bigger problem, the lessening of competition that would present an incentive for railroads to improve the efficiency of operations.

Instead, the railroads' response to high cost and capacity problems is to simply pass the problems through to the customers, increasing rates and accessorial fees and, in some cases, announcing new accessorial charges.

Railroads submit that rail rates have declined substantially since Staggers was passed. However, you have to be careful when you look at this. It's somewhat misleading, because there has been a dramatic shift in responsibility to the shippers to provide equipment for the moves and, in most cases, the private car rates do not compensate the customer for use of the private cars. Therefore, a comparison of pre-Staggers versus post-Staggers rates and revenues do not present an accurate picture.

Currently, the railroads appear to be out of control with their pricing practices, demanding double digit increases in addition to the double digit fuel surcharges, and they have been very aggressive transitioning rates from contracts to tariffs. And it's apparent that the motive is that they want the ability to announce increases and charges on short notice.

The impact of railroad pricing practices and tactics on manufacturers in North America has been very significant, but there is a saturation point. A chemical manufacturer, as an example, faces increased rates and fuel surcharges not only on their finished products, but also on their inbound raw materials. Compiled, the fuel surcharges alone can increase costs by more than 30 percent.

For a manufacturer with $140 million rail spin, double digit fuel surcharges equate to big dollars. At 10 percent he is paying $14 million and at 16 percent more than $22 million a year.

CHAIRMAN NOBER: If you wouldn't mind summarizing your testimony.

MS. DEARDEN: Okay. Sure.

CHAIRMAN NOBER: We're a couple of minutes over. That's okay. We have all read what you submitted.

MS. DEARDEN: Okay.

CHAIRMAN NOBER: But, please, you can --

MS. DEARDEN: Well, I think one of the key points, like Tom alluded to, is we need a better system for addressing reasonableness. The rate reasonableness should include not only the rates, but also other factors such as the fuel surcharges. Also, URCS, which has been used in measuring cost, does not reflect the cost the way that the railroads view their costs internally and there is better systems to do that. What do you want me to talk about, Roger?

Also, one of the significant things. I really think the STB should have more staff and authority to monitor the industry and inaccurate and illegal publications to make sure that the industry behaves the way it should.

CHAIRMAN NOBER: Okay. Well, thank you very much. Mr. Grimm?

MR. GRIMM: Good afternoon. My name is Curt Grimm. I am the Dean's Professor of Supply Chain and Strategy at the University of Maryland. I am very pleased to participate in this hearing on the 25th anniversary of the Staggers Act.

My remarks draw on almost 30 years of experience in rail policy matters, including extensive academic research in this area. In addition, I had the privilege to work at the Interstate Commerce Commission during 1981 which was, of course, the first year that the Staggers Act was being implemented.

The Staggers Act is a component of a significant trend towards microeconomic reform worldwide and has been manifested largely as deregulation in the United States. Traditional public utility regulation has given way to markets and competition across a number of industries. U.S. rail deregulation provided a greater reliance on free markets to promote railroad profitability and public benefits. As detailed by many of today's speakers, clearly, Staggers has boosted rail profitability.

A Brookings Institution study, in which I participated in the early '90s, evaluated the economic effects of surface freight deregulation, thus encompassing both Staggers and the Motor Carrier Act. This study found that, in aggregate, shippers had benefitted, as well, from surface freight deregulation. Based on 1977 dollars, shippers reaped $11 billion in annual benefits and, adjusting to today's dollars, that's about $27 billion in annual benefits.

Rail deregulation has clearly been a successful policy. Looking back, the key point, in my opinion, is that the infusion of competition into freight transportation markets has been the driver of economic benefits. Going forward, in my opinion, policy makers should preserve and enhance rail competition to continue and extend the benefits of Staggers.

Now, my students often ask me for book recommendations and I'll take the liberty to provide a couple on today's topic for further reading. Now, as my second choice, I'm very pleased to highly recommend the book written by Paul London, who I thought was going to be my panel mate today, maybe he still will be, but he has written a book <u>The Competition Solution</u>, which I would highly recommend.

And London goes through the move towards competition, both resulting from deregulation and freeing up of some of our trade restrictions and posits with, I think, quite a convincing array of evidence that the economic performance of the U.S. economy, which has, of course, been very good for the last 20 years, is primarily the result of these movements towards increased competition. As I say, it's an excellent book well worth reading.

My first choice, of course, is my own Brookings Monograph, <u>The Economic Effects of Surface Freight Deregulation</u>. We're still trying to overtake Harry Potter as the number one Amazon.com ranked book. With your help, I think we can do it.

I would like to close my remarks today by saluting the Commissioners and the staff of the ICC and the STB whose outstanding work over the past 25 years in implementing Staggers has provided significant benefits to the public. Thank you.

CHAIRMAN NOBER: Well, thank you very much. I confess, we do have Harry Potter in our house. We don't have your book.

MR. GRIMM: Okay. All right. Remedy that.

CHAIRMAN NOBER: And if it's under $20, I could accept that, but if -- Mr. Scheunemann?

MR. SCHEUNEMANN: Good afternoon. Art Scheunemann, Northwest Container Services, Seattle, Washington, Portland, Oregon. Deregulation has been a win-win for Northwest Container Services. It would have been difficult for a small company like ours to leverage a business relationship with a Class I railroad in the previous regulated environment.

Deregulation, in our view, has promoted cost and service rationalization in this, profitability and opportunity on both sides of our relationship with the Class I railroads. We're a 22 year-old company, so we have been in this business almost as long as the railroads have been deregulated. We have five facilities, soon to be seven, in the Pacific northwest, soon a facility in California between Oakland, California and the lower San Joaquin Valley.

We're an intermodal short haul rail service provider. We move containers to and from steamships to rail and move our intermodal rail cars from our facilities to our facilities then the to customer. We own our own facilities or partner with port authorities as operators of port intermodal rail, river barge operation facilities. We own our own rail cars, custom built, double stacked, intermodal rail cars that by this year's end will give us the ability to move upwards of 200 containers per train on a daily basis in the Pacific northwest.

We employee a fleet of 135 trucks that provide gray services from ship to rail at the harbors to the customer. We are a hook and haul operation. We contract for power and corridor usage with two major Class I railroads, the Union Pacific Railroad and the Burlington Northern-Santa Fe, our partners. Short haul in our business model is 300 miles or less and our shortest route is 160 to 180 miles between Seattle, Tacoma and Portland.

We are very profitable. We provide quality revenue to both the Union Pacific and the BN and we don't compete with their core of business. Business model works, it works in the Pacific northwest. It will work in California and it will work in other parts of the country. We move 110,000 plus containers on rail between Seattle, Tacoma, Portland, Pasco and have a new facility starting up next month in the Columbia Basin of eastern Washington that will connect to the Port of Tacoma.

That is 110,000 truck trips off of the I-5/I-90 Corridor that has reduced congestion, that has reduced road wear and improved their quality. It is our contribution to social engineering in the transportation industry.

We are not a class railroad. We are not a railroad nor do we aspire to be, but we know a lot about the rail business and we have a longstanding partnership with UP and BN. And to be sure we are dependent on the UP and the BN in our core business which rises and falls with their success or failures. In that context, we are very supportive of their efforts at reducing congestion through investment and power infrastructure and capacity.

Again, a win-win relationship made possible, in our view, through deregulation and a great example of that economic opportunity gained through less regulation rather than more. Thanks.

CHAIRMAN NOBER: Well, thank you very much. Mr. Sussman, I apologize, but you'll be our last witness of the day.

MR. SUSSMAN: Well, mostly looking ahead.

CHAIRMAN NOBER: You have our condolences.

MR. SUSSMAN: Great timing.

CHAIRMAN NOBER: Please.

MR. SUSSMAN: Yes. Since 1994 when I founded Strategic Rail Finance, I met with over 150 Congressional Offices and most of the entities responsible for federal transportation policy. I have developed relations with almost every state's rail office. Along the way, I have coordinated financing for projects in 21 states.

In these 12 years, I have met so many individuals with tremendous railroad experience and intellect, both in the private sector and the public sector, as we have in this room today. I have seen that we aren't short on intelligence, but we are woefully short of cohesive coordination of that intelligence. I believe that none of us are as intelligent alone or in adversarial debate as we are in a thoughtful collaborative dialogue.

25 years after the Staggers Act can we now shift from competition for survival and into working together for the long-term dynamic growth of North America's utilization of freight rail transportation? Yes, we can, but accomplishing this requires a much higher level of coordination and collaboration that what we see in most industries and indeed what we see in the rail industry.

Most importantly, to produce growth that actually contributes to the quality of life and the economic well-being of our continent, we must provide the right framework. That framework consists of: One, a clear set of measurable goals toward which to set our commercial and public policy sites. Two, an intellectually sound multi-discipline, multi-stakeholder forum for teasing out win-win approaches to growing the rail industry. And three, increased coordination of public sector and private sector financial and business interests and resources.

Economic statistics for industry growth have often been amorphuses and misleading. We can no longer afford to invest without clear goals. And we can no longer assume that what is best for the most successful competitors will trickle down to support the whole system. It is time to collectively ask and answer what do we want our rail system to do for us as a nation and a continent?

The process for determining these goals must be mediated amongst wide multi-stakeholder concerns utilizing leading edge group and collaborative methodologies. Only in this way can we implement plans that satisfy long-term goals as well as short-term goals and public interests as well as private interests. When we agree on the results we want from our railroad system and how to measure our progress toward those goals, I believe we will have a heightened concern for the ongoing decrease in rail service to rural and urban America.

Too many small and large businesses are suffering from a diminished or an entire loss of rail service. It is time to move beyond the fear that coordination and collaboration in the best interest of the community or the country is somehow anti-capitalist or anti-American. Maximizing and managing competition is an incomplete regulatory principle.

There is no beneficent marketplace that somehow economizes all the self-centered activities of individual commercial enterprises and then delivers to the community the services and systems it deserves. It is time to establish a new regulatory principle that integrates thoughtful collaboration with useful competition. This new principle will provide the regulatory framework for all of our hard work and investment to be more effective and profitable.

Funding for freight rail development will flow in record amounts from around the world as it did in the 19th Century when private sector funding sources are presented with an assertive and cohesive industry business plan for growth. Government can play its most productive role by stimulating and facilitating this planning process.

I have conceptualized the methodology for this public/private sector collaboration. I look forward to the Board's input into making it a reality. Thank you for this time to speak.

CHAIRMAN NOBER: Okay. Well, thank you very much. Commissioner Mulvey?

COMMISSIONER MULVEY: Let's see, Ms. Dearden, the railroads have invested very, very heavily in computer technology and in car tracking systems over the last decade. In fact, all the railroads are demonstrating what they are doing in terms of improving their tracking systems. Have you seen some improvements over the past decade in the railroads' abilities to keep track of their cars and equipment? You sort of suggested that you haven't seen improvements.

MS. DEARDEN: It depends upon the railroad. Some railroads are doing a better job at managing their property than others. The one -- there is one western carrier that is causing my client significant increase in charges for emergency trucking and plant shutdowns.

COMMISSIONER MULVEY: But overall, in general, are most of the railroads doing a better job in tracking their cars and tracking shipments?

MS. DEARDEN: In general, but, you know, what happens is when they do, it seems like when something goes wrong, they are so large and so bureaucratic, it's very hard to get past the first line customer service people who actually just report what they see on the computer screen and get a problem resolution. The size of the organization is very difficult to deal with.

COMMISSIONER MULVEY: And do you think that has been exacerbated by the consolidation of the industry?

MS. DEARDEN: Yes.

COMMISSIONER MULVEY: Okay. Dr. Grimm, you estimated $27 Billion,in current dollars and in benefits to shippers from railroad deregulation. Does that take into account the costs that have been passed on to the shippers, in terms of increasing responsibility for providing equipment and things or is that not net of that?

MR. GRIMM: Well, first, that was the combined effects of both rail and truck deregulation.

COMMISSIONER MULVEY: Okay.

MR. GRIMM: We looked at both together, so the number I gave you was both, rail and truck.

COMMISSIONER MULVEY: How much of that was rail and how much of that was truck? Do you recall?

MR. GRIMM: I think about -- some is intertwined, but I think it's probably about 40 percent rail, 60 percent truck.

COMMISSIONER MULVEY: Yes.

MR. GRIMM: In terms of the benefits to shippers. We looked at both service quality impacts and rate increases or decreases, in other words rate effects as the foundation of analyzing benefits, so we were not able to get into the issue that you raised, for instance, to the extent there are additional costs that have been passed on to shippers. That would not have been measured in our study.

COMMISSIONER MULVEY: You are a great

believer in the competitive solution and so am I. One of the things I have been talking about is the elimination or reduction in the terms of paper barriers in order to provide for potentially more competition to the Class I railroads from these spinoff Class III railroads. Could you opine on whether or not you think paper barriers are something that should be sunsetted?

MR. GRIMM: Well, I think overall a direction of trying to empower the short line and the regional railroads as well as the smaller Class Is is a very good strategy. I think similar to the airline industry under deregulation, I think it's the smaller companies that have been the most innovative. They have been the most cost efficient. They have a lot of potential to not only invigorate the industry with much needed competition, but also to show the way for, I think, a lot of additional efficiency benefits.

Again, as we have seen in the airline industry with companies like Southwest and now a lot of other small carriers that are kind of shaking up and I think greatly improving the airline industry to create benefits for the customers. Of course, in the railroad industry, you have significant entry barriers, so we need to be more creative about how we can empower these smaller companies.

But I think there are many opportunities out there. For instance, the DM&E Project is one example where you have a smaller railroad that wants to expand and I think those efforts very much need to be supported. We also had the instance in the UPSP merger case where Montail Rail Link was very ready, willing and able to acquire the central corridor line, the parallel line between UP and SP if there were a divestiture as a competitive solution to the parallel aspect of that merger.

And again, that was another kind of opportunity that we had to empower the smaller railroads. I think there is a lot to be said for removal of the paper barriers. And again, some of the previous discussions suggested that may be possible if we renegotiate the contracts with the railroads or buy them out, and I think as with a lot of the efforts to infuse the industry with competition, I think some kind of public assistance to the railroads as in a sense of compensation.

So in other words, you could compensate for whatever harm has been done or to the extent you are changing terms of the contract, you could potentially compensate in terms of capital funding and so on, which is being talked about anyway, but in conjunction, work together with the stimulation of competition. So I think there is a lot of potential there for removal of paper barriers.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN NOBER: Vice Chairman Buttrey?

VICE CHAIRMAN BUTTREY: I'm afraid I'm going to mispronounce your name. I want to be sure I pronounce it correctly.

MR. SCHEUNEMANN: Scheunemann.

VICE CHAIRMAN BUTTREY: Scheunemann, okay. Thank you. Mr. Scheunemann, when you were mentioning your partners, as you call them, UP and BN, I think you said, I didn't hear you mention anything about turning over any traffic to either CP or CN. They operate in that vicinity as well. Do you do any business with them?

MR. SCHEUNEMANN: No. Part of the problem is that our service that we provide in the Pacific northwest can't rail to Vancouver because of bridges and tunnel limitations and double stacking limitations. So our concentration has been the Puget Sound region, Portland and eastern Washington and the Columbia River, and as I mentioned, expanding into California.

VICE CHAIRMAN BUTTREY: Okay. Thank you.

CHAIRMAN NOBER: Well, I just have one question for Mr. O'Connor. I know you mentioned our small rate case proceeding and talked about some of your proposals for how to handle small disputes as fitting in with what happened in the small rate case proceeding that you brought and has been resolved. Some of the other witnesses this morning were, you know, concerned about the small rate case procedures and thought that more needed to be done by the Board.

As one of the few alumna of the actual process, what's your take on whether more needs to be done or whether the process, you know, can work as it is?

MR. O'CONNOR: I agree that more needs to be done. And it seems to me that the best way to proceed is to have more cases brought and to focus in particular. As you recall, we had a mediation track followed by a litigation track. And the mediation track was 30 days and the litigation track was 200 days. And it resolved itself in the mediation track in about three days.

Now, it resolved itself through the collective action of the STB staff, the Norfolk Southern, BP and perhaps a little bit from their advisors. Getting the people in the room focused on first identifying the problem and then working through the problem to work out a compatible solution, that was the key.

Now, if we had tried to define a set of policy regulations that would have embraced everything that happened during even those three days, it would have been probably a proceeding that would have gone on for perhaps months, perhaps years. But getting the people engaged focused on the problem, identifying the problem, put the peripheral issues off to one side, don't waste energy on the peripheral issues, worked quite well. I think that's the way to go.

CHAIRMAN NOBER: Do you think more cases will be brought?

MR. O'CONNOR: I can assure you more cases will be brought.

CHAIRMAN NOBER: Okay. Well --

MR. SUSSMAN: Mr. Chairman, if I may?

CHAIRMAN NOBER: Yes, sir.

MR. SUSSMAN: I would like to suggest another way to look at the paper barrier question. The perspective that I would like us to be looking at the rail system is how attractive is it to the shipping public, to the shipping community? How attractive is the rail system as a whole? When you are out in the field and you are working with potential customers of the rail system, the number of freight options, the number of shipping options, the number of connections a short line or a regional railroad has is the number one factor in its ability to attract new customers.

So in an environment where the key mood is competition for survival and you say to one railroad do I want to give this customer access to my competitor, so that he has more competitive options to come back to me to have me lower my price, it's very understandable that that railroad A would say no, I don't want to give that option to that shipper.

If we were in a growth mode, clearly if railroad A provides more options to its customers so that it can ship via railroad B as well as railroad A and access more of the distribution, marketplace sales, marketplace and supply marketplace, and railroad B gave its customers access to the other railroads, then the whole railroad system becomes more attractive and provides more of a service to the country.

That's how I believe we should be looking at paper barriers as well as many other issues around competitive access.

CHAIRMAN NOBER: Well, again, I want to thank all of the witnesses, both this panel and for all the panels for their, you know, very interesting and provocative and thoughtful testimony. I know a lot of folks spent a lot of time waiting and, you know, I think it was a very, very valuable hearing for the Agency and for the Commissioners. Hopefully more for my fellow Commissioners than for myself, since anything that comes out of it, obviously, will be involving them more than myself.

But anyway, again, I want to thank all the witnesses for their patience and my fellow Commissioners for their hard work and the staff for their hard work in preparing for it. And if there is nothing further, the Board stands adjourned. Thank you.

(Whereupon, the hearing was concluded at 4:44 p.m.)

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This is to certify that the foregoing transcript in the matter of: Ex Parte No. 658

Before: Surface Transportation Board

Date: October 19, 2005

Place. Washington, DC

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