UNITED STATES OF AMERICA

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SURFACE TRANSPORTATION BOARD

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PUBLIC HEARING

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IN THE MATTER OF:             :
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COMPETITION IN THE RAILROAD   :  Docket No.
INDUSTRY                      :  EP 705
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Wednesday,
June 22, 2011

Surface Transportation Board
Suite 120
395 E Street, S.W.
Washington, D.C.

The above-entitled matter came on for hearing, pursuant to notice, at 8:30 a.m.

BEFORE:

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ANN D. BEGEMAN	Vice Chairman
FRANCIS P. MULVEY	Commissioner

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C-O-N-T-E-N-T-S

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

8:35 a.m.

CHAIRMAN ELLIOTT: Good morning, welcome. Today we begin a two-day public hearing to explore the current state of competition in the railroad industry, and possible policy alternatives to facilitate more competition where appropriate.

There's been broad public interest in this hearing, and we have already compiled an extensive record. I want to think everyone who participated for their thoughtful comments. Many have heeded my call to work to find solutions, and many have provided us with ideas worth considering.

Competition lies at the heart of the balance contained in the statute we are governed by. The Interstate Commerce Act, as amended by such laws as the Staggers Rail Act of 1980 and the Interstate Commerce Commission Termination Act of 1995 directs the board to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail, and to minimize the need for federal regulatory control over the rail transportation system.

That is, our system relies on competition, in the first order, to regulate the railroad industry. Our economic regulation largely serves as a backstop for shippers where competition does not exist, and for many shippers, this has worked well.

The U.S. freight rail system is the envy of the world, providing transportation efficiently in an environmentally friendly way. Shippers served by two railroads, or who can move their goods by other modes, generally should get good service at reasonable rates.

But for some shippers, competition for their business does not exist, and the board must provide a forum for regulatory relief from unreasonable rates and practices.

The board has worked diligently over the past several years to ensure that those regulatory processes are working, by reforming large rate cases, establishing new rules for smaller cases, and issuing orders on unreasonable practices. I commend my predecessors for their work on what is always an ongoing process.

The law also contains provisions that allow the Board to take additional actions in certain circumstances, to facilitate rail-to- rail competition. For example, the Board has authority to order carriers to provide alternate through routes, or to provide shipper service over a different route than the ones carriers offer to them. The Board may order reciprocal switching services, where one railroad switches traffic to another carrier that that carrier cannot physically reach.

The Board also has authority to order terminal traffic rights to physically operate over the terminal tracks of another carrier to serve shippers.

One area that this Board has concluded in the past that it may not have full authority to order relief was to require railroads to "bottleneck rates." That is, the agency has ruled that it cannot routinely order a railroad to quote a rate to a point on its system, where it interchanges with a second carrier, to allow a portion of the move to be subject to competition.

Underlying all of these is the question is how the price of access should be set. These are the areas that we will hear about in the next two days. I don't think it is too debatable to observe that the railroad industry has changed in many significant ways since the Board's competitive access standards were originally adopted in the mid-1980's.

Railroads have seen improving economic health. Class 1 carriers have consolidated through mergers. The Shortline

Railroad Network has grown dramatically, and customers are participating in the provision of more capital such as rolling stock. So it is important that we review these issues now.

This country's economy has faced a serious downturn. It is no secret to anyone in this room that railroads play a central role in making our national economy work. Railroad employees are out there every day overcoming tremendous obstacles to allow our commerce to flow.

Right now, railroads and their customers are facing historic flooding in parts of the country, working very hard to get our goods to market. The President has made U.S. exports a priority to lead the economic recovery. The National Export Initiative calls us to marshal the full resources of the United States government behind American businesses that sell their goods and services abroad.

So one area I will be listening in

to very carefully is how our regulation affects exporters. Certainly to be competitive internationally, exporters need excellent rail service at reasonable rates. We are also cognizant of the need to foster a healthy domestic economy as well.

Of course, railroads need to earn adequate revenues to allow them to invest in their networks to make all of that happen.

I look forward to the testimony. I may have a lot of questions, and I'm sure my colleagues do as well.

Before we begin, let me just take a few minutes to review a few procedural points about today's hearing. We have two full days of testimony scheduled. We 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. Consistent with our practice, we will allow the witnesses on each panel to make full presentations before the members ask any questions.

We will have a light before you at the front of the room. One minute before your allotted time, a yellow light will appear. When you see the red light, your time is expired. Please conclude your thought at that point.

After the conclusion of the witnesses' presentations, we will rotate among the members asking questions. I would remind parties that this hearing is not the proper forum to litigate any specific pending matter. These issues touch many cases under consideration, but arguments as to the merits of any case are best left to those dockets.

If you are scheduled to testify, please make sure that you check in with the clerk at the front of the room. I have also been asked to remind witnesses to please speak clearly into the microphone. In addition, the public should be aware that a video archive of the entire hearing will be placed on the STB website, within a few days of the close of the hearing.

In the unlikely event that we have a fire alarm or other event requiring evacuation, which we did at the last hearing, please proceed in an orderly fashion out of the double doors at the back of hearing room, and out of the building through the front entrance.

Specific instructions have been posted at the back of the hearing room for assembly, and notification of return, if any, to the hearing room following any evacuation. Also, a note regarding PowerPoint presentations. If you haven't done so, within the next two days, provide two hard copies of the PowerPoint presentation to the Office of Proceedings.

Finally, if you have not done so

also, please turn off your cell phones. With that, I will now turn it over to Vice Chairman Begeman.

VICE CHAIRMAN BEGEMAN: I want to begin by commending Chairman Elliott for his leadership in calling this hearing on Competition in the Rail Industry. This hearing was announced long before I joined the Board last month, and I applaud the Chairman and Commissioner Mulvey for recognizing the importance of taking a fresh, comprehensive look at these important issues.

I'm glad to see that there are so many stakeholders that have taken the time to participate in this proceeding. I've had the opportunity to meet with many of you over the years on a very wide variety of transportation issues. There are also many of you that I have not met, and I'm very interested in hearing from all of you.

I'm not one who believes that all Board policies and regulations are perfect.

At the same time, however, any changes that might be considered must be fully and formally vetted prior to implementation. As you know, the Senate Commerce Committee has looked at many of these issues over the past years, and we relied heavily on stakeholder input when developing legislation.

Your input here is equally important, if not even more important. I hope that all of you will approach this hearing in an effort to be constructive, not to simply define or oppose the status quo, but to inform the Board how specific proposals might reconcile, at least in some way, the concerns of both captive shippers and the large railroads.

Again, I thank the Chairman, and I look forward to hearing from all of you. Thank you.

CHAIRMAN ELLIOTT: Thank you, Vice Chairman. Commissioner.

COMMISSIONER MULVEY: Thank you,

Dan. This hearing has been a long time coming, and I want to address issues that are at the core of the Board's mission, how to ensure that an industry that is characterized by a certain degree of monopoly or duopoly, is sufficiently competitive, either through market forces or through litigation, to promote reasonable rates and service, and also how to ensure that this capital-intensive industry, with most of that capital coming from private sources rather than the government, continues to have access to private capital markets.

Over the years the Board, and the ICC before it, have used many different tools to address competitive issues, with varying degrees of success. Pre-Staggers, the ICC tried to balance the interests of the competing modes, and to promote the inherent advantages of each mode of transportation, not with great success.

Post-Staggers, and since overall

transportation deregulation, the focus has shifted more towards reliance on market forces, and less regulatory intervention. For example, the ICC adopted our current competitive access standards, requiring the showing of competitive abuse back in the mid-80's.

As a result, however, the railroads and shippers have spent the last 25 years arguing about it. In the late 1990's, the Board decided the bottleneck cases, finding that a shipper cannot ordinarily require a carrier to short haul itself by quoting a rate between two points less than the full origin to destination movement, if the carrier in fact is capable of providing origin to destination transportation.

In 1998, the Board invited shippers and carriers to discuss competitive access issues, with the assistance of a Board administrative law judge. The result of that, no progress was made in crafting a new competitive access standard that shippers believed they could use or that railroads believed they could continue to prosper under.

Despite these setbacks, the Board has not given up in trying to address the fundamental competitive issues affecting both shippers and carriers. Today, we will try again with fresh perspectives and with open minds. The filings in this proceeding suggest that railroads and shippers are as far apart on these issues as ever.

However, I believe that the Board has a responsibility to examine its competitive access regulations, especially given the sea change in the railroad industry since its current policies were first adopted. My hope is that the parties today will put some of the entrenched rhetoric aside, to explore mutually agreeable solutions to these thorny issues, rather than promoting only winner-loser scenarios.

My hope is also the Board will

keep moving after this, taking the necessary hard look at the options, and then finding the right solutions for today's industry and competitive environment. This nation depends on a healthy rail industry to move the massive amount of freight that ends up in our stores, our farms and our homes.

We also depend on the shippers of those goods not paying inflated transportation rates, or enduring poor service. Two distinct possibilities in non-competitive market environments.

When I meet with shippers, they often complain about the take-it-or-leave-it attitude exhibited by the railroads, a problem that can impact everything from rates to routes to car supply and even to demurrage.

When I meet with railroads, they are concerned about having the revenue needed to invest in their infrastructures, and to meet the extraordinary demands for capital, and to make the business decisions that are right for their companies. Neither side has a monopoly on being right.

Finally, I want you to note that I value thoughtful pleadings from all sources, whether it's a three sentence letter from a small company that ships ten carloads a year, or a 25 page submission from a Fortune 50 company, accompanied by six expert, verified statements.

Many of the pleadings were received on both sides of these issues appear to be standardized, identical letters, in volumes I have not seen before in my seven years at the Board.

Although I am pleased about the great interest in the proceeding, I hope that dueling form letters will not become a precedent for every major proceeding going forward. Our nation's trees deserve better.

Thank you to all those who are participating over these next two days, for sharing their ideas with us, and I look forward to this important discussion. Thank you, Chairman Elliott.

CHAIRMAN ELLIOTT: Thank you, Commissioner. Thank you, Vice Chairman for your insightful and helpful comments, and now we will get the show on the road.

First, we'll begin with Panel II, and just as a matter of information, as you noticed, Panel I is Members of Congress when they arrive. So when they do arrive, we'll interrupt and allow them to go forward to their pressing schedules.

So why don't we start out? I believe Interested Parties begin with 30 minutes, and you may begin at any time.

Panel II

MR. STONE: Thank you, Chairman Elliott. My name is Scott Stone. So we're very happy to be here today, to help you address this issue, and Vice Chairman Begeman, delighted to welcome you to the Board and Commissioner Mulvey, your insight is extremely valuable.

I tend to think of you as Professor Mulvey, but just don't ask questions that are too hard for me today.

I'm from Patton Boggs in Washington. With me today are Jeff Moreno, Thompson, Hine; Mike McBride of Van Ness Feldman. Together, we represent a number of trade associations who have filed joint comments. We've given this group of trade associations a very creative name of the Interested Parties.

The Interested Parties comprise 26 different associations representing all types of shippers, including shippers of agricultural products, forest and paper products, coal, chemical fertilizer and mineral products and a wide range of other products.

These shippers are all dependent upon rail, meaning that given the nature of their products and the distances they have to be shipped, they typically don't have competitive options for their shipments. In many cases, in fact, their shipping locations are captive to a single railroad, and in almost all cases, as the comments in this proceeding have detailed, and as you'll hear today to a painful extent, I hope not but perhaps, even when there might theoretically be a second rail carrier that can participate in some way in providing some competition, the reality is that for all practical purposes, rail to rail competition has simply disappeared.

That's why we're here today. We appreciate that the Board in its notice, initiating the case, seemed to recognize what's become so painfully clear to us, that following the mega-mergers of the 90's, and not coincidentally after the expiration of the oversight period of the Conrail split-up, rail to rail competition has simply disappeared.

Rail rates are rising; services

declining; and there's very little most shippers can do about it. Notwithstanding the good efforts of the Board, it's still very, very expensive and time consuming to bring a rate proceeding.

Meanwhile, rail profits are at a record level. They're among the highest of any industry, in the top ten percent of all industries. They're raising dividends, they're buying back shares, and financial analysts and the railroads themselves are continually pointing to the pricing power of railroads. They have the ability to raise rates and get away with it.

It didn't go unnoticed that the railroads were able to raise the rates steadily, even in the face of the worse recession we've had since the Great Depression. Some circumstances have changed dramatically from the days of the 1980's, when the current rail competition policies were established by the ICC.

In the 1980's, although railroads were financially healthy, they could still say with some degree of credibility that they were emerging from a period of financial weakness. Today, railroads are the darlings of Wall Street and have more profits than they need to invest in their systems.

Again looking back to the 80's, even if shippers were dependent on rail, they often had some choice at how to combine the railroads that were out there, to create some competitive options. In 1980, right after the Staggers Act was passed, there were 39 Class 1 railroads still.

Today, as you know very well, there's four megasystems, two in the east and two in the west, an additional carrier that connects the middle of the country with Canada, and an additional Class 1 that connects the middle of the country to Mexico, and that is basically it.

Despite the changed circumstances,

we hear the railroads in this proceeding continuing the same arguments that they have been making for the past 30 years. Their finances are precarious. They have special capital needs. They need to engage in monopoly pricing to earn adequate revenues and yes, ladies and gentlemen, they argue that they are competing vigorously with each other. I hope the evidence will convince you today that that's not true.

You'll hear today from over two dozen witnesses from companies, associations, and government entities, who will tell you that meaningful rail to rail competition no longer exists. Service and responsiveness are abysmal. Railroads simply do not behave like a competitive industry, because they are not one.

In this proceeding, we have been met with a new and somewhat novel argument offered by the Burlington Northern. BN says wait, we don't need competition, because we have regulation. Well, I think we all understand that that gets the policy of 49 U.S.C. 10101 completely backwards.

That policy, as Chairman Elliott pointed out in his introduction, says that to the maximum extent possible competition is to be relied upon to establish reasonable rates, and that regulation is only a backstop.

As the Board has tentatively suggested in this proceeding, it's time to reexamine our rail competition policies, so that indeed competition can be strengthened to the point that according with the statute, competition, rather than regulation, can establish and maintain reasonable rates.

The Board should respond to the vastly changed circumstances we've identified, to reexamine and rebalance its rail competition policies.

Now as we've made clear, the intent of the Interested Parties is not to re-regulate the railroads. Quite the opposite.

It's to fully deregulate the railroad industries, in the same way that telecommunications and other industries have been successfully deregulated, with not only robust competition but investment in healthy competitors.

In telecom, for example, we've seen a boom in investment, innovation and revenues that has greatly benefitted our country, not just the telecom companies. Frankly, if we were to turn back the clock so that telecom companies were given the same power to monopolize that the railroads now have, the public would be outraged. I think in fact we would see marches on Washington.

So why aren't shippers marching on Washington? Well, it's not that we don't care. It's simply that we've been through these battles for so long, and if I could say the brick wall erected by your predecessors has been so substantial, that we simply got tired of beating our heads against that wall.

So we're very grateful that you've opened a door in that wall, so that we can together look at how we might change policies. Now I'm not really here today to beat up on the railroads, and I take to heart what all of you have said about being constructive.

I simply want to point out that for the last 30 years, we have tended to elevate the revenue adequacy of railroads as our number one policy. As Chairman Elliott pointed out, the policy of this Board has to be directed fundamentally at what is in the public interest? What is in the interest of the people of the United States of America?

Our economy, our exports and the efficiency with which transportation happens in this country depends upon rebalancing our competitive policies. With that, I'd like to yield to Jeff Moreno, who's co-counsel for the Interested Parties, who will discuss the Board's authority to revisit its policies.

MR. MORENO: Thank you, Scott and

good morning. As noted by Mr. Stone and by a multitude of comments filed in this proceeding, there has been a significant reduction in competition over the last decade or more, accompanied by significant improvements in the railroad industry's finances.

The combination of these changes suggests that now is the appropriate time for the Board to review its policies towards enhancing rail competition. My testimony will address the Board's authority to modify both its competition and its bottleneck rules, in light of these changed circumstances.

As a threshold matter, I feel it's important to address the rail industry's distorted mischaracterizations of what most shippers are requesting, and specifically what the Interested Parties are requesting here. The railroads have framed the issue here as a choice between the status quo or wholesale open access.

That is a false choice. The Board can alter its competition policies to encourage greater competition that is short of open access, but at the same time is not nearly as strict as the competitive use policies that comprise the status quo. In requesting that the Board adopt competition-enhancing policies, the Interested Parties have not advocated complete and total open access.

But we've advocated for a degree of access that would restore the balance between the often-conflicting rail transportation policies of competition, and revenue adequacy. The most direct and effective ways that we believe the Board can do this is through modifications to its policies on reciprocal switching and bottleneck rates.

With regard to the reciprocal switching, the rail industry contends that this Board is locked into its existing rules and policies for all time, regardless of any changes that have occurred in the 16 years since ICTA.

Unless and until the Congress enacts contrary legislation, this argument is absurd on its face. In order for the Board to reach that result, it would have to conclude that in ICTA, Congress intended to eliminate the broad discretion that it gave this Board in the Staggers Act, without actually changing the text of the statute itself.

The statute very broadly states that the Board "may require rail carriers to enter into reciprocal switching agreements, where it finds such agreements to be practicable and in the public interest, or where such agreements are necessary to provide competitive rail service."

These are the very words used in the Staggers Act and in ICTA. The term "may" implies discretion. It's permissive. The alternative standards of practical and in the public interest, or where necessary to provide competition, competitive rail service, are both broad and undefined terms, and in such circumstances, an agency has broad discretion to define and apply those terms in a way that represents a reasonable accommodation between the conflicting policies that are committed to that agency's care by the statute.

The ICC did just that in the *Midtec* cases. There, the ICC went beyond the statutorily enumerated standards by superimposing competitive abuse standards on top of those statutory standards. On appeal, the ICC was affirmed, and the Court reiterated this discretion, and concluded that the ICC had reached a reasonable decision.

The Court did not conclude that this was the only possible outcome or decision, but simply that it was a permissible one. It is hornbook administrative law that agencies may change their policies and reverse prior conclusions, so long as they provide a reasonable explanation for such changes.

Moreover, an agency's view of what is in the public interest may change, either with or without a change in circumstances, although we contend that there certainly are adequate changes in circumstances in this case, so long as the change is supported by reasoned analysis.

This permits the Board to modify both its *Ex Parte 445* competitive access rules, and its *Midtec* decision, so long as that new interpretation is a reasonable reading of the statute, and the Board adequately explains the reasons for doing so.

The rail industry has blithely ignored this precedent and contends that the passage of ICTA in 1995 somehow carved *Ex Parte 445* and the *Midtec* decision into stone. The railroads, however, do not explain how Congress did this without changing a word of the statute itself.

If anything, by leaving the

statute unchanged, Congress confirmed its intent to leave this matter within the broad discretion that it originally gave the Board in the Staggers Act.

The Board has similar discretion with respect to its outdated bottleneck rules. In the bottleneck decisions, the Board superimposed the very same competitive abuse standard on top of the Section 10705 statutory standards for alternative through-routes that would short haul an origin carrier.

Those decisions, too, were confirmed by a reviewing court on the basis of the Board's discretion, but without finding that to be the only permissible interpretation. Thus, the Board is not bound by its prior bottleneck decisions if it can rationally explain its changes in light of new circumstances.

Nor does the Supreme Court's decision in the *Great Northern* case preclude bottleneck rate challenges. The Staggers Act was enacted over 45 years after the *Great Northern* decision, as part of a sea change in favor of greater reliance upon competition, and much less reliance upon regulation.

A bottleneck rule that prevents rail to rail competition is inconsistent with that statutory change. Moreover, although the STB relied upon the *Great Northern* decision as a basis for its bottleneck rule, it's important to note that the reviewing court, in affirming that decision, did not rely upon the *Great Northern* decision; rather, it relied upon the Board's discretion to interpret the statute.

The combination of reduced competition in the rail industry and significantly improved finances constitute changes that would warrant modification of the Board's policies on enhanced rail competition. The record in this proceeding is replete with examples of reduced competition.

Indeed, I would say that as a

consequence of the major mergers since the Staggers Act, there is less rail competition today than there was under Staggers, or under ICTA. Consolidation has enabled railroads to exercise greater market power, and to engage in consciously parallel decisions not to compete with one another.

These facts indicate a strong need to restore competition that has been lost. Dramatic improvements in the rail industry's financial condition also support a policy change.

Although the railroads claim that this fact should play no role or have no influence in the Board's decisions on this matter, they ignore the fact that this fact was a major issue used by the Board to support the current status quo.

In *Ex Parte 445*, the Board expressly cited revenue adequacy as a justification for the competitive access rules, or rather revenue inadequacy at the time. Similarly, in the bottleneck decisions, the railroads themselves argued that their own revenue adequacy required dismissal of the bottleneck cases.

In both cases, the reviewing courts affirmed the agency's discretion on the basis of railroad revenue adequacy objectives. If the Board could and did take revenue adequacy into consideration in setting the current status quo between conflicting rail transportation policies of competition and revenue adequacy, it surely can do so in resetting that balance today.

The Interested Parties seek a balanced approach toward competition-enhancing policies. Contrary to the railroad mischaracterizations, we are not pushing for open access. For the past 30 years, the pendulum has swung far to the extreme, in favor of revenue adequacy whenever there has been a conflict with the competition policies.

We ask the Board merely to swing

that pendulum back towards the center. Just as the Board had discretion to favor revenue adequacy for the past 30 years, it has the discretion to pursue a more balanced approach, based upon changes in both the state of rail competition and in the rail industry's financial health.

With that, I will yield the remainder of my time to Mr. McBride, to discuss the impact of reduced rail competition on the American economy.

MR. McBRIDE: Good morning Mr. Chairman, members of the Board. My name is Michael McBride, and I want to address the subject of competition, which has been addressed by so many parties in this proceeding, and I want to see if I can pull it together for you.

No one buys rail transportation for the transportation alone. But railroads obviously need to be profitable and shippers who depend on railroads need them to earn an adequate return. The reason railroads were given their franchises to operate was to serve the needs of the public, i.e. their customers.

Regulatory policy for most or all of the last 30 years was focused on the financial needs of the railroads. Now it is time to give equal weight to the shippers, as Congress intended.

The Board will no doubt have observed that a very large number of shippers, as well as shipper organizations speaking for many more shippers, have largely told the same factual story.

This is not form letters expressing opinions, Board Member Mulvey; these are facts. That railroads for the most part, no longer compete and provide neither competitive rates nor the type of service shippers receive from their other vendors.

The overwhelming weight of evidence indicates that there is a lack of adequate rail to rail competition. What I present here is an overview of the governmental filings supporting the shippers, and of the shipper filings. We provided a more comprehensive summary in Section 5 of our opening comments, and Section 3 of the Interested Parties' reply comments.

However, first let me mention what may be the most important point, and that is that the impact that rail rates and practices are having on the ability of railroad customers in this country to produce products to compete with imports, and the ability of railroad customers in this country to compete abroad with exports from other countries is established, and is harmful, according to this record.

Now with respect to foreign imports, U.S. railroads do not compete with railroads in other countries, but their customers do. Therefore, when a rail customer is charged an excessive rate, it hurts an American industry's ability to compete with

China and other foreign countries, and the industries in those countries.

Certainly every dollar by which U.S. industry can reduce its shipping costs is a dollar that goes towards creating American jobs and making American goods more affordable DuPont and Oxychem, among others, have offered examples of such problems, in attempting to compete with imported chemicals because of high U.S. rail rates.

Exports from other countries, Northwest Ohio Regional Economic Development Association, on behalf of a metal castings exporter and Weaver Popcorn, among others, whom you heard in *Ex Parte 704*, have explained the problems that American exporters are having, because railroads will not provide rail service from the shipping point, in the case of Weaver, thus requiring the exporter to first ship via truck to Chicago, for Weaver in a weight-restricted container, materially impairing its competitiveness abroad. Similar problems for the metal casting producer.

Loss of American jobs. Total provided an example of a situation in which because of rail rates to a customer in California, they could not produce. Their product had to be made abroad and 300 jobs were lost. Total could not get the railroad to be reasonable.

It's often said these shippers are bigger than the railroads. Why can't they get the railroads to respond? When you're a monopoly, it doesn't matter how big the shipper is. The railroads have the monopoly or the duopoly.

The Departments of Transportation and Justice have made an historic filing in this proceeding. We haven't seen much from the Department of Justice since the UP/SP merger in this agency; the Department of Transportation has most of the last 30 years taken the side of the railroads.

But this time, those two

departments have told you that we shippers should not be required to pay more than is necessary for railroads to earn adequate revenues, that shippers should not pay more than is necessary for efficient service, that shippers should not pay for facilities or services that do not benefit them, and that the responsibility for facilities should be based on demand elasticities of each shipper. We, of course, do not oppose differential pricing.

This is an historic filing. The Department of Agriculture you have seen on occasion, but the Department of Agriculture has come in far more aggressively for shippers and competition in this proceeding than ever before.

Agricultural producers and shippers have continued to express the concerns you've heard for many years about decreased rail to rail competition, increasing rail rates, poor rail service, rail capacity constraints and the fair allocation of rail capacity.

The Department of Agriculture has generally endorsed these comments. It also endorses the view we have expressed, that there is greater rail market concentration than ever before.

The North Carolina Department of Transportation has expressed similar concerns about the lack of rail to rail competition, and the adverse impact on its ports and its economy. NIT League, now I turn to industry groups, has surveyed its members, and most of them do not get contracts that substantially differ from a tariff.

The railroads can cancel on 30 days' notice and the contracts are devoid of any service obligations. The railroads refuse even to negotiate, let alone to enter into mutual contract terms.

Further, despite rising rail rates, railroads are shifting more of their costs onto their customers, to maximize their profits. Today, many more shippers furnish their own rail cars, handle the switching of cars at their plants and may be responsible for the maintenance of certain rail infrastructure, even providing insurance on them.

Now with respect to commodity groups. Coal. Numerous coal shippers have complained, and this is consistent throughout this record, that rail to rail competition stopped in about 2003 to 2004, at around the same time that capacity constraints occurred and railroads developed substantial market power.

All of the rate trend data confirms that circumstances changed substantially about that time. The railroads have cited a few exceptions they claim prove otherwise. But in general, the trends are clear in essentially all cases. When a contract is offered, as I think Board Member

Mulvey said, it's take it or leave it. That's what the shippers said obviously to you, I know.

Moreover, almost universally, the non-bottleneck railroad that has a single line haul will not offer a competitive rate to interchange with the bottleneck railroad. Yet the premise of the bottleneck rate decisions was that the shippers could get such a contract, and then would be entitled to a bottleneck rate. It hasn't happened.

The rate impacts of all of this are clear. For example, Basin Electric's rate increased over 100 percent, Dairyland Power's transportation charges increased by 93 percent, and many other coal shippers' rates have increased by comparable amounts in recent years.

Arizona Electric Cooperative in California filed comments subsequent to the filing of our reply comments, saying similar things. In the automobile sector, automobile manufacturers have experienced firsthand the negative competitive effects of Class 1 railroad consolidation. This is a change in position for the automobile industry, if you go back to seeing where they were in the 1980's.

But rail rates have risen steadily over the last five to six years, where railroads have reduced their service commitments.

Cement. According to the Portland Cement Association, "more than 80 percent of U.S. cement manufacturing plants are captive to a single railroad." Not only do these captive facilities pay "substantially higher rail rates" than the competitive plants, but the captive plants "often receive less reliable service."

Many shippers of cement and related products are reporting double-digit increases in rail rates, "far beyond the effects of inflation."

Chemicals. Numerous chemical shippers, you'll hear from several of them, related circumstances similar to the coal shippers. No or little rail to rail competition, and even where the plants are served by more than one railroad, there have been substantial rate increases.

Crushed stone. Texas Crushed Stone told a similar story and said the railroads would not change their position, despite the customers' explanation that business would be lost as a result.

Fertilizer. The fertilizer industry filed similar comments. The fact that rail customers who supposedly have competition are facing substantial rate increases is very troubling to the fertilizer industry.

Forest products. Roseburg Forest Products Company filed similar comments, including the important point that so-called Rule 11 rates are being cancelled, so that shippers cannot get competitive rates. The American Forest and Paper Association filed similar comments in *Ex Parte 704*.

Potatoes. The Washington State Potato Commission submitted substantial comments documenting the high rail rates and poor service its producer-members get from the railroads, primarily BNSF, which controls most of the rail lines in Washington.

That despite the fact that the railroads have a cost advantage over trucks, and despite the clear preference of the potato producers for rail transportation, the producers showed that only seven percent of their produce moves by rail, with the rest moving by truck.

This contradicts the railroads' oft-repeated public service claims that they are taking goods off the highway and moving them by rail.

Paper and paper products. Despite being the largest manufacturer of paper and paper products in the United States, International Paper Company apparently was getting adequate rail service as late as 2009, but cannot get adequate rail service from Norfolk Southern now and filed a petition in Docket No. 35465, raising its concerns about inadequate service.

Popcorn. Weaver Popcorn's president appeared personally in *Ex Parte No. 704*, to explain his company's inability to get sufficient rail service, to export all of the popcorn largely to China that his company could export, with more adequate rail -- with adequate rail service.

However, it is losing the battle to Argentina. The reason it can't compete, as I said earlier, is the weight limit on containers for truck transportation to Chicago. NS will not provide rail service from Weaver's plant, so that it could use heavier weight containers than the highway weight limit.

Steel. AK Steel, in many instances, is captive to a single railroad for its transportation requirements, subject to monopoly rail power and market dominant rail pricing, even with the exempt commodities that it ships. Subsequent to the filing of our reply comments, Nucor-Yamato Steel filed comments stating that it does not want re-regulation, but rather just needs a level playing field, as it has with all its other vendors.

All of these examples make the point crystal clear. Rail rates harm U.S. producers of electricity, grain, chemicals, lumber and other products, and therefore not only deprive U.S. customers of funds that could be used otherwise to produce jobs throughout the country, but in many cases effectively cause manufacturers to produce their products abroad, costing the U.S. valuable jobs and tax revenues.

While there are a couple of

hundred thousand jobs involved in direct employment by the railroads, more indirectly there are many times that, many direct and indirect jobs in the industries that depend on the railroads to ship their products.

Without your help in providing the balance Congress intended in the Staggers Act, and a reasonable opportunity to obtain a regulatory remedy if need be, but only if need be, shippers generally cannot get reasonable rates and service from the railroads.

The key point, though, is most shippers do not want a regulatory remedy. They just the regulatory remedy to be available as a fallback if all else fails. The prospect of commercial success and dealing with the railroads has to be a reasonable one.

With that, Mr. Chairman, I'll stay within the time. Thank you.

CHAIRMAN ELLIOTT: Thank you, Interested Parties. We'll now hear from the National Industrial Transportation League.

You have five minutes.

MR. WARFEL: Good morning Chairman Elliott, Vice Chairman Begeman and Commissioner Mulvey. My name is Curt Warfel, Sourcing Manager for AkzoNobel's North American operations.

I am here today on behalf of the National Industrial Transportation League, the nation's oldest and largest organization of shippers. Accompanying me is Ms. Karen Booth, the League's general counsel.

The League represents approximate 600 member companies that range from some of the largest to smallest users of the nation's transportation systems. Rail transportation is vitally important for many League members, and especially for those who ship chemicals, petroleum, agricultural, cement, paper and forest products.

Some of our members are captive shippers, operating facilities or shipping to customers that have access to only a single rail carrier. I am very familiar with the rail competition issues that are most important to the League members, as I have been a member of the League and its Rail Committee for 25 years.

I have also served as chairman of the Rail Committee from 1998 to 2001, served on the League's Board of Directors from 1998 to present, and acted as chairman of the League's Board of Directors from 2006 to 2008.

The League applauds the Board for its willingness to evaluate the effects of dramatic reductions in rail competition over the past decades, and for considering whether changes to its current policies are needed to increase competitive rail service to sole-served shippers.

As the Chairman noted, it is beyond dispute that the railroad industry today looks and operates very differently than it did 25 years ago, when the Board adopted its competitive access policies. Bankruptcies and mergers have left just seven Class 1 railroads, with four dominating the industry.

This major structural change has provided the railroads with substantial market power over their captive customers, and resulted in steadily rising freight rates and mediocre service for many such companies. A survey of League shippers showed our members' base rates up to 50 percent higher at captive facilities than at dual-served facilities.

For a number of reasons, these captive companies cannot readily ship their traffic to other modes of transport. Thus, even during our recent recession, captive shippers were forced to endure rising rail rates despite depressed freight volumes.

Year after year, rate increases prevent rail-dependent companies from competing effectively against their domestic competitors, and thwart efforts to increase exports, negatively impacting job creation in the U.S.

Although a shipper may file a rate case at the Board in hopes of achieving reduced rates, for most, this is not the preferred solution. Rather, the League believes that rail rates should be established by a competitive marketplace and not by the government.

This view mirrors the policies in the Staggers Act, to minimize the need for federal regulatory control, and to allow to the maximum extent possible competition and the demand for services to establish reasonable rates for transportation by rail.

The lack of sufficient competition allows railroads to raise rates unchecked for the most part, and to dictate contract terms to their customers.

Although many League members use rail contracts, the railroads often are unwilling to engage in meaningful negotiations. Illustrative of their dominant market position, many railroads simply present shippers with take-it-or-leave-it terms.

Now over the past 30 years, the freight rail industry has also transformed itself into one of the prosperous industries in America, as noted in both the 2010 Senate Commerce Committee's report on the railroad industry, and a 2009 *Fortune* magazine article, ranking railroads fifth on their list of most profitable industries.

In fact, nothing demonstrates the financial success of the railroads better than the purchase of BNSF railway by Berkshire Hathaway.

This Board has asked whether the competition policies created in the mid-1980's are able to effectively address the dramatic losses in rail competition that have occurred in our nation, and whether those policies have swung the pendulum too far in favor of the railroads' need to earn adequate revenues.

For the League, the answer is clear. The Board's policies have not and cannot function to fulfill the pro-competitive mandates of the Staggers Act. The simple fact is that no shipper has ever obtained competitive access under the Board's rules.

So what policy changes should the Board make? Despite the railroads' attempt to mischaracterize the League's and other shippers' positions, we do not desire radical open access remedies, nor do we desire change that would return the railroads to a state of financial weakness.

As rail customers, we understand that the rail carriers need to remain vibrant and healthy and earn revenues, to permit them to reinvest in their networks. The railroads, on the other hand, have distorted the shippers' positions as extreme, and presented doomsday scenarios if there is any policy change.

The Board has asked parties to put aside their rhetoric and to present specific recommendations that will help guide the Board in solving today's problems. The League is ready to assist you.

We recently surveyed our diverse Rail Committee members to determine what competition policies are most important to their company, and what policies should be changed by the Board.

They responded that greater access to reciprocal switching and changes to the Board's bottleneck rule would help them and their companies to achieve more reliable, efficient and cost-competitive rail transportation, and improve their ability to compete. Changes to reciprocal switching policies were rated as most important.

The League's captive rail shippers want to increase their access to a second rail carrier, while respecting the railroad revenue policies of the Staggers Act.

However, given that the Board's present competitive access rules have failed to provide any after-shipper with any access to competition, we believe the Board should open a proceeding promptly after this hearing, for the purpose of developing new, administratively simple reciprocal switching rules that would provide for competitive access where appropriate.

The League also supports the other recommendations set forth in its opening comments, and the joint comments of interested shipper parties, including that the Board should open one or more future proceedings regarding bottleneck rates and merger conditions, among other potential policy changes.

The time has come for this Board to modify its policies, to make them more current, relevant and responsive to the competitive challenges in protecting today's railroad marketplace. The League stands ready to assist you. Thank you for allowing me to provide this testimony, and to run a little bit over. On behalf of the League, I'd like to thank you and I'm happy to answer any questions you have.

CHAIRMAN ELLIOTT: Thank you, Mr. Warfel. Thank you Interested Parties. I have a couple of questions, and I think a more general question. So feel free to hop in in an orderly manner.

First of all, I think one of the themes I've been hearing throughout this proceeding and in the comments, and equally so here today in the initial statements by this group, is that the railroads haven't been competing.

I guess that's a pretty serious statement and a serious allegation. Do you think, based on the record that we have before us today, that we could make some types of changes to our access policy based on the record before us at the present time?

MR. STONE: Certainly, Mr. Chairman, we would advocate opening a proceeding that would reexamine the rules for competitive access. We think that the Board can proceed as it wants, but it would make some sense to open one proceeding rather than a sort of plethora of proceedings.

I second what the gentleman from NIT League said about having a goal of establishing simple rules. When clear guidelines are given, parties know what to expect, and they can negotiate and work out transportation contracts.

We would envision that if the regulatory policy is rebalanced in a clear way, and if fairly simple, it would enable the parties to work out competitive transportation contracts without requiring further Board intervention.

CHAIRMAN ELLIOTT: Thank you.

MR. McBRIDE: Mr. Chairman, if I could just add. The Supreme Court has made it crystal clear that regulatory agencies can proceed through rulemaking or through adjudication.

So for example, you have an oral argument tomorrow, and I'm not going to get into the merits of the proceeding, but it's very interesting in that proceeding that even one of the railroads has taken the position that where an interchange is efficient and reasonably feasible, you have the authority to order it. So I believe you can proceed in both types of proceedings.

CHAIRMAN ELLIOTT: Now with that in mind, if the railroads, I guess, if the allegations are correct that the railroads aren't competing, my understanding, and this comes from various comments by some shipper groups, and I think also somewhat in the railroad comments, that if we do engage in some kind of different access policy that makes that more available to shippers, if the railroads are not competing, would that policy, by opening up the access, be more effective? Would that be effective at all?

I'm hearing some of the shipper

groups saying no, that would not be effective. I don't think I heard that in your comments, but I would be curious to hear what you thought about that.

MR. MORENO: I think, Mr. Chairman, that you raise a very good question, and this tension was actually addressed in the Interested Parties' comments. We are concerned that even if the Board does modify its reciprocal switching and bottleneck rules, that there's the possibility that we'll throw a party, but no one will come.

The hope is, and I think this will take some time to evolve, is that because the rail industry has become so concentrated, right now it's easy for them not to compete, because there's so few places where they are faced with direct competition with one another.

However, if you make competition more widely available through greater reciprocal switching, more opportunities for bottleneck rates, the number of opportunities to compete will become, make it more difficult for the railroads to chose not to.

I would say in the rail industry, there are some pockets today where the rail industry competes. But it's certainly not very widespread, and I think if we create more opportunities for that competition, we'll see it will become more widespread, and it may take three, four years after your policies are enacted to see the results of that. But I'm very confident that there will be some competition.

MR. STONE: Mr. Chairman, if I could simply add --

CHAIRMAN ELLIOTT: Sure.

MR. STONE: You know, there are going to be instances in which an alternative combination of railroads will be so much more efficient that the potentially competing railroad will say you know what, I really can offer a much lower rate here. I can get that business. In contract negotiation with a big customer, the railroad may finally say you know what? I'm actually going to compete now.

Once the competitive dynamic is established; that is, once railroads understand that they may in fact lose business, they're going to be faced with the reality that they're also going to have to compete to gain business.

I agree. It may take a while for this competitive dynamic to kick in, but it will start, and it will be assisted by a change in the policy.

CHAIRMAN ELLIOTT: Let me follow up on that. With that in mind, as Mr. Moreno said, if he gave a party and nobody came, what would be your preference, if we proceeded down that path of trying to make access and competition more available, with the risk that we would result in giving a party and nobody coming, versus taking a look at the regulatory policy that's in place now with respect to making the rate cases more effective?

If you had to choose between the two, which one would you prefer?

MR. MORENO: I think undoubtedly most of the shippers in this room would probably prefer to have competition. The very fact that they have to expend resources on pursuing a regulatory remedy means that that's resources investment they're not making in this country and in other facilities and job growing opportunities.

Therefore, I think most anyone would say we'd rather let the free market decide this.

MR. McBRIDE: Mr. Chairman, if I may add, I think that's true even of the coal shippers, who tend to be the people who bring the most rate cases before the Board, although the chemical shippers have certainly brought several in recent years.

The coal shippers want bottleneck rates, I think, more than anything else, so that they can get out there and try to create some competition. It may not work, but it's a necessary if not sufficient first step.

MR. WARFEL: I'll step up to the plate on this one. Most shippers are going to be very reluctant to file any type of a rate case. I mean it's going to be a definite last resort, one where you feel that you have closed off pretty much all other avenues.

As counsel here has noted, it's expensive, it's time-consuming and it certainly wouldn't do anything to improve your relationship with the carriers that serve you.

CHAIRMAN ELLIOTT: And the last question that I have, with respect to the present standard on access and anti-competitive conduct, I know there's been some discussion in these comments about the standard and what's happened in the past. Obviously, we've been at this for 25 plus years, really, without many results.

If you had to set a standard, you

know, there's obviously one extreme which I think you believe is the anti-competitive conduct standard, and then there's the other extreme, which you hear is some kind of open access. Is there a standard that you think would work somewhere in between?

MR. STONE: Mr. Chairman, we have to beg off on this question for a very simple reason. We represent a broad coalition, and the members of the coalition have different ideas. We actually cited, by necessity, that we couldn't offer as a group a specific proposal.

But I think you've heard in the comments a number of sensible ideas, and these ideas, in our view, should be debated in a further proceeding, and I'm sure you will get a number of ideas and more academic comment on various ideas as well.

CHAIRMAN ELLIOTT: Thank you.

MS. BOOTH: Mr. Chairman, on behalf of the League, we very much believe that a middle ground standard can be developed, and I can tell you that our organization is working right now to try and develop something that we hope we can bring before this Board very soon.

We're not in a position to unveil that here today, but we absolutely think it can be done, and we look forward to having that productive dialogue with you in the very near future.

CHAIRMAN ELLIOTT: Thank you. We appreciate that.

MR. McBRIDE: I just want to add, Mr. Chairman, that no shipper supports, so far as I know, with perhaps one or two exceptions, the Board's current policy. No shipper, as far as I know, not a single one, has endorsed open access in this proceeding.

That leaves you in the middle, and I think the statute does provide some guidance on that in 10705.

CHAIRMAN ELLIOTT: Thank you.

Vice Chairman.

VICE CHAIRMAN BEGEMAN: My first question for you is are you basically talking about the Class 1's, or are you also talking about the shortlines in your testimony?

MR. McBRIDE: Let me speak to that first, because I spoke about the facts and the lack of competition. It's overwhelmingly a problem with the Class 1's. There is evidence in this record of Class 2's and 3's competing more extensively than the Class 1's, although when a Class 2 becomes part of a Class 1, then you start to run into a problem.

But we have certainly circumstances in which at least the shorter railroads have indicated a willingness to compete, and as Mr. Marino said, we're not trying to prove that 100 percent of the time in all 50 states, the railroads refuse to compete.

There are pockets of competition. Certainly, in the area of intermodal transportation, there seems as if there's been some vigorous competition, at least for much of the last 30 years. But in most areas, we see the Class 1's have figured out how not to compete with each other quite frankly.

VICE CHAIRMAN BEGEMAN: And by "not competing," do you mean they're not offering you a competitive lower rate than the guy down the street?

MR. McBRIDE: Sometimes they don't even offer a rate, and when they do offer a rate, it's so unreasonable, there's no point in continuing the conversation. That's a product of the last several years.

Until 2003 or so, I can tell you that people in places like Chicago, which has no shortage of railroads typically, you know, could get competitive rates from the railroads.

After 2003 or 2004, the railroads didn't have to do that anymore. They didn't have enough capacity to go around for things like coal, and therefore for the most part they did not. Union Pacific's offered some specific examples. I won't go into the details, because they're redacted, under protective order. But those few exceptions, I think, don't disprove the rule.

VICE CHAIRMAN BEGEMAN: What I find interesting about your comment about how things changed in 2003 or 2004 is that probably half of you in the room were trying to come before Congress or the Board back then to make changes because things were not satisfactory to you.

You know, a lot of this is very repetitive, and I don't mean that in a derogatory way. But you know, you weren't satisfied, happy with the way that things were before 2003 or 2004. So my question is, were they legitimate complaints, or did things just completely change in 2003 and 2004?

MR. McBRIDE: I've been around this for 35 years. I was a young lawyer who worked on the Staggers Act, so I think I can speak to the entire history of it. I will tell you that the shippers were not all on the same page before 2003 and 2004, as I've alluded to a bit in my opening remarks.

There were industries that had the benefit of more competition in the past. So you didn't see the kind of unity back in the 80's and the 90's that you're seeing today, as reflected in our comments.

There were huge problems in the 80's and the 90's and early 2000's, but they tended to be for the people who were the classically captive shippers, coal, chemicals and grain, and some of the other industries.

What's happened is that the rest of the industries, the rest of industrial America has now experienced the same problems, the NIT League members, the automotive industry, potatoes and on and on.

So what's happened is there's been a structural change in this industry, and it just kept getting repetitively worse and worse. We all tried to warn the ICC and the Board in the BNSF merger, in the UPSP merger, in the Conrail acquisition, this is going to happen. We're not going to see competition, trackage rights over thousands of miles are not going to work.

The tenant can't compete with the landlord railroad. I don't know how many times I said that. The Board said oh, it will all be fine. Then in 2001, the Board adopted merger guidelines that said well, I guess it didn't work out so well.

So now we're going to change the merger guidelines. But that was locking the barn door after the cows had gone. Then the railroads took advantage of the situation that they had been presented with in those mergers, as approved by the Board.

You have the authority to do something about that, but that's what happened in a nutshell. It was bad; it's gotten worse, and now we're all in it together.

VICE CHAIRMAN BEGEMAN: One of your proposals was reciprocal switching. What would the impact be on rail operations, and of course, I will ask the next panel that as well. But you know, and what are you willing to pay for the switch?

MR. MORENO: I think it's telling that even in the Christensen report that was prepared for the Board, reciprocal switching was identified as probably having the greatest benefit with the least cost to the rail industry. Therefore, that provides an opportunity to enhance competition with the least risk, from the Board's perspective, on this issue.

As far as the pricing, we put in testimony from Dr. Economides, suggesting that pricing on a bottleneck segment, which is what a reciprocal switch essentially is, should be cost-based. I think the Board can conduct a proceeding to ascertain that.

MR. STONE: Yes. The cost-based standard was adopted by the FCC, for example, in response interestingly to Dr. Willig's testimony in favor of a cost-based standard, in addition to Dr. Economides' testimony at that time before the FCC.

What exactly the costs are that should be included, I think that's going to be one of the subjects for debate in the additional proceeding. But you know, the railroads are not going to get a paltry amount. They're going to be able to recover all their costs.

MS. BOOTH: Vice Chairman Begeman, I'm sorry Mike. You know, on your point of impact, I think that everyone can also look to the north in Canada, and see another country that has a system of interswitching rules that is certainly much simpler and allows for almost automatic access, as long as certain conditions are met within a distance of a terminal.

We see the CP and the CN doing just fine, in terms of the impact on their profitability and their revenues. So our view is competition will be good for the railroads, just as it will be good for the shippers.

MR. McBRIDE: And Madam Vice Chairman, I just want to add something you may or may not be aware of, and that is when the railroads themselves have agreed to grant trackage rates to one another, to resolve their differences, leading up to or in the mergers and acquisitions, for example, in UPSP and in Conrail, they used cost-based terminal trackage rights, access rights, as the solution.

They don't have to come here have you set a rate. This 29 cents in Conrail per car mile, for example; I think it was 34 cents in UPSP. That's how they do it, and that's something similar that we think would work very effectively without your having to have hundreds or thousands of these kinds of disputes.

VICE CHAIRMAN BEGEMAN: Well again, besides the cost of it really, the impact on operations and, you know, an efficient and effective transportation system, I really will want to hear from the operators as to at least what their thoughts are on it. I think I'll stop for now.

CHAIRMAN ELLIOTT: Thank you. Commissioner Mulvey.

COMMISSIONER MULVEY: Thank you. I want to turn to this issue of profitability. There are a lot of ways in which to define profitability, and economists have their way; others seem to have somewhat unique ways. I was interested in the testimony of Mr. Stone, that railroads are in the top ten percent of all industries.

This sort of runs counter to the Board's finding that I believe as late as 2009, again we found that none of the railroads actually achieved revenue adequacy, when you took into account the cost of capital, both equity and debt capital.

We have made changes in the way in which we calculate the cost of equity capital. At the suggestion of the Western Coal Traffic League and others, we've adopted a capital asset pricing model. We have now since included a multi-stage discounted cash flow model, to try and get an accurate measure of the cost of capital.

The railroads also complain that our measure of railroad profitability does not fully account for the cost of replacing the capital stock as it wears out. They would prefer that we use replacement cost in valuing the capital assets of the railroads, which would reduce their profits even further.

I think one of the things that's bothered me a bit about all the testimonies I received, and I alluded to this in my opening remarks, that there's a shortage of analyses. I would like to get more analytical input to help the Board make decisions.

I would like to throw out a question to the parties, how do you reconcile the Board's finding that the railroads do not earn their cost of capital with these findings, reported in *Fortune* magazine?

I worked on the Hill, so I'll stick to the ones -- I'm looking for objective, analytical studies, that show that the railroads are in fact relatively that profitable, and not just for a single year. That was a recession year, but in the last four or five years, that the railroads have made very good profits.

MR. STONE: Commissioner Mulvey, I'd simply point you to the Senate Commerce Commission --

COMMISSIONER MULVEY: I said I wanted the Fortune 500 article or something in the academic literature, that does an analysis. I've read very, very carefully the Senate Commerce Committee. I worked for the

Hill, as you know, and I'm looking for something that is reflective of academic analysis and numbers.

MR. STONE: Well, I can't really add to the academic analysis, but certainly the reality has been that the railroads have not had difficulty raising capital on Wall Street. People have pointed to the Warren Buffet acquisition and so forth.

I would point out one comment that Mr. Buffet made. He was not buying Burlington Northern because it was an entity that could charge monopoly profits. He compared it to the utilities that he already owned; that is, they would make steady profits; they were regulated to some degree, like electric utilities, and the traffic wasn't going to go away. There was really no other way you could ship coal, no other way you could ship chemicals.

With his faith in the growth of the American economy, he just found that this is a company that is going to continue to be profitable year-in, year-out.

COMMISSIONER MULVEY: Mr. Buffet, I believe, said he was investing in America, not simply a particular industry, that he believed that railroads were critical to the long-term success of America.

MR. STONE: And you know, I think everybody who's spoken so far shares that perspective. We're looking to increase economic efficiency; we're looking to promote the growth of the United States economy for the benefit of everyone, railroads, shippers and the public.

MR. McBRIDE: Commissioner Mulvey?

COMMISSIONER MULVEY: Yes.

MR. McBRIDE: There is an analytical study in the record. Fourteen years ago, Alfred Kahn provided this to me and said, you know, make use of it when you need it. It's Attachment A to the initial comments of Wesley Chemical Corporation, and he suggests market to book ratios.

He concluded that the Board's standards were unworkable, and it's not because of the cost of capital. You labored hard to try to get that right, and that's perhaps beyond the ability of mere mortals to get exactly right.

So let's assume you got that as close to right as you can get it. The problem is not in the cost of capital. The problem is in the denominator and the return on investment calculation, and both Professor Kahn and Professor Jerry Hass, who used to be at FERC, now at Cornell, provided a backup report to Professor Kahn's statement, explaining that with merger premiums, with double-counting of assets when the accounting standards changed and with a variety of other problems, the Board's revenue adequacy standard, the return on investment standard is not workable.

The Wall Street standard is

average earnings growth and return on equity. Equity is easily ascertainable. So I suggest to you there is the analytical work available to you, if need be, to proceed on this, and I hope we finally have a level playing field for that analysis. Thank you.

COMMISSIONER MULVEY: Thank you. Any other comments on that one? Another thing that was raised was also the effect of railroad rates, whether they're unreasonable or not, on our ability to compete in world markets.

The railroads charge that many of these concerns about railroad rates are overstated, because the cost of rail transportation is a small fraction of the overall cost of a product, and in fact, because it has been America's excellent transportation system that has improved that competitiveness around the world in terms of competing in world markets, even when other countries have lower labor costs or lower resource costs.

But our transport network has been so efficient and so effective that it really has made us more competitive. Now we're hearing that these higher rates are making us less competitive.

Again, I didn't see very much in the presentations showing what percentage of costs, the rail rates were of total cost, and how that translated itself into higher product costs worldwide, causing us to lose market share and for businesses to move overseas.

Does anyone give some examples of that that they might have? Mr. McBride.

MR. McBRIDE: I did give you some in the opening, and I did note the fact you're going to hear from several chemical companies. But let me just give you one astonishing fact. You might want to come back to this when you hear from them.

I'm told that rail rates are now more than 50 percent of the total cost of producing chlorine in many markets, and even where lesser percentages are involved, as I indicated with respect to the DuPont situation, Oxichem situation, the Total situation, rail rates either are or could have been determinative, if DuPont hadn't come to the Board for relief, and Oxichem was its customer.

Apparently, there was a resolution there that didn't necessitate a Board's merits ruling. But DuPont presented you with affidavits from Oxichem of the problem, and Total's comments here present the problem of loss of production in California, simply because of rail rates. So this has now become a very substantial factor.

One final point. It used to be that the chemical companies told me that natural gas was the single biggest determinant on their costs. It's no longer, because natural gas prices have declined so much, and rail rates are now often the single most important factor in whether they can compete.

COMMISSIONER MULVEY: The railroads made that very point about the importance of natural gas prices. But it is true that with the development of domestic natural gas supplies in the last few years, that seems to have changed.

MR. McBRIDE: Yes, I don't think there's any dispute about that. But what they don't go on to say is what I then said, which is now, therefore, rail rates become the most important factor.

MR. STONE: Commissioner Mulvey, I don't have much to add on the quantitative analysis. But just as a conceptual matter, I think it's been alluded to in part, but let me just state it more expressly.

If you look at what the leading export industrial sectors in the United States are, they might change a bit from year to year. But typically chemicals is one or two; coal is up there in the list; agricultural commodities, often one or two.

These are the -- this is the freight that bears some of the highest rates of any industry group in the United States. They're the ones who are trying to export. The freight that tends to bear the lowest rates are the manufactured products from abroad. So you know, at the same time, we're sort of hurting domestic manufacturers in a sense by giving lower rates to that traffic.

We understand it's competitive. We're not arguing that intermodal traffic should not have the rates that it does because of competition, and we're in a sense penalizing the main export sectors of the United States economy.

MR. WARFEL: I can give you a little bit of a real life example too. My employer, one of our business units, all of the capital that has been expended for capacity enhancements has been in Canada for about the last five to ten years, simply because of the competitive rail situation up there.

COMMISSIONER MULVEY: One final question, and it sorts of gets to this argument of *primum non nocere*, that is, "first do no harm." Some of the suggestions and recommendations would result in relatively draconian changes in the Board's policies towards reciprocal switching, open access in general, etcetera.

If the Board were to make a major policy change regarding access, would you support doing so on a trial basis, so that the Board could gauge the impact on the railroad industry?

Say for example, put new rules into place which might sunset in five years or so, so we could go back and see whether or not these changes have done the damage that the railroads suggest they might do, or in fact have, improved competition, lowered rates, but the railroads are still revenue-adequate.

Would you care to opine on that?

MR. STONE: Commissioner Mulvey, I think your time frame, five years, is about what we have in mind, in terms of seeing whether this works or not, will a competitive dynamic. I guess the one thing I would take issue with, the railroads are quite able to bring to the attention of the Board, if something's not working.

I'm not sure you need to build in an express sunset provision at the outset. Rather, adopt a policy. I think what you're going to see is not a draconian change, but as I said, assuming there are clear guidelines that people can look at and know what to expect, people are not going to be flocking into proceedings.

They're simply going to be sitting down to the negotiating table, aware of the changed regulatory environment, and they will work out policies. You may hear very little from your end. You'll hear some.

Yes, there will be some proceedings, no doubt. But again, a five year time frame is probably reasonable in terms of seeing how the competitive dynamics work out, and what the effects on the parties are.

MR. McBRIDE: Two quick comments. First, remember that the Christensen report indicated that reciprocal switching would likely have the least financial impact on the carriers. So that would be a good place to start, and with respect to bottleneck rates, there's a great irony in how the Board's regulated it for the last 25 years.

The statute says that you shall consider whether the railroads are earning adequate revenues when you set rates, and yet stand-alone cost has nothing to do with revenue adequacy.

You've actually prescribed a SAC rate, for example on a BNSF case involving Omaha Public Power District, shortly after the standard was adopted, despite the fact that

BNSF, the BN at that time, was revenue inadequate.

So I suggest to you that if you required the quoting of bottleneck rates, and you moved toward a different standard, and the railroad's revenues were impacted, you can adjust the prescription to take that into account.

Just as in the Basin case, you used 240 percent, and in the small shipment cases, the three benchmark cases, you set revenue variable cost ratios that are indicative of the other traffic on the railroad.

So I think the Board has the flexibility in setting rates, to take revenue adequacy into account, and I submit the statute requires you to do that.

CHAIRMAN ELLIOTT: Thank you. We'll now bring up the next panel. I appreciate your comments and your responses.

(Pause.)

MR. HAMBERGER: I hope this doesn't count against our time, Mr. Chairman.

CHAIRMAN ELLIOTT: You're good so far. Is there anybody left over there at the AAR?

(Off mic comments.)

CHAIRMAN ELLIOTT: We'll now hear from Panel III, the Association of American Railroads. You have 40 minutes.

Panel III

MR. HAMBERGER: Mr. Chairman, thank you. Vice Chair Begeman, pleased to be here before you for the first time; Commissioner Mulvey, good to see you again as well. The AAR is pleased to have the opportunity to present its members' views on the Board's rail competition rules, and the Board's responsibilities in carrying out its statutory obligation in the context of those rules.

To offer a perspective at the outset, there are four fundamental considerations that we believe the Board must keep in mind, as it evaluates the comments and testimony in this proceeding.

First and foremost, today's balanced regulations work. They work for the railroads and they work for our customers. After decades of decline, attributable in large measure to over-regulation for much of the 20th century, America's freight railroads today connect American businesses to the global market, support millions of jobs across the country, and deliver the goods consumers want and need.

We have succeeded in achieving enviable productivity gains and solid economic growth, in an era of decreased regulation. The country's rail system is second to none in the world because today's regulatory framework supports the private investment freight railroads make each and every year to meet customer expectations, to help keep the economy running.

Since the passage of Staggers in 1980, freight railroads have invested $480 billion in private funds to grow and modernize this country's rail network. That's more than 40 cents out of every dollar in cap ex and we do it, not the U.S. taxpayers.

President Obama recently called on U.S. companies to "get off the sidelines and invest." I was there at the speech at the Chamber. It was a great call for investment in infrastructure. It was one of the areas he particularly stressed.

Well last year alone, during the worse recession in decades, the Class 1 railroads invested nearly $10 billion in cap ex, and in 2011, they announced intentions to invest another $12 billion in cap ex.

We're not sitting back and waiting until the economy is fully recovered. We are already on the playing field today, planning and building for tomorrow. These private investments must continue in the face of customer demand for more capacity and more service.

In fact, the administration's draft National Rail Plan recognizes the public benefits when more freight is moved by rail. Less fuel is consumed, less pollution releases, less congestion on the nation's highways, and fewer public dollars needed to maintain and build highways.

Forced access will reduce railroad revenues. That will in turn severely harm our ability to reinvest, and without these private investments, customers cannot grow their businesses and support new jobs. Our nation can ill afford this scenario, particularly as our fragile economy looks to recover.

We need to preserve those regulations that encourage private investment, and in turn allow us to meet the needs of our customers, large and small.

Secondly yes, railroads are indeed in better financial condition than they were before 1980 and thank goodness. But even with these improvements, the best year on record, the industry is at the median of return on equity and return on invested capital.

As Mr. McBride himself just said, it is return on equity, ROE, that Wall Street looks to, and in ROE, we are at the median, as you will see in Mr. Rennicke's statement. In fact, the fact is let's face it. Customers calling for forced access really want lower rates by eliminating differential pricing.

But changing the rules for access is not a remedy for rate concerns. The Board has today and exercises it, and again, Mr. McBride just commented, DuPont came here and got relief. The Board has the authority and exercises it, to address customer concerns in individual rate proceedings or, as it has done, in reviewing the standards for rate review.

There is no basis from the testimony in this proceeding to change the access rules. Third, requiring forced access will significantly affect the level of service and network operations today's freight rail customers have come to expect, and Vice Chair Begeman, you mentioned that in your questioning.

I draw your attention to the comments of Lance Fritz of Union Pacific, and Mark Manion, who will be here before you tomorrow, chief operating officers, and they can go into much more detail than I about how forced access will affect the ability to invest, the ability to achieve economies of density, and the ability to have a free-flowing network that our customers need.

Last, there has been no change in the law or Congressional policy regarding rail competition. Statutory provisions, as well as attendant Congressional policy and guidance to the Board, have not changed. The Board and its predecessor, the ICC, have followed the direction of Congress with respect to *Midtec*, bottleneck and other decisions regarding competitive access.

Congress has not found fault with the agency's approach by directing it to do otherwise. Since the Board has appropriately followed Congressional policy and that policy has not changed, there is no legal or policy requirement for the Board to change its approach to rail competition issues.

But beyond that, there is no Congressional mandate to change the law or policy. You have before you, in the strongest possible statements from members of Congress in both houses and both parties, that they believe that the type of changes being proposed by some in this proceeding will have severe consequences not only on the railroads but more importantly on the customers we serve, the employees that work for the railroads, and the U.S. exports and global markets.

Reexamination of the Board's

competitive policies is unwarranted and unproductive. The Board's current competition rules have contributed to the ongoing rail renaissance, and there is nothing in the law, in Congressional policy, in economic theory or in the testimony in this proceeding which would justify the Board taking any further action to consider or to reverse the proper course it has followed to date.

In conclusion, as you have mentioned as well, Mr. Chairman, the changes that some are calling for are not tweaks around the edges. They're clearly systemic changes to the economic model of this industry. I submit to you that these kinds of fundamental policy changes are more appropriately resolved in Congress and not by an administrative agency. I'll turn it now over to Mr. Burkhardt.

MR. BURKHARDT: Well good morning Chairman Elliott and colleagues. Thank you for this opportunity today. I'm not going to repeat my written testimony, but will continue to focus on competitive access and the operating issues that come out of that.

I believe that forced access puts in jeopardy the many gains that we've seen in the last 30 years. Let me spend a few minutes, first of all, in an area that I've been active in, and that's investments and operations in Europe.

Often, the European model is cited as being very pro-competitive by customers, and in a sense it is. But it's hard some very adverse effects that we as rail operators in Europe have suffered with. It creates some very inefficient outcomes.

First of all, the full cost of infrastructure capital falls on the government, and I don't think that we're ready to do that in the U.S. So European railways don't have that responsibility on them. Operators are essentially using trackage rates, but they have no control over the infrastructure.

Because these operators have lost control, on all aspects of the point-to-point operations, they have no say over issues such as train lengths and weights and other vital factors that denominate rail efficiency. The result of this is interesting, in that freight rates in Europe, measured on charges for net ton mile or any other basis, are far higher than what we experience in North America.

This model has failed to achieve what railroads and shippers require, and has resulted in a very small rail market share, on a continent that has higher population than North America, and should be doing proportionately better in terms of rail volumes.

Further, the result has been that railways in Europe are dealing only in unitrains, and the small part of the operations that remain handling single car shipments, which is, as you know, is very significant in North America, is fading fast, because the regulatory infrastructure does not provide good conditions for a network operator, which is what is necessary to handle single cars.

Let me spend a minute on the testimony of Dick McDonald, who is a friend and long-time colleague when I was with Chicago and Northwestern Railway. Dick has been representing the coal industry in this proceeding. He and I both worked on C&NW's entry into the Powder River Basin in the mid-80's.

He was planning the infrastructure, the engineering side of it; I was managing the negotiations with Union Pacific, our connecting line and the train operating plan. I think we did a very good job in a streamlined run-through operation involving two railways.

But when I look back at that, we could have done better if it was a single railway. For example, at the interchange point, South Moreau, Nebraska, we provided for repair facilities, a locomotive shop and other aspects where railways normally interchange in the traditional manner.

So we lost some efficiencies there that I'm assuming Union Pacific, after they later merged with C&NW, has since corrected. There was also duplicate facilities at Council Bluffs, Iowa, where those trains came back onto C&NW. So with some of the open access and competitive changes that are being talked about, there is a loss of operating efficiency.

Let me spend then a moment on the capital requirements of the industry. There's going to be an awful lot of discussion of that. As I mentioned, the European capital for infrastructure comes from government, and I don't think our government is in a position to increase their spending on rail infrastructure spending, with the other demands that they have.

I don't think we as an industry want to cross that bridge. It's hard to believe the size of the requirements for increasing capacity. In my experience, back in the 70's and in the 80's, we were fighting the ability to maintain rail operations and to maintain every plant that we had.

In fact, we were abandoning lines wholesale, in the idea that increasing capacity was an idea that never occurred to us. Today, that is completely changed, and one of the key reasons that it's changed are that the changes that have come out of the Staggers Act, now 30 years old. Rail management today are planning increases in capacity, and this comes at huge cost.

We heard earlier testimony about pricing changes in the early 2000 period, 2003-2004. I think what we find at that time is when the industry ran out of capacity on the main lines. They needed to raise additional capital to improve capacity on the lines, and the market was allowing them to increase their prices because of this constricted capacity.

We need to protect that type of outcome, because that's what free markets are all about. Something that's mandated just plain doesn't work. Involuntary proscriptions can cut off capital investment, and not allow the large funds to be raised that are necessary to do our job.

Let's keep what works in place, and try to move forward on a voluntary basis with our customer base. Thank you.

MR. RENNICKE: Good morning. My name is Bill Rennicke. I'm a partner in the consulting firm of Oliver Wyman. Over the past 40 years, I've been fortunate to assist with the transformation of railroads all over the world, starting as a brakeman in the 1960's on the New Haven Railroad, which was bankrupt at the time, working later in the industry restructuring the B&M Railroad, and then as a consultant setting up the entire structure, for example, of the Mexican railroads, restructuring the railroads in Europe. We're now working in Africa and throughout South America.

So my comments today are based not just on our U.S. experience, but some experiences over the world. In Europe, I think as Mr. Burkhardt pointed out, state-owned enterprises maintain the railway infrastructure at considerable public expense.

The freight railroads continue, and in fact they cannot afford to pay really for a good portion of the operating expenses and almost none of the capital expenses. Even in the circumstance, they are facing conditions where the freight rates are, in some cases, two, three, four and five times higher than the rail rates are in the United States.

I've provided a couple of exhibits

this morning. One of them just shows part of the reason why we are able to function that way and offer the kind of rate structure that we do in the U.S., is that we really have tremendous productivity. The work of the railroad industry really over the last, you know, 40 years have brought costs pretty much in line.

That has resulted in, as measured here by some work done by the World Bank, in some of the lowest freight rates in the world. Now certainly not on every commodity and every time, but the other interesting thing is that for most of those other countries that are shown on that chart, those are only the freight rates that are paid to the railroad.

You know, that doesn't take into consideration or try to adjust for the taxpayer or the public support that goes into paying for the infrastructure, and in some of my initial reply, I provided some information on what percentage that is.

The other astounding thing, and we've brought many of the European and South American railroad executives, regulators and even in some cases shippers to the U.S. or showed this to them, is the extraordinary set of outputs from the railroad industry.

If you look at that top bar, the railroads have faced, since the Staggers Act, a 210 percent increase in inflation, as measured in the Rail Cost Recovery Index. So the dollars they pay for everything they buy have gone up.

In spite of this, you know, the operating revenue per ton mile has gone up only one percent, and the operating cost per ton mile has gone down 15 percent.

So the tremendous change in activity in the industry has been plowed back into holding rates down, which have made us much more competitive, both for domestic activity as well as for exports and, I think, has provided the foundation for, you know, for a lot of the changes that have occurred.

The other important thing is that there's been a number of comments about poor service. I guess all these things are in the eye of the beholder. But to the rest of the world, the freight service in this country, unlike passenger service, is the leader.

It's the absolute pinnacle, and we bring many of the foreign railways -- we are now working with Kazakstan and Russia and South Africa -- we've brought them all to this country to learn how, while not completely without fault, how the U.S. railroads are able to, on such a consistent basis, produce levels of service that are unexpected and unrivaled almost anywhere in the world.

I'd like to tell you just a little something about the role private investment in the industry. Investment in railroads is largely supported by the recognition by the capital markets that individual customers on the rail network have differing competitive characteristics, which roll off into the overall value of the network.

So when a private investor invests in one of the U.S. railroads, and I provided information just on the size of that from the large equity providers, and standing aside for the moment even the debt, they're basically recognizing the value of that franchise, just like you would look at the property value of any other assets and any of the productive assets in the economy.

The changes to that dynamic, of what is the value of those, of that franchise and the value of those assets, will have a huge impact on the interest and investing. In fact, instability or testing of various types of regulations that could materially affect whether differential pricing could be applied as it is today, recognizing that there are different competitive circumstances, will substantially chill, I believe, the investors' interest. We work for a large number of people who invest in the railroad industry and their equipment.

In fact, it has been the relative stability of the last 30 years, not the nature of the regulation itself, that has brought investment levels up to where they are today.

If you just take a couple of simple back of the envelope metrics, if the actions that you're considering here today were completely successful, and moved all freight rates down to 180, to the regular 230 threshold, the railroads would lose $5.2 billion of contributions.

You can simply use numbers that are provided by the STB to calculate that base, and I think that's 2009.

That falls right to the bottom line. Even if you say, well that would never happen. That's catastrophic. That assumes competition everywhere. Even if it falls to an average of 210, so the rates above 180 center around 210, they lose $2.6 billion, and there's really no way to recover that.

One, you know, a couple of comments, I think going back to some of the questions about whether the railroads are profitable and how they stack up against the industry in my reply comments.

I call your attention to some exhibits labeled 2-1 to 2-5, I believe, which basically use public measures of industry performance, where we took some of the companies participating in this hearing, industry standards.

We just plot the railroads' performance using Hoover and Value Line, which are recognized, you know, independent companies, to show, and the railroads are not certainly in the top ten percent. You find good ones and you find some in the middle and some that are below.

Just a few remaining comments on the importance of railroads with imports and exports. We've talked a lot about exports, and I think the railroad industry, and I've been involved in many both railroad-related and shipping line-related and port-related activities, you know, provide a foundation for the export base in this country.

Our distances are far greater. If you look at coal, in Queensland, the coal is much closer to the ports and in this country, the coal is sometimes two, three, four, five times those distances, particularly western coal.

So for exports, the railroads have done quite a bit. I mentioned they were even willing to invest in a port in Washington state, and were willing to do that than totally shut down. But imports are extremely important also. Most auto parts that fuel American jobs in the auto industry have at least ten percent, and some as high as 50 percent foreign parts content. All those parts come in containers in railroad cars.

If we did not have an efficient

system to handle both imports and exports, just as that one example, you could not support that kind of offshore production.

My final comments, and they will be addressed, I'm sure, by other people, refer to what are the operating impacts of creating reciprocal switching or access, as is being considered. You can almost go back and track to the 1980's, the improvement in railroad performance based on the simplification of the system.

There were once five or six hundred intermodal terminals in the country. There were thousands of interchange points. That consolidation has led to a much more efficient system. Every time you open up another classification choice, or sorting choice, you open up the probability of a failure and you open up an opportunity for service deterioration.

One of the things that we provide is the technology that the railroads use. All six North American railroads use that technology to put their operating plans together. It's called different things on different railroads.

That plan basically looks to minimize the number of transfer points, because that's the reality of how matter how hard you try, you're going to have a problem. If you think of airplane travel, if you have a direct connection from Washington say to Los Angeles, and you are on that trip, versus Washington to Los Angeles via a hub someplace, your probability of having a misadventure is much greater, because you have to make that one stop.

That's essentially the same principle carried out thousands of times, and there are others who are much closer to the day-to-day costs. I think we'll talk, we'll refer to that. But that has been an advantage that we have focused on, as we've taken the U.S. model and taken it to the foreign countries. Thank you.

MR. WILLIG: Good morning. I'm an economist. Everybody else is playing economist so far. I'm a card-carrying one. I've been studying regulation policy toward transportation and toward telecommunications for a very long time, so much so that I easily predate Staggers.

I know that competition, along with appropriate regulation, thanks to your predecessors and yourselves, since the Staggers Act, have led to absolutely excellent rail industry performance for the public interest, both competition and appropriate regulation.

So as a result, I'd like to focus on some of the indications in this record that bear on your views of what is appropriate policy toward both regulation and competition going forward. I'm disturbed because there's some mistaken claims in this record, first of all, about what are signs of monopolization.

How do you tell? What are the indicators? First of all, increasing prices are not signs of monopolization. Increasing prices can be an important part of competition when costs are rising, and when capacity is tight, and you'll be hearing more about that for the next two days, but I just wanted to get that off my chest.

Economic testimony for WCTL, economic testimony asserts that UP and BNSF have not grabbed the coal traffic from each other, and the testimony further assets that that's a sign of collusion. Well, the railroads' testimony already on the record, and you'll hear more about this, I'm sure, shows that this assertion is factually way off base.

What bothers me even more, as a matter of economics, is that the assertion is surprisingly wrong and needlessly inflammatory, as a matter of policy. I just wanted you to hear that from me.

After all, to say that coal traffic is moving from carrier to carrier neglects totally the fundamental point that match-ups in general between suppliers and customers, can be efficient and stable under totally highly competitive circumstances, exactly like those that the UP and the BNSF describe, those circumstances that surround their businesses.

So it's just bad economics to jump to an inflammatory conclusion like collusion, just because traffic patterns are stable. Well, speaking of what is competition and what is not, the most important point I think I can make today, given what I've been hearing, is that involuntary access should not be confused with real competition.

That's because it, involuntary access, does not bring the benefits that real market forces create for the public interest. Three reasons I want to highlight. First of all, the involuntary pricing of involuntary access, which is a key part of any such policy, is regulation, not competition.

Moreover, it's regulation or prices that has a very strong, maybe even a controlling effect on the regulation of end-to-end pricing, not just the pricing of the bottleneck or the access points or the interchange.

It goes right to pricing of end-to-end services. It does so without the care that regulation of end-to-end prices really needs and that has been exercised by the Board and by its predecessors since the Staggers Act. So it's a way to get in the way of appropriate regulation of end-to-end pricing.

Second of all, even the prospect of forced access impedes voluntary negotiations that themselves tend to lead to efficient routing and efficient logistics. Third, involuntary access arrangements undermine the differential pricing that everybody agrees is absolutely essential in this industry, the Ramsey pricing, as we economists like to call it, because the carriers absolutely have to have the ability and they do exercise it, to undertake differential pricing in order to boost total traffic, in order to have a shot at recovering their costs and providing the funds that they need for appropriate capital investment.

So that's why there should be no forced access, unless there is a finding of any competitive abuse, that stands in the way of efficiency. You shouldn't just go out and prescribe all kinds of access arrangements of any kind, without a showing that there is a competitive problem for which that would be a remedy.

Telecommunications is different. It has a totally different set of basic circumstances than railroads, and those differences go right to the appropriateness back in '96 and since then, to a system of mandated access, quite different from the circumstances in our industry here.

First of all, telecom's total system costs can be covered by cost-based prices for basic network elements in telecom, and this is not true in railroading. But it is true in telecom, and that was the finding of Congress, of the FCC, by me and my co-authors in long testimony, which we proudly put forward on the subjects in telecommunications. Different than in railroading.

Second, mandated access in telecom was seen, and we now see the good results, as the only way in the time to straighten out retail rates, which would totally infuse with long-standing cross-subsidies. That was the situation in telecom, and part of the findings of the FCC and me and my colleagues, was that it was hopeless to get rid of those cross-subsidies without cost-based access pricing, that would not stand in the way of overall coverage of costs.

Of course, here in this industry in railroading, regulation has had the good sense to stop cross-subsidization, rather than fostering it, as had been the case in the history of telecommunications.

Meanwhile in telecom, I don't know if you followed this history, but I've lived it in my old age, every step of the way toward implementing mandated access in telecom was horribly complex, and led to and still is leading to endless litigation, both before the FCC and in federal courts, with three trips to the Supreme Court on those issues over the last 15 years.

Even though telecom is in some ways more propitious to mandated access, it has been a terribly nightmarish process of trying to get it implemented.

In this record, we have testimony by Professor Economides, who was also involved in telecom in its time, on the subject of forced rail access. I hate to say it about a colleague and a friend, is that his testimony does not try to take into account, in his policy prescriptions, the basics of the rail industry.

So as a result, his conclusions about access here ignore the needs in railroading of differential pricing, cost recovery and the operational nightmares that come from forced access in railroading. In contrast, I think the Board and its predecessors have succeeded in taking these factors seriously into account, and crafted an economically efficient policy posture toward access.

I hope and it is my view that we should stay with it. You've done a great job and we should let it rest where it is. Thank you. I'm being given the hook.

MR. HAMBERGER: I think we're about to be given the hook.

MR. WILLIG: You're getting the pat on the shoulder.

(Off mic comments.)

COMMISSIONER MULVEY: We want you back for questions. Thank you.

CHAIRMAN ELLIOTT: Are you done with your testimony?

MR. HAMBERGER: No, but I see the Senator, and I assume you'd like to give him --

CHAIRMAN ELLIOTT: Of course.

MR. HAMBERGER: I know you have questions for us, so why don't we --

CHAIRMAN ELLIOTT: This panel will be quite a while, so we'll have you step in.

SENATOR ROCKEFELLER: I think that was bad behavior on my part, Mr. Chairman.

CHAIRMAN ELLIOTT: That was not. We'll permit it here, and thank you AAR for being deferential. We appreciate it.

Panel I

SENATOR ROCKEFELLER: They were pouring out their souls, and they suddenly had to get up and they had to listen to me. But

I'm not going to be long.

Chairman Elliott, Vice Chairman Begeman and Commissioner Mulvey, I thank you for this opportunity to let me speak to you, and I'm fairly brief, but I try to be sort of clinically logical.

For over a quarter century, I've been working to make sure that businesses that ship their goods by American railroads get a fair deal, and that the railroads serve their essential role in getting goods and commodities to their destinations efficiently, for the benefit of the consumer and the entire U.S. economy.

The Surface Transportation Board and its predecessor, the Interstate Commerce Commission, was created to oversee and regulate the railroad industry, to enforce the law and guarantee fairness all around. Frankly, in the past, the Board has let us down, if I can be so bold. It's a bit rude, but I have to speak what I have to speak.

What it has meant for West Virginia, which is obviously a more difficult state than many in terms of its economics, but I represent it and care about it greatly, is near bankruptcy of steel mills, chemical companies being bullied on prices and service, to the point that they have to consider and do consider relocating their facilities overseas, and consumers who have pay more for their electric rates.

There are a lot of specific examples; I won't bore you with a lot, but I will mention one, which is PPG Industries, which is very large. You're going to hear from them tomorrow, and PPG has a captive facility in Natrium, West Virginia, that last year paid 85 percent higher rates than its own facility in Louisiana.

Pure and simple, this is not competition, in my humble judgment at work, and it is prejudicing businesses against my state, which I greatly resent, because we need every single job we can get. So I'm here to urge you to be scrupulous in your review of the competition in the railroad industry.

After this review that is extensive, I encourage you to act boldly where you can, and where you can't, I hope that you will make incremental changes. Sometimes you can't do everything, but you can do some things. But sometimes people think if they can't do everything, they don't do anything.

The first words I heard when I walked in here, I don't know who was saying this, "let it stay the same." Those are the words I am unhappy with. There's nothing wrong with making incremental changes, because not doing anything is not really, to me at least, an option, and to millions and millions of American consumers and businesses.

You must regulate for the future of the industry, not continuing to solve the railroad industry problems of the past, that have already been remedied. Last fall, I held a hearing about the future of our rail policy, at which you testified Mr. Chairman, to look at the projected needs for both the passenger and the freight rail network.

At this hearing, I released a report on the profitability of the railroads. I didn't write the report; it was a regular report. The report shows that the Staggers Act goal of restoring financial stability to the U.S. rail industry has been achieved, and that significant consolidation has occurred, so that four Class 1 railroads dominate the industry.

When I came here my first year in the Senate, there were 50 Class 1 railroads. There are now four, maybe to become two. I do not know. In fact, last year, these railroads ranked among the most profitable businesses in the U.S. economy. Unlike other transportation modes, they maintained their high profile profit margins, even during the recent economic turndown. Unusual.

With the freight railroad industry entering this new chapter of financial strength, it seems to me that it's not unwise to revisit our national rail policy.

I believe that when this proceeding is over and you evaluate the voluminous facts presented by all sides, you will find that one-sided policies whose sole focus is protecting the health of the railroads is outdated, as well as unfair, unnecessary as well as unfair.

I firmly believe that you will find that we need to restore balance to protect the shippers against the virtual monopoly of the railroads, and modernize the STB's rules to reflect the railroads' profitability and the new industry structure, in fact, quite a lot of new structure in the whole American economy. I think it's a new day.

In that light, I have three priorities for this agency, which I humbly offer. Increasing competition, fixing current laws, rules and policies to give captive shippers competitive options, as a method to control rates and to improve service.

Secondly, improving the regulatory process, making the Board more accessible to more shippers, even to those shippers that may not be captive. They may not have something to bring before you, but they feel that they have an entrance into this extremely powerful Board.

So that if they do have disputes, they can be resolved timely and cost effectively. If they don't, they can learn and have a better understanding of how the system operates.

Finally, making the STB more robust, giving the Board the authority to proactively address industry-wide problems and the resources they need to accomplish that mission. That's not something that's a complaint; that's just something that, you know, like everybody else, you need money.

With these changes, the Board will be primed to oversee the industry's future. I believe the industry's future is a very bright one. I'm very clear about that. I'm fully supportive of a healthy, vibrant rail system.

Railroads are critical to the success of our nation's economy, to support our transportation network and to encourage domestic production of goods. But the American economy doesn't work if all industries aren't thriving. That statement may be a little bit broad, but you understand my point. It all has to kind of work together, for it to work for anyone.

It's really a symbiotic relationship. The nation's manufacturing sector needs the railroads, and the railroads would be out of business without their shippers. But for this relationship to work, it must be fair. Shipper, railroads, industry stakeholders and most important, American consumers, must believe that the system is functioning properly and that the rules are not being blatantly broken or ignored.

Now more than ever, in my judgment, the STB's decision has a very, very clear effect in this new economy of ours, which is whirling about. You have a very, very clear effect on our competitiveness and how business makes their decisions about whether to invest in the United States, or to go overseas, which is the present trend.

I've long believed that legislative reform would be required to exact required fairness from the Board and the railroad industry. Senator Hutchinson and I had hoped to give the STB clear new policy direction in a bipartisan piece of legislation that we had introduced.

But, to your amazement, the legislative gridlock on the floor of the United States Senate and Congress in general, makes this very unlikely in the near term. But I remind you that the STB has also the responsibility, regardless of legislative processes or momentum or lack thereof, to make changes to correct any imbalances in the rail industry.

As commissioners, each of you play a very critical role in making this system work, a formidable role. It's extraordinary power in the hands of three people, and you take your jobs very seriously, I know that, and the current law permits you make significant change to inject competition in the industry and give the shippers the rate and service relief that they do in fact deserve.

Without ignoring history, you must update, I would respectfully suggest, our rail policies for the 21st century, and correct the imbalances in the industry. They are there for all to see. The question is that only a few can correct them.

Now, and I stress this point, the Congress is not functional right now. Everything is held up. Everything is objected to. Every motion to proceed at the consideration of any piece of legislation is objected to.

So I have to face that reality. So I move away from the idea of legislation just a bit, because nothing will happen with it, and I have to be realistic about that. That doesn't make me happy, but I have to deal with reality. So I think that shifts more, in a sense, responsibility to the Surface Transportation Board.

So I hope that you will update our rail policies for the 21st century, and correct the imbalances in the industry, now that the railroads have been brought back to robust financial health. I thank the Chairman, the Commissioner and the Vice Chairman very much.

CHAIRMAN ELLIOTT: Thank you,

Chairman Rockefeller for taking time out of your busy schedule to present your comments to us today. We appreciate it.

SENATOR ROCKEFELLER: Up and out?

CHAIRMAN ELLIOTT: You're good.

SENATOR ROCKEFELLER: Okay.

(Laughter.)

CHAIRMAN ELLIOTT: The AAR can come forward.

MR. HAMBERGER: By my count, there's still 38 minutes left?

(Laughter.)

MR. HAMBERGER: That's not their count.

MR. SIPE: I'm going to say good morning to the Chairman when I can see him.

VICE CHAIRMAN BEGEMAN: He stepped out.

MR. SIPE: Shall I go ahead and start?

VICE CHAIRMAN BEGEMAN: Yes.

MR. SIPE: Good morning, Mr.

Chairman, Vice Chairman Begeman, it's a pleasure to appear before you for the first time, and Commissioner Mulvey. My name is Sam Sipe. I'm outside counsel for the AAR in this proceeding, and this is the first time I've ever had the opportunity to speak immediately following a United States Senator.

I hope I will be equal to the task, and can address the questions that might be on your mind later on when we get to the question and answer period.

I'd actually like to pick up where Senator Rockefeller left off, which was to ask you, as a Board, to revisit transportation policy, inasmuch as it appears in his view there will not be a legislative change any time soon.

As the Chairman indicated in his opening remarks this morning, and in fact he laid it out quite explicitly, there is in fact a guiding rail transportation policy on the books already, and that policy has basically been in place since Staggers. Congress has not seen fit to change it. Unless and until Congress sees fit to change it, I know that your actions will be guided by that broader rail transportation policy, because it's part of the statute.

Now that doesn't mean that within the interstices of the policy and on a case-by-case basis you can't make changes in the way you've done things in the past. But it does mean that the basic lay of the land, in terms of rail transportation, has been pretty much set in stone by Congress, and unless and until Congress directs you to make policy changes, you're not going to be in a position to make some of the changes that we've heard about here this morning.

One of the most critical components of the policy, as Chairman Elliott himself acknowledged in his opening remarks, is that Congress expressed in Staggers and reiterated a strong intent that the agency intervene in rail markets, only to the minimum extent necessary. That hasn't changed.

Now we have something of a debate in this proceeding as to whether what the shippers are contending for would amount to more regulation, re-regulation, or whether it would amount to what they claim is deregulation.

It's hard to answer that question in the abstract, because the shippers have not in fact put before you concrete proposals about what the changes that they're advocating might entail. But I submit to you the notion that they are advocating a regime of deregulation really doesn't pass the laugh test.

In order for the Board to change its regulatory policy regarding access, it would have to make decisions about, first of all, what are the new standards that should govern competitive access. We have a coherent standard on the books today. The shippers find it too stringent, but in perhaps the most striking exchange with the last panel this morning, the shippers were unable to respond to Commissioner Mulvey's question about what standard are you advocating for change.

If you get reciprocal switching, what's the standard that's going to govern when the Board would authorize reciprocal switching. We have not heard a coherent proposal on that issue to date in this proceeding, and I submit that it would be very difficult for this Board to propose a change, given the record that's been established to date, since there is no conduct-based standard for reciprocal switching that's on the table.

If in fact the shippers' real position is that reciprocal switching should be available whenever we ask for it, then that's not a standard at all. It may not be carte blanche open access, but it gives the lie to their notion that they're not asking for restructuring, because carte blanche reciprocal switching would absolutely be restructuring.

The D.C. Circuit in the *Baltimore Gas and Electric* case, said that what the shippers were asking when they advocated a regime like that in the telecom industry, the D.C. Circuit characterized that as restructuring, and it said there was not the slightest indication that Congress intended to mandate a radical restructuring of the railroad regulatory scheme.

Standardless reciprocal switching would amount to such restructuring, and the courts have indicated that that's not going to pass muster.

Let me address briefly another suggestion offered this morning by Mr. Moreno, that the Board would have discretion to modify the existing bottleneck standard. I believe the Chairman alluded to the state of the law on this issue, when he said, in his opening remarks this morning, that the Board had previously addressed its leeway to grant the shippers the kind of relief they were seeking in the bottleneck case.

What the Board said is that giving the shippers the rate control that they sought would not withstand legal scrutiny, as it would defeat a railroad's right to determine at the outset the rates it will use to respond to requests for through service.

Moreover, and this goes to the very heart of what does competition in the rail industry actually mean, the Board found that the relief the shippers were seeking back then in the bottleneck case, does not encourage competition, but would go further and artificially force competition by impermissibly depriving the bottleneck carriers of their initial rate and route discretion.

The Board is on record, at least in my view, having read the cases, that real competition arising from market forces, which is what we, the railroads advocate, is not the same as forced competition of the sort the shippers were asking for back in the bottleneck proceeding.

In conclusion, the current competitive access and bottleneck rules have been affirmed by the courts, and have been established agency precedent for years.

In light of the clear policy and statutory underpinnings of the current rules, and lack of any Congressional action to replace those policies, there is no legal basis for the Board to adopt an expanded program of involuntary access. Thank you.

CHAIRMAN ELLIOTT: Thank you, panel. I'll go to Vice Chairman Begeman.

VICE CHAIRMAN BEGEMAN: I won't have too many questions, I don't think, but I guess we'll see once we get into it. Mr. Hamberger, I do have to say I do disagree with your comment that this proceeding is unwarranted, and --

MR. HAMBERGER: Further proceedings is I believe what you --

VICE CHAIRMAN BEGEMAN: Yes, unwarranted and unproductive.

MR. HAMBERGER: Further proceedings.

VICE CHAIRMAN BEGEMAN: All right. I mean I do think this is a very useful process that we're going through, and I know I'm learning a lot and have a lot more to learn. Thank all of you for helping me do that.

Do you care to respond to Mr. Moreno's and Mr. McBride's comments about reciprocal switching and the cost-based approach that they were suggesting? I realize that you don't even want to get to the concept of whether reciprocal switching could even be changed. But I want to kind of get a sense of impacts.

MR. HAMBERGER: I feel compelled to defer to the real economist on the panel, Mr. Willig.

MR. WILLIG: Card-carrying.

MR. HAMBERGER: Card-carrying, if that's okay with you.

VICE CHAIRMAN BEGEMAN: Okay, sure.

MR. WILLIG: The point I was trying to make, and I was doing it very hurried because of timing, so thank you for bringing that up again. But the point I was trying to make is that when access arrangements are pushed or mandated or forced, especially at cost-based pricing, that governs all of the pricing that results in the industry, including end-to-end pricing, the pricing of the entire movement.

VICE CHAIRMAN BEGEMAN: So it's a domino effect?

MR. WILLIG: You might call it that, although domino effects are always negative, the way, going back to Vietnam anyway. But in some industries like telecom, where cost-based pricing as an ideal that we think we should strive toward, because cost-based prices will cover total costs, and because in the absence of a regime like regulation or better placed regulation, we're going to have a morass of cross-subsidization as we had in telecom.

In a system like that, the domino effect may not be so bad, even though it's a very costly process in terms of the legalities involved and the operational impediments involved. But in railroading, we can't live with cost-based pricing. We don't want cost-based pricing. We need differential pricing.

Everybody understands that. We heard the shippers endorse that. I was delighted to find some point of contact between the first panel and my own understanding, because there's so much in the way of fixed and common costs in the industry, so much track which is used by so many different movements and so many different shippers, so many different commodities.

We want the railroads to have the ability to cut prices close to variable cost, to encourage more traffic, and yet price those shippers who have more value from their rail movements at a level that can help to cover the total cost necessary for the operation.

So we have to have pricing that is not slavishly governed by variable costs in railroading, and for the public interest. If we push access to be widely available on a coerced basis, at cost-based rates, then we're making it impossible for the industry to undertake the different pricing, which is vital for the public interest.

So from the start, the whole idea of wide open, involuntary cost-based access pricing is really the wrong approach for this industry, and really it's quite a disastrous scenario, I think.

VICE CHAIRMAN BEGEMAN: But it works in limited context such as the merger agreements?

MR. WILLIG: Well, maybe as a remedy for a discernible problem. Then, it might very well make sense. I think that is the current standard, that if there's a showing of a competitive abuse which is standing in the way of efficient, logistical arrangements, then there ought to be some regulatory remedy for that public interest problem, as well as for the shipper involved.

Going to then access arrangements that are mandated makes a lot of sense as a remedy, like for a merger problem or for a showing of anti-competitive conduct.

VICE CHAIRMAN BEGEMAN: And that doesn't negate the ability to differentially price?

MR. WILLIG: As long as it's narrow and it's in response to a found problem, then it doesn't undermine the entire needed structure of the industry.

MR. HAMBERGER: It's more

voluntary.

MR. WILLIG: Yes. That's the other point to make, I think, thank you, is that we do see lots of voluntary interchange access routing arrangements in the industry. You folks can probably speak to that much more factually than I can.

But I know that in general, railroads have just loads and loads of voluntary arrangements that lead to efficient routing, efficient logistics and pricing that is subject to regulation if there's a competition problem, or that is just a marketplace, market force kind of pricing if there's not a competition problem, and that's part of the efficiencies that the Staggers Act and the history since then have brought about. Voluntary cooperation in routing. That works for efficiency.

VICE CHAIRMAN BEGEMAN: Can one of you comment on the Canadian model, and I'm a little disappointed that none of the Canadian carriers are going to testify before this in the next two days. But if one of you could kind of -- I mean I know they have submitted for the record, the written record. But why can't it work?

MR. BURKHARDT: I can discuss that, having done business there as well. They call it interswitching rates, and it's based on distances from the interchange location, where two railways come together in kilometers. I believe it goes out as far as 50 kilometers, and there are about three or four zones, 10, 20, 30 -- I'm speaking from memory, so I'm not exactly sure where the dividing line is.

It's a fiat system. Transport Canada, the regulator or the authority, has established a charge, applying within Zone 1, Zone 2, Zone 3 and so on, that they update about once a generation. They're generally seen as loss leaders for the railways that perform the services, although I suppose the railways that are buying the services think that that's okay.

I don't see it as a particularly effective system at all, and as other people on our panel have pointed out, it's a completely regulated system. I don't know what the basis of their charges are, whether it's something that they actually went through a procedure to determine cost and then implemented that, or whether it was some number that was pulled out of the air. But the charges are very low. They're much too low to cover cost.

MR. HAMBERGER: Might I throw in a -- I'm sorry.

VICE CHAIRMAN BEGEMAN: How does it impact their ability to provide service?

MR. BURKHARDT: The railway actually performing the switching services is damaged, and in fact the operation that I'm involved in in Canada today has a lot of industry. It's a shortline railway that has quite a bit of industry on its line, that is accessed by Canadian National.

We lose money on the business moving to or from those points, because they're moving on these mandated interswitching rates. So that has weakened our position there considerably. Now we have no say over those, the pricing that the customer gets.

That's all determined by Canadian National, who's taking long haul movements out of Western Canada and then moving them, and then we move them maybe 25 kilometers over our railway at destination.

MR. HAMBERGER: If I can make two comments. One, I think the CNCP have made it clear that this was a policy in Canada as the network was being developed. So it also is a much more linear network than you see here in the United States. So I think that the operational impacts may not be as great, since they have developed with this as a policy.

But secondly, just from a policy standpoint, I would observe, and I just was at a conference in Canada a couple of weeks ago, that with this policy in place, the customers in Canada still want further rate reductions, still want further rate regulation.

I think it really underscores my belief, and what I said in my opening comment, that this is not about access; this is about setting some sort of cap on rates. If this was the answer, then I would infer that shippers in Canada would be quite happy, and that's not the case.

MR. SIPE: One final comment on this, Vice Chairman Begeman. I spoke earlier about how any significant change in access policy by this Board would have to be grounded in statutory change. In NIT League's comments in this proceeding, their opening comments, they stated that the Canadian switching model could not be adopted wholesale in the United States, based on our current statutory structure.

So I don't think it is in fact on the table. It would be, if I understand the shippers' position correctly, there would be no conduct-based standard as well. So you go, once again, from the current situation of a well-defined, albeit stringent standard, to no standard for access.

VICE CHAIRMAN BEGEMAN: You don't want to say anything, Mr. Economist?

(Laughter.)

MR. WILLIG: Oh, ask me another question.

VICE CHAIRMAN BEGEMAN: Well actually, I agree that the issue of the standard has not been addressed, and I am sort of kind of going to the next step, just based on what I have before me here.

Mr. Sipe, in your opening statement, you mentioned that there are changes the Board can make, has the ability to make, and then you also made a comment along the lines of "but yet you can't." What is it that you believe the Board cannot do?

MR. SIPE: Well, I talked about the two things I think the Board absolutely cannot do, which I believe at least some of the shippers are pressing for. One is to basically overturn the bottleneck decisions.

The second is to adopt an approach to reciprocal switching or prescription of through-routes that is essentially standardless, and that has the effect of restructuring the industry.

Now in between those extremes, it's really hard to speak to what the Board could do, because we don't have coherent conduct-based standards on the table. It's going to be very hard for the Board to formulate one based on this record, I think.

VICE CHAIRMAN BEGEMAN: One sort of last issue I'd like to touch on. We've heard a lot about whether it's open access, forced access versus reciprocal switching, bottleneck. What is your definition of what the first panel was recommending? Do you define reciprocal switching and bottleneck as open access?

MR. SIPE: If it's standardless, yes. It's a form of open access. If anybody who -- let's just say if any line haul carrier that gets to a terminal area in which there are closed industries, has the right to serve any industry in that terminal area, then that's a form of open access, at least as to that terminal area.

MR. RENNICKE: I think in looking at the record and the different filings, this is very similar to what we saw in Europe in the 90's, that led up to the European Union 91-440, which was their promulgation of open access. So they may be calling it something different, but without any boundaries, or even with limited boundaries, it will have the effect of open access, because I don't think it will stop with the first tranche of customers, because then the next step will say well gee, I have two shippers, but -- or two railroads, but boy, I'd like maybe a third to come across the Mississippi.

So it looks very similar to the open access commentary, dialogue, cases that were being offered, and in Europe, they adopted it. I think it was a poor decision, but they adopted it.

VICE CHAIRMAN BEGEMAN: Thank you.

CHAIRMAN ELLIOTT: Commissioner.

COMMISSIONER MULVEY: Thank you, Chairman Elliott. I have a few questions on reciprocal switching also. The Christensen report suggests that of the myriad of competitive options that, or the policy options that they looked at, that seemed to, in their mind, have the smallest effect on railroad profitability, and might be one that is most positive for shippers.

Presuming that the Board has the authority to do something about reciprocal switching, and I recognize that they qualified their position in their supporting statement that they filed with the AAR, but nonetheless it doesn't seem to change the position that if one assumes that reciprocal switching is limited to less than ten percent of the total movements, or somewhere in the 30 mile proposed limit proposed by the USDA, why isn't that a reasonable and limited approach for the Board to pursue?

Mr. Rockefeller talked about incremental change, and if this Board was trying to improve the competitive landscape, wouldn't reciprocal switching be probably the least onerous for the railroads to deal with?

MR. SIPE: It could be the least onerous, Commissioner Mulvey, but least onerous doesn't mean that it's in the public interest, by any means. Lest onerous may mean, you know, you only lose a pint of blood a day instead of a quart. For me, that's not -- I'm not on the road to health.

COMMISSIONER MULVEY: Of course, the shippers would say that that's not a loss of a pint of blood; it might be a transfusion, in which case they may feel that they're benefitting from that.

MR. SIPE: Well, they're certainly looking for a transfusion. There's not much doubt about that.

COMMISSIONER MULVEY: Well, reciprocal -- go ahead.

MR. SIPE: Let's focus on the public interest dimension of it though. Yes, I concede reciprocal switching might be less onerous than the other remedies that have been mentioned in this proceeding. But is it in the public interest?

Christensen doesn't say that. Absolutely Christensen doesn't say that. They say the impacts, the adverse impacts would be the least possibly, but then there are two very important caveats. One, they did not have operational issues on their agenda. They didn't look at the impact of any access remedies on operations, and the testimony in this record of Mr. Fritz and Mr. Manion suggest strongly that operational problems, stemming from reciprocal switching, could be substantial.

Second, Christensen made its observation about reciprocal switching within the context of positing a voluntary transaction between two willing parties, and positing compensation that would make sense for both those parties.

I'm quite sure that the kind of compensation that the shippers are talking about here, and we actually got to it this morning in the discussion of the cost-based compensation, is not the sort that you'd find in a voluntary transaction.

COMMISSIONER MULVEY: And reciprocal switching, of course, begins as a voluntary transaction, because there was that reciprocity that was presumed. But it is also true that there has been a real decline in the number of stations and shippers open to reciprocal switching, and there's been a substantial decline for some railroads since 2007.

CN, for example, has had a 60 percent drop in the stations open to reciprocal switching; CSX, who we'll hear from later, has had almost a 50 percent reduction in stations open to reciprocal switching.

This is something of a concern. The availability for reciprocal switching seems to be going down. CP just put out a tariff that announced that any shipper who had not used reciprocal switching, or any station had not used it in the past year would be closed.

Do you want to comment on that policy, and is that a preemptive strike at the Board doing something about reciprocal switching?

MR. SIPE: I personally do not

have knowledge of this policy or practice.

COMMISSIONER MULVEY: We have the data on this, and it is --

MR. RENNICKE: I think just a couple of points. One is just maybe taking a half step back from what you were asking before. One thing I don't think the Christensen study does is look at what the revenue impacts of those locations are.

If in fact differential pricing is being applied as you would think it might, the stations that are asking for reciprocal switching is where your higher-rated traffic works. So your revenue loss is very, is disproportionate. So it may be ten percent of the stations; it may be, you know, 25 percent of the revenue.

That's really a critical item, because that's what investors really look at. They look at, you know, the contribution, the application of Ramsey pricing and differential pricing. As far as the reduction in reciprocal switching, the only thing I can say to that as part of some of the operating work that we've had some experience with, if people are not using it, it's like a turnout or a switch. Many railroads are ripping up switches where the shipper hasn't given them a car in five years or four years, because there's a cost basis to that.

If you're not having to gear up to split the traffic through reciprocal switching from an operating standpoint, and you could start focusing on a better service and a better density, it becomes an operating convenience to say it's not being used, and let's put it away.

I've not seen it used in any anti-competitive way. I've seen it used almost like in the same regard as closing switches. I just will add something about the Canadian experience. We just worked on a situation up there that had to do with coal, and the interesting thing was because now the traffic is up for grabs every year back and forth, one of the two railroads had an enormous investment in car shops, to repair coal cars and to handle the infrastructure, is now saying you know, I've lost this two years in a row, because now I'm getting short-hauled.

I only need 70 percent of those shops. They're making some longer-term structural changes, that if in fact it does come back, there's going to be a service issue, because they don't have the cars and they don't have the shops.

So that's one of the reasons why I think shippers in Canada have maybe not used that as much as they could, because flopping back and forth creates huge havoc for the two railroads, as to whether or not the traffic is going to show up on my line next year, and do I have to gear up to handle it.

COMMISSIONER MULVEY: But of course for the two Canadian railroads, that leaves one. They've had reciprocal switching, the mandated reciprocal switching now for a while, and both of those railroads, especially the CN, I believe, is profitable, even though they may not be happy with reciprocal switching as public policy. Is that not true?

MR. RENNICKE: I think they're profitable. You'd have to go back and really look, and I haven't seen any research on how much of it is really going on up there. I mean it does exist. It's on the books. Whether it's two percent, five percent --

MR. BURKHARDT: It would be a relatively small percentage of the total business in Canada that ever gets interswitched, and the charges -- part of the problem from the standpoint of the railway performing the switching service, which may actually be a shortline, with the guy that's got the 2,000 haul, then coming in and saying now I'm going to give you two cars of business, and we expect you to haul out 20 miles to an industry, and we're going to pay you $150 apiece for this. They're going to get $300 and run out to that industry.

Now if you got a unitrain or call, and you had 100 cars and you got $150 apiece, that might work fine. But part of the problem is that in a regulated, mandated system, there's no way to make those individual judgments that the market does, where the situation is different between one location and another, the difference in what service is provided, what volume is being handled, what is the --

And very frankly, what is the value of the commodity so that the handling carrier can look at differential pricing that are supported in the marketplace, because there is no marketplace, then, in providing that service?

MR. RENNICKE: The other thing I think you could maybe get from the CTA, because I've seen it in hearings that they have, there's a map that shows how many points on the system are within whatever the distance is. Canada is a very long and thin country, and the railroads developed essentially in parallel, and not many places that were within whatever it is, 25 or 35 kilometers of one another.

So if I remember the map that I saw some years ago, there was not a lot of overlapped areas where they were, even within the zone, where it could work.

COMMISSIONER MULVEY: Yes, I think it's widely agreed that any implication of reciprocal switching in the American environment could not mirror the Canadian. It would have to be different, to take into account the very, very different nature of the railroad network here in the United States.

It was mentioned about, that graph came up that we'll see many, many times, the growth of productivity and the lower rates and on and on and on. But isn't it also true that for a long time, productivity gains and the railroads set records in productivity gains, both in labor and capital productivity over the last few decades, especially since Staggers, and most of those gains were passed on to shippers in terms of lower rates.

However, more recently, rates have been rising, and in an analysis that I believe is coming out, and I believe you are familiar with, the productivity gains are no longer being passed on to shippers, but now greater portions of them are being kept by the railroads.

Would you want to comment on those findings, and I'm sure you're familiar with them, because one of the authors of them is somebody who is now testifying on behalf of the AAR. Not here, but --

MR. RENNICKE: Just one comment, and maybe some others can also contribute to that. I think there was actually an exercise you could do quite handily over the last 25 or 30 years, that you could look at the cost structure of the U.S. railroads, railroad by railroad, and almost estimate what could be done if things were done differently.

So you could say I know how far I can go if I can get the flagmen off, get the caboose off, and all of these things, you know, would fit together. So during that period of time, if you looked at the graph that I put on there, the way that the railroads were able to offset over 200 percent cost inflation was that they were taking units of input out of the bottom of the system.

I think one of the things that's happened, and we keep talking about 2003-2004, is that pool of opportunity has vastly shrunk. I mean you maybe even go down one trainmen per train and you can get better efficiency out of some track.

But we've squeezed, you know, you're up to 286,000 pound cars you've got the contents of. That reservoir of change has declined substantially. So that means that for the -- and the inexpensive things were taken care of.

That means that for the next steps of productivity change, you've got to spend money, some real money. You've got to build flyovers, like you see in Amarillo and in Kansas City, and in some of the big complex infrastructures. So the railroads, it wasn't just the case of suddenly capacity got tight, is that they ran out of the cheap productivity things.

Now they're at a point where they've got to spend a lot of money to get the same productivity changes they were getting five years earlier by just abandoning or cutting back, and they need higher rates to cover that. So that's what I've seen as a big driver of why the rates have gone up, and that's, I think, reflected in that chart that I put up there.

COMMISSIONER MULVEY: And it also suggests why the productivity gains and the benefits from them are going back to the railroads, more than they were in the past, because the railroads are having more, have greater cost outlays to achieve those productivity gains. Is that your --

MR. RENNICKE: Exactly, and I also think, I think as Mr. Burkhardt pointed out too, that my first ten years working in the railroad, particularly when I was on the B&M, my job was to abandon half the miles of that little railroad. It was an easy way to get productivity. You know the more miles you cut out, the higher your average density went up.

Those kinds of cheap reductions are gone, and the railroads now found themselves, in the early 2000's, with having to start planning and building for increased capacity. You can't add railroad capacity just next year, you know. That goes into why was there high spending, in my view, during the downturn?

The railroads didn't cut their

capital spending back like the rest of the industries, because they see that coming out of the recession, there's two, five, six year, ten year capital spending programs that we've got to run up our investment in infrastructure, or we're not going to be able to catch up.

We can't do it in 2013 or 2014, if in fact traffic was back. We've got to do it in 2008. So I think that's partially, I can't explain everything, that's what was going on during that period.

COMMISSIONER MULVEY: Would you also say it's partly coterminous with the fact that a lot of legacy contracts were there, and railroads couldn't raise rates, although after Staggers, the railroads went from 100 percent tariff-based rates, to I think 90, 95 percent contract rates?

Now many of those contracts were long term and rates couldn't be raised, and so that was one of the reasons why rates, that costs, that productivity improvements were passed onto the shippers, because you couldn't raise rates, and there's no way to make the railroad more efficient?

MR. RENNICKE: Yes. The legacy rates carried some of the revenue through the recession, and also, many of them kept the railroads from charging fuel surcharges. So there was --

COMMISSIONER MULVEY: Yes, we had the hearing on that. Mr. Willig, I have one question. You were talking about the involuntary access issue, and as an economist, one of the complaints that's raised by shippers is that railroads, as duopolists in the east and in the west, collude.

That is, as Game Theory would suggest, the fewer competitors you have, the easier it is for the players involved, to figure out what the other one is going to do, and then behave accordingly. Because I know if I do this here, you're going to do that there.

So there's this agreement I am not going to compete with you here, and in so doing, you will not compete with me there. This is argument that you don't really have price leadership or followership. What you really have is almost classic collusion on the part of the railroads. Would you want to address those arguments that the shippers often make?

MR. WILLIG: Yes, thank you. I was trying to talk about it in somewhat circumscribed terms during my eight minutes, because I found it extraordinary that the testimony by the economists and also by the direct representatives of the Western Coal Traffic League were jumping to the conclusion in testimony of collusion, as a conclusion from evidence that well, prices for going up for the coal shippers.

As we've been talking about all day, there's lots of good pro-competitive reasons why prices sometimes go up, as well as our record frequently go down, but also directing themselves to a conclusion of collusion, based on the fact that traffic wasn't changing, coal traffic, from one carrier to the next, and saying that that's a sign of collusion, which I expressed as inflammatory or conclusory, but kind of troublesome is the bottom line.

Because it makes sense that after a while, when competition has worked itself out, the market will find efficient match-ups between the abilities of a transportation carrier and the needs of a customer.

Even if the traffic jumps back and forth for a while, it's likely to settle down into its most efficient set of logistics, as long as the basic circumstances aren't changing radically from year to year.

That seems to be totally off the table as far as the commentary that stable match-ups, as they say, is a sign of collusion, and it's just as much equally likely to be a sign of efficient arrangements, stabilizing in a competitive environment.

COMMISSIONER MULVEY: An equilibrium solution, so to speak, yes. I know that you are an advocate of the contestability theory, and but contestability theory is also predicated on the assumption of low barriers to entry. Clearly, in many cases, we don't have low barriers to entry here.

I mean to use Mr. Hamberger's term, singly served shippers or to use another term, captive shippers, don't really have competitive access.

In order for a market to be contestable then, another railroad would have to have access. Did you want to comment on the applicability of the contestability theory solution in the railroad case?

MR. WILLIG: Sure, I'd love to. Thank you. The first thing to say is that railroads are not a perfectly contestable market, far from it, because one doesn't just go out and build new railroads to access the shipper, even though there may seem to be a business opportunity here.

You're talking about 40 year commitment, huge sunk costs, fixed costs, geographical issues, permitting. This not easy entry to build new rail facilities, in response even to market need. But that's not to say that there aren't other forms of fluid competition in the industry.

For example, where the trucks go is certainly highly contestable, and if trucks can go and pick up a load and then bring it to a rail interchange, that's a form of contestability without there being the ability to build brand new rail assets. It's just redirecting the trucks is quite a contestable part of the market.

Or likewise, a utility plant that decides, with some cost to change its source of coal. So they go from one mine to another mine, which means going from one railroad to another railroad as the serving entity. That also can be quite fluid as a form of contestability or competition, without building brand new rail facilities.

But with all that said, there's going to be situations in the industry where there are captive shippers, and that's why you've got the right kind of regulation that you have.

That's why it was so smart for the ICC and in a continuing way by the Board, at some level of principle, to say that yeah, contestable markets were trying to stimulate, through appropriate regulation, the discipline on pricing that a truly contestable market would bring.

Because nobody thinks that this is an Adam Smith-like industry. But as a guidepost to regulation, contestable markets makes a lot of sense. It fits, and that's the way rate regulation has attempted to be configured, but with alterations for practicality, which is understandable.

COMMISSIONER MULVEY: Just one more question, and that is to Mr. Hamberger. You mentioned about the 400 plus billion dollars the railroads have invested in the last few years. We recognize too that the vast majority of that is simply to replace capital as it wears out, as opposed to being expansion capital.

I think Mr. McBride pointed out that the railroads, the advertisements the railroads have is that they can carry so many tons and take so many trucks off the road, and are much more efficient and have much, much better fuel economy, etcetera.

But the reality is that much of the traffic growth is really in the non-truck competitive areas. The industry seems to be focusing on coal, on grain, on chemicals and the like. As opposed to really taking the trucks off the road, and that we see both railroads and trucks both increasing their traffic, and much of the increase in the rail market share can be traced to the decline in water carriage and movements by the minor modes.

Would you comment on that? Are the railroads actually going to begin taking trucks off the roads, as we see them, or are they simply going to grow coal traffic and grain traffic and the like?

MR. HAMBERGER: I'm sorry that Mr. Lanigan of BNSF will have to wait until tomorrow to answer that question. Being a former trucker and a chief marketing officer of BNSF, I see he's here, and I'm sure he'll give a much more eloquent response.

But I think I disagree with your basic premise. The fastest-growing market share, the fastest-growing sector of business is intermodal. In fact, if it were not for export coal, I think coal would be down right now, and that intermodal is what is growing at five, six, seven percent. Everything else is below that.

So I think the focus that I see, with the two, three hundred million dollars per copy, are railroads investing in intermodal yards, railroads cooperating with ports, trying to see how to make sure that both export containers and containers imported can be moved effectively.

So I disagree with your premise that the focus is on bulk commodities alone. Obviously, that is a focus as well. But I think the truck competitive piece of the market is where a lot of the growth is actually occurring.

COMMISSIONER MULVEY: I agree. The intermodal, I should have added that. I was more concerned about the onesies and twosies, the small merchandise traffic shippers, where you only have a handful of cars. That's truck traffic, and is going more to truck traffic also.

I know that some people like Charlie Mauser, for example, believes that's where the railroads' future actually is, is getting back to merchandise traffic.

MR. BURKHARDT: I would like to weigh in on that, because this is one of my favorite subjects, because I mean we've all read about it. It's the boxcar data and all of that type of thinking. In fact, the place that's doing the best job in the rail industry today, with that type of traffic, onesies and twosies, is the shortline and regional railroads.

Generally, they get cooperation from their connecting Class 1's. Sometimes you have to pound the table a little bit to get their attention, when they've got lots of intermodal trains, coal trains and all of that in the picture.

But overall, it's very much in the interest of the Class 1's to cooperate with their smaller connections in developing that traffic. If you present it right and if it's priced right, you can do it. Today's increases in truck costs, largely because of fuel and some other things related to the economy, driver shortages. We're starting to hear about that again. This has helped rail competitiveness.

I think a really well-managed Class 1, and most of them are, will take that opportunity.

COMMISSIONER MULVEY: Thank you. Ed.

MR. HAMBERGER: And while it's not onesie or twosie, I would draw attention to the Board, I'm sure you've seen it, that while UPS has been our single largest customer for some time, FedEx has been reluctant to use rail. They have just earlier this year announced, I think, with all the Class 1's, a major partnership to get trucks off the road and move their long distance shipments by rail.

So I think that speaks to the fact that that's what we are doing, and the reason that that is possible, in my opinion, is because, getting back to our theme, the investment makes it truck-competitive. If you don't have the service, it doesn't matter what the price is. You're not going to get a FedEx or UPS.

So the investment is there, so that the service is there, so that you can get the trucks off the road, and FedEx has just tumbled to that conclusion as well.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN ELLIOTT: Thank you, Commissioner Mulvey, our card-carrying economist. I just have a few questions today. Most of my questions, I think, have been answered in this lengthy discussion, and I do appreciate you stepping aside for a moment for the Chairman.

First, this is what I really

struggle with here, I guess, and one of the big reasons why we're here. 25, 26 years ago, the ICC came out with *Midtec*, and they issued a standard of anti-competitive conduct and, from what I can see, over the period since that time, we really haven't had a case since.

So it appears that something is not working. I know that the railroads, maybe you don't think something's not working. But it appears that something's not working. I find it hard to believe and this is not any slight on your behavior that your behavior was perfect throughout that entire time.

So my question is what would cause anti-competitive conduct under that standard? Is there something that you -- I think I see your card-carrying economist nodding that there is an answer to that question. But what I hear from the shippers is there isn't an answer to that question. So I'd be curious to hear what your answer is.

MR. WILLIG: I was just jumping up

and down as you were speaking because my first impression is that, and this is based on the logic of the situation, that when the right standard is put forward, a good result is that the standard is not needed, because it provides the right incentives to the marketplace to solve access issues, in a voluntary and efficient way, that harnesses market forces.

So the fact that there aren't bevies of complaints that meet the standard, I would take, as a matter of logic as a really good sign, rather than as a bad sign, as your remarks were suggesting.

When the parties know that they have recourse, and the shippers know they have recourse, when the carriers know that the shippers have recourse to a proceeding, based on the abuse standard, they're very highly motivated not to abuse, and to make a deal which ordinarily would make economic sense.

If there is an efficient

interconnection, an efficient use of switching, an efficient routing which is not already on the table, there's already good economic incentives to make it happen. It's a win-win for the shipper and for the interconnecting carriers.

If in addition there's a standard that's well-tuned, as yours presently is, that's just icing on the cake, further cementing, the changing metaphor, icing and cement, to the very strong incentives backed up by the legal environments. I would take it as a good sign, not as a bad sign.

CHAIRMAN ELLIOTT: Counsel.

MR. BURKHARDT: There's no reason why a shipper wanting to move a carload between any two points in North America, can't get the interest and the pricing out of the railroads involved. Now will that pricing be always what he wants? Well, this is the nature of the competitive economy.

Often, it won't be. If it's too

high, relative to the road, the railway is wasting their time and they might as well plan to get out of business, because the road's going to take the traffic. So an intelligent railway is going to find a way to handle this.

The less prescription we have in the thing, the better, because prescription tends to overrule the market and prevent the market mechanisms from working.

CHAIRMAN ELLIOTT: Okay. So first of all, I wasn't really making a judgment on the standard itself, as far as that there hasn't been a case that's necessarily a bad thing. I didn't mean that.

What I meant, and I don't think I still have heard an answer, is what would a railroad have to do to, as far as anti-competitive conduct, to permit a shipper under our standard, the present standard, to gain access under the present standards. Maybe that's more in Mr. Sipe's roundhouse.

MR. SIPE: Well, the Board did

speak to that in *Midtec* -- excuse me, the ICC, the Board's predecessor spoke to that in *Midtec*, but perhaps in language that some of us might find more abstract than we would like.

The Board said competitive abuse encompasses "classical categories of competitive abuse, foreclosure, refusal to deal, price squeeze or any other recognizable forms of monopolization or predation." Kind of abstract, but let me try and make it concrete, with reference to Dr. Willig's framework.

First of all, I agree, that I think it's probably a good thing for everybody, but there's not a lot of competitive abuse floating around out there. Railroads have good incentives to avoid actions that are going to cause them to run afoul of regulatory standards, even if the standards are not frequently invoked.

People are aware that the

standards are there. So you know, what might rise to the level of actionable foreclosure or refusal to deal? You know, suppose there is an arrangement, a potential arrangement out there in the marketplace, like a through route, where there is currently a single bottleneck carrier who is handling it from origin to destination.

A second carrier could come in for part of the route, and provide a more efficient transportation arrangement at a lower cost with a net savings to the shipper, and actually increased contribution to the incumbent.

If Carrier No. 2 presented that arrangement to Carrier No. 1, and showed that there was a demonstrably more efficient arrangement that represented a win-win for the two carriers, and Carrier No. 1 says "I'm not going to deal with you," that conceivably could constitute an actionable claim under the Board's competitive access rules.

I don't think it happens very often because, as Mr. Burkhardt and others have suggested, the railroads have strong incentives to collaborate in those situations, and not collaborate in a bad, collusive way, but collaborate the way that vertically integrated parties collaborate, to make that final product.

MR. BURKHARDT: And actually *Midtec* is an interesting one to me, because in my career, I had the opportunity to serve that plant twice, once when I was on the Chicago and Northwestern, and then years later, when I was heading up Wisconsin Central. The whole rail network in Wisconsin had changed in the intervening years.

This was a paper mill. It didn't have unit train business. It had -- it did a pretty good business, and a high percentage of their total traffic was exempt under the Board's boxcar traffic exemptions.

There was no particular reason for

this industry to receive some kind of special consideration, that was very much inline with what some rail customers would request today. They didn't get it then, and there was good logic for them not to.

Now if you're running unit trains, and you have a -- you can make the case, on certain types of traffic, of market dominance, the Board has regulations that address those particular subjects, and certainly shippers have used them, actually with more success in recent years than I think they've had. So I see that as going on.

But *Midtec* was a classic case of onesies and twosies. This industry, everything in there and out was a single car of traffic going to or from some location, and the serving railway certainly needed the revenue in order to continue to provide the services that were necessary there.

CHAIRMAN ELLIOTT: The second question, flowing out of that. Basically what

I'm hearing in your comments is the regulatory system in place, is more or less working, and it's demonstrated by the success of the system over the past 30 years.

So that drags me back to our last proceeding, with respect to exemptions, because it seems as if what you're saying is if there is some kind of unreasonable rate or unreasonable practice, we should allow the present regulatory system that's in place to resolve that issue.

I guess my concern in the last proceeding with respect to exemptions was there were certain groups that didn't have that avenue available to them. Obviously, there is the ability to seek a revocation. But I saw in that proceeding was there were some groups of traffic that had quite large RVC ratios, that were significantly above 180.

Would that change your ideas, what you've said in this proceeding, versus what you said before, that none of those exemptions should be revoked as far as universally speaking for a group of traffic?

MR. HAMBERGER: AS a witness in 704, let me try to set the record straight as to what I thought I meant to say, which is to say that whole-scale revocation of exemptions, we did not believe, was appropriate.

But where there is evidence on an OD pair of a specific shipment of a specific commodity, then that shipper should come in and seek a revocation, and if the facts warrant it, then it should happen. But it should be done on a case-by-case basis, not on a commodity-wide basis.

MR. BURKHARDT: This was primarily related to business that was seen as truck-competitive, and it is, and the trucks are still very competitive, very much limiting what railways. Railways may have, in the context of a local rail market, a monopoly.

But I don't like that word at all,

because they're operating in a large transport market, where they don't have a monopoly, and trucks are hauling everything.

If there's another railway within 100 miles, there's transloads and things like that available. So the exemptions were put in place, I think, on a very intelligent basis. I don't see anything there that's changed.

CHAIRMAN ELLIOTT: One final question. I noticed in the Concerned Captive Coal Shippers, comments that they put in for access, I believe for through routes, a trigger at RSAM for access. I noticed in your comments that you went down to 180, and I think I've heard some comments in your statements about that being, I think, about a $5.2 billion effect on the railroad industry.

What, if you know, and you may have already done this analysis in the past, during some of your discussions you've had about RSAM and access and things of that nature. What do you think the effect of a policy like the Concerned Captive Coal Shippers would do to the rail industry, as far as monetarily speaking?

MR. SIPE: Well, I don't know the answer to that question, Chairman Elliott, because to my knowledge, we haven't done the analysis.

We could do that, but I do want to make an observation about the Concerned Captive Coal Shippers' proposal, and link it back to something I said earlier, which is a measure of rate relief; it is not a standard.

So to think about their trigger, as I think you'd call it, as something that would enable them to claim access is, I think, inappropriate, because it is not a conduct-based standard. I don't think you would want to adopt anything like that. But in terms of the RSAM impact, I don't know what it is. We could do that for you.

MR. RENNICKE: Just as far as calculating the impact of changes, the numbers, the 5.2 and 2.6 I mentioned came from a study that the STB puts out, that shows the long-term variable costs and then the revenue by commodity category.

So you can basically take whatever ratio you wish against your long term variable costs by category, and I don't know what the recent RSAM is. I know with some of the railroads you can calculate what those impacts are, if that's what you're interested in asking --

CHAIRMAN ELLIOTT: I'll do that right now. I'll get on that. Any further comments, questions?

MR. HAMBERGER: Mr. Chairman, might I make just a closing comment?

CHAIRMAN ELLIOTT: No. Yes, go ahead.

MR. HAMBERGER: Thank you. I'd like to say something that I'm sure you perhaps did not think I would say, and that is I agree very strongly with something Chairman

Rockefeller said this morning. He indicated that there's a symbiotic, his words, symbiotic relationship between railroads and their customers.

That's incredibly accurate. There is a symbiotic relationship. We, as he put it, we're out of business without their business. So when people say gee, we are locating over in Doha because of rail rates, when people say we're not able to run a second shift because of rail rates, it makes no sense that the railroads would allow that to happen.

Every day, I submit to you, and I know you have given eloquent talks about reaching for middle ground and trying to work together. It might be difficult inside the Beltway.

But I submit to you that out there in the real world, each one of these railroads is sitting down with their 25,000 customers and talking every day about how to work better, how to make them more competitive, domestically and on the world markets, because if they're out of business, we're out of business, and therefore that's what we do, is work with our customers to get them more business.

So I just hope you keep that in mind, and as the railroads come up, I'm sure they will be able to give you much more specific detail about how that works. But thank you for your -- and I apologize to the Vice Chairman for an overly-broad statement.

Of course, this is a very excellent proceeding. I just was indicating that maybe we don't need to go too much further. But thank you.

CHAIRMAN ELLIOTT: We appreciate you coming today. Thank you very much.

(Pause.)

CHAIRMAN ELLIOTT: Okay. We're going to begin now with Panel IV, and I believe that's just one group, the North Carolina Department of Transportation, and you have five minutes. I don't think your mic's on.

MR. TROGDON: Mr. Commissioner, there we go. Thank you.

CHAIRMAN ELLIOTT: Thank you.

Panel IV

MR. TROGDON: Thank you for the opportunity to speak today and provide testimony on behalf of the State of North Carolina. I'm Jim Trogdon, chief operating officer for the North Carolina Department of Transportation. Transportation Secretary Gene Conti would have been here and wanted to be here, but unfortunately sends his greetings and regrets that he's abroad and could not reschedule his previous commitments.

But he and I certainly commend the Board for your timely inquiry in this important matter. So that the key economic well-being of shippers, rail carriers and of course the public interest, can be discussed and reviewed.

Much of the testimony I'm sure you've heard on the record so far in this matter reflects the competing commercial interests of shippers and rail carriers and railroads.

We felt like it would be important to provide the perspective of the public in the State of North Carolina. Our citizens certainly believe that this proceeding is important, that the shipment of our commodities through rail and all transportation means are important, and certainly in this economy, how we can be more effective is a very important topic to our state, all of our economic development opportunities and our citizens.

North Carolina has invested heavily in improving rail infrastructure in our state, to benefit both passenger and freight service. The Department of Transportation and our state-owned North Carolina Railroad have invested more than 400 million over the last decade in modernizing rail infrastructure, improving safety and enhancing the capacity for carriers, shippers and passengers.

In addition, more than 625 million in funds have been spent for safety, capacity and reliability for both federal, state and North Carolina Railroad assets. The North Carolina governor, Beverly Perdue, established two years ago the Governor's Logistics Task Force, specifically requiring us to look at, over those last two years, ways to enhance our transportation efficiencies, to include ports, rail, aviation and highways and trucking.

That was to make sure that we as a state can better compete in the local and global economy, and provide much better access to jobs for our citizens of our state. We are actively looking at any way we can to improve the synergies between our ports, both freight rail, aviation, highways and all of our logistics, and provide services to meet the needs of the economic demands for our state.

Our citizens have clearly a direct stake in this proceeding, so that can possibly result in improving freight rail competition for our state.

But the current state of rail competition in North Carolina significantly restricts our state's ability to compete in the global marketplace, and to adequately serve the needs of our shippers seeking to transport goods to, from and through North Carolina.

We have two commercial ports in our state, one at the Port of Wilmington and the other at Morehead City. Both are effectively captured by the positions of the Class 1 railroads that control access to these for freight, for rail freight only.

In the case of the Port of Wilmington, there is currently one Class 1 railroad that can provide intermodal service from Wilmington to Charlotte and beyond.

Despite bridges and other constrictions that were raised to allow double-tracked operations along this corridor, that service has not been established because the rail carrier quotes that were provided from Wilmington and Charlotte were approximately twice the rate of truck movements for the same destination, and approximately twice that for other destinations between Charlotte and other parts, specifically Savannah.

We are also interested because Charlotte is our largest retail market, and how we can make that Charlotte facility much more competitive with the Port of Wilmington, because that would provide us access from our ports to destinations beyond Charlotte, to include Greenville, Spartanburg, Atlanta and Memphis.

Without competitive rates, the Port of Wilmington is not able to attract ocean carriers that can reach beyond one day truck trip limitations, and most ocean carriers are seeking to access markets other than just those in our local area and well into the Mid-Atlantic region.

This requires intermodal rail service, because trucking cost that distance is specifically prohibited. This lack of trade lanes and ocean carrier service severely limits the ability of North Carolina businesses and our ports to reach these global markets.

This translates into jobs lost for our state, and higher costs for transportation of goods and services. The situation in Morehead City is similar. As illustrated in a recent example, last year's Spirit Aerosystems, a major manufacturer in aircraft components, located at a facility in an economically depressed inland county in eastern North Carolina, to build aircraft components for transhipment to Europe, for assembly for Airbus aircraft.

The original plan was to move this cargo by rail from the Kinston area to the Port of Morehead. North Carolina constructed a six mile rail line to make the connection to the Class 1 carrier at significant expense to us, but the Class 1 rail carrier's rate that was quoted was not competitive, even with a much higher than average truck rate. The quoted rate was approximately ten times that of trucking.

Again, the private carriers' position prevents the safest, most efficient movement of goods by this important new corporate citizen to our state. Spirit Aerosystem ultimately would hire approximately 1,000 employees.

80 percent of the wages are at an 80 percent higher average wage rate than most of the counties in eastern North Carolina experience. We definitely need a very competitive rail service to serve this shipper, and allow us to attract other

shippers and manufacturers to this region.

The final example I will provide is the intermodal freight service in the Charlotte area. North Carolina has partnered with two Class 1 carriers, both Norfolk Southern and CSX, to invest in separate intermodal facilities in the Charlotte market.

An alternative would have been one joint public-private investment to create a union of intermodal facilities in that region, a single facility that could scale to handle the needs of both carriers, and optimally sited to balance the needs of the carriers and the entire transportation network.

The public made repeated requests to both of these Class 1 carriers, to consider a single facility, but neither would meet to discuss such a concept or project. The result was the two facilities being constructed at a much higher public and private cost.

North Carolina and her citizens clearly have been negatively impacted by lack of competition among the freight carriers in our state. Our state policy is certainly to invest in all modes of transportation, and we will continue to do so.

But moving forward, we would want to do it in the most effective and efficient way possible, and our hope is that these examples are persuasive in considering that we must get some relief from these tight controls on these individual rail lines, and that whatever the terminology, the Secretary likes to ask for improved access.

So we would like improved access for other railroads and other appropriate regulatory changes that can increase our competitiveness in the rail freight industry. We offer to work with you, certainly as a Department of Transportation, and to support your efforts in advancing the discussion in any meaningful way to achieve change and improve freight rail service for all of our customers and our citizens.

So I thank you for the opportunity to participate, and will answer any questions that I may.

CHAIRMAN ELLIOTT: Thank you for your comments. Commissioner?

COMMISSIONER MULVEY: Does North Carolina have a proposal for changes to the Board's policies that can address some of the issues that you face, some more specifics?

MR. TROGDON: Mr. Commissioner, I don't think we've had any specific proposals, other than the Secretary did provide some written ideas or objectives, because this is a series of what we would consider probably many proceedings and meetings, where he did have a couple of strategies on improving some competitive pricing, and improved access.

But I think probably the one that he discussed with me the most was how to make the entire pricing process a much more public, transparent and open process, where you could see quotes that are being made on various facilities across the nation. A great example is our port, the rate that was quoted from the Port of Wilmington to Charlotte.

Two times the truck rate, and the port has been asking for quotes from Charlotte and beyond to other locations, and still have not gotten quotes to those other locations beyond the Charlotte intermodal facility.

COMMISSIONER MULVEY: I know Secretary Conti fairly well. I worked with him many years ago on high speed rail issues and higher speed rail issues in North Carolina. I know that's a great interest of his. As a matter of fact, my experience with North Carolina and the North Carolina DOT and rail has been heavily focused on passenger issues.

So I am glad to hear that there's a greater emphasis being put on freight issues as well, as they are critical to the North Carolina economy. You mentioned a couple of projects that you had down there, and I was interested in two things.

One, of the several hundred million dollars you mentioned, how much of that was basically freight-related, and then secondly, you mentioned building a six mile line that the state of North Carolina paid for, and then got a rate quote from the railroads that was ten times the truck rate.

MR. TROGDON: Yes.

COMMISSIONER MULVEY: Wasn't there an agreement before you built the line as to a commitment for carrying the traffic at a known rate, or did you build it and expect that they would come in and be reasonable?

MR. TROGDON: The answer to the first question is we do spend a lot of our both state and federal grant money on improving rail crossing, rail safety, sealed corridors, removing crossings.

We are focusing today and in the future on mutual benefits of passenger and freight rail, particularly on the line from

Raleigh to Charlotte, and then Raleigh, both going north into Richmond and beyond.

The second part of your question is, and I'll defer just for a moment, because I wasn't at the Department when the rail was negotiated. But my assumption was we had some initial agreement, and then when the shipper finally got the quotes, because as you know, initial agreements are you never know the dimensions, commodities, what they all look like.

But that the final quote was much higher than the initial concept. I'll defer to Pat Simmons, who's our Rail Division, on the specifics.

MR. SIMMONS: Thank you for the question, Commissioner. Yes, we had a working agreement with the Recruitment Team, which included the freight railroad, to recruit Spirit Aviation to come to North Carolina, create the jobs. Part of that discussion that secured that 1,000 jobs in eastern North

Carolina was the commitment to provide service.

We agreed to build the rail line, and the railroad agreed, of course, to provide the service. But as Jim pointed out, when it came to pricing, then we were priced out of that competitive marketplace.

COMMISSIONER MULVEY: Thank you. That's it.

VICE CHAIRMAN BEGEMAN: Actually, I don't really have a question, but more of a comment. When Mr. Hamberger left, he kind of ended on a high note, talking about the effort that the individual railroads take to reach out to their shippers and resolve issues and that if the shipper isn't there, the industry goes away.

Hopefully, whatever carrier or carriers are serving North Carolina, I don't want to call anyone out, hopefully they'll reach out and have a conversation with the State of North Carolina, because I think maybe something productive could come from that.

MR. TROGDON: Well, and one recent change for us is that our Ports Authority was an independent authority, and you know, based on our latest legislation from our state legislature, our ports will now come under the Department of Transportation.

Part of the direction from the Governor's Logistics Task Force is to build a Tiger, if not administrative, a Tiger policy planning coordinating relationship with all of the aspects of our industry.

So we're moving very hard to do that, to make sure that the strategies that we're working on the highway and bridge side, matches the strategies that we're working with the ports, and then work with the railroads and aviation and all of our other industry clusters, to make sure that we're doing that.

So I believe that we will work very hard in improving communications among the Class 1 railroads, in making sure that the ports are speaking louder than just by themselves. But we certainly look for every opportunity to work with this Board in improving that communications.

CHAIRMAN ELLIOTT: I don't have a question, but I do want to mention, kind of flowing out of the Vice Chairman's comment, that we do have a program here at the Board called the, and I always like to do a free plug, the Rail Customer and Public Assistance program, which has been quite helpful with shippers, ports, communities, etcetera, in resolving issues.

Not that we won't take full consideration of your comments in the context of this proceeding, but it is a very useful avenue to begin communications where they may have stalled, by having the Board help reach out. So I just wanted to recommend that to you as well.

Thank you very much for your time today, and we greatly appreciate you taking that time.

MR. TROGDON: Thank you.

MR. SIMMONS: Thank you.

CHAIRMAN ELLIOTT: I'll now call forward Panel V. Just as a matter for people's schedules, I think what we're going to do is push forward and try to get in the next two panels and then take a lunch break for about an hour, because I understand in some of these lengthy proceedings people like to get out and about for a little while.

So we're going to try and do that today. But I'd like to at least work forward until around one o'clock, and then take a lunch break at that point in time.

(Pause.)

CHAIRMAN ELLIOTT: Okay. Now we'll start with Panel V. I believe we'll begin with the Alliance for Rail Competition. Mr. Whiteside, you have ten minutes.

Panel V

MR. WHITESIDE: Chairman Elliott,

Vice Chairman Begeman, good to see you, and Commissioner Mulvey. My name is Terry Whiteside. I'm honored and pleased to be here today on behalf of the Alliance for Rail Competition members and the wheat commissions across the country.

ARC members and the Wheat Commission exist to represent the needs and interests of their members, and I'm the principal of Whiteside and Associates in Billings, Montana. I serve as chairman of the Alliance for Rail Competition, and representing the Montana Wheat and Barley Committee on that committee.

I also am a transportation consultant to the wheat and barley commissions in Montana, Colorado, Idaho, Kansas, Nebraska, Oklahoma, South Dakota, Texas and Washington, which kind of covers the mid-central part of the country up in the Northwest.

ARC is an association of shippers that are captive to railroads for significant portions of their freight shipments. ARC members include shippers of agricultural commodities, coal, chemicals, glass, manufacturing and rail customers, and other bulk commodities consisting of large companies, small businesses, shipper associations and groups.

So ARC and the wheat commissions are subscribers to and supporters of the joint written comments and reply comments by the Interested Parties. ARC is appearing today to highlight aspects of this matter, particularly of concern to its members.

The main purpose of these comments is to urge the Board not to lose sight of the shippers' need for protection against unreasonable rates and unreasonable railroad practices that directs its attention to competition issues.

In many regions of the country, rail to rail competition is non-existent for most shippers, and it is likely to remain non-existent, no matter how much effort the Board puts into eliminating or reducing anti-competitive policies and precedents with programs outlined in this proceeding.

That does suggest that every effort needs to be made by this Board to increase rail to rail competition. In fact, the situation cries out for increased and proactive efforts by the Board to make efficient competition one of its prime directives. I was an old Star Trek fan.

In the vast hinterlands, where distances are great, attracting effective competitors for monopoly-encumbered railroads is an unlikely scenario at best. Many of the ARC members ship less than truckload shipments from thousands of origin-destination pairs. Many other ARC members are large volume rail customers who ship between a few or single origin destinations.

What's common between them? They're all captive. They all have little rail to rail competition. The USDA study, the USDA and DOT study recently in April of 2010 indicated that a number of crop reporting districts in many of the western states have gone from 4.25 down to 2.58 competing railroads, and with equivalent RVCs in the 180 to 240 range, ten in the period of 1985 to '92 and then 24 in the period of 2003 and 2007.

Some of the RVCs that we've calculated in those grain rate areas include Montana, very high ones in Montana, North Dakota, South Dakota, Nebraska, Kansas, Colorado, Oklahoma. The level of rail competition in the United States presented in this proceeding is of enormous importance.

Action has been delayed far too long by the STB and the ICC before it, and the vast majority of the nation's captive shippers have been waiting really since 1980 for a methodology that will implement for their freight the command of Congress that rail rates on captive traffic must be reasonable, in 49 U.S.C. 10701(d)(1).

As stated in our comments, under current conditions, railroads can easily make rate cases an ineffective remedy through the tactics of monopoly pricing. They can say to the captive shippers, and they've done this, that if the shipper doesn't like the 35 percent increase that it's proposing, they'll publish a 50 percent rate increase, effectively making the shipper an offer it can't refuse.

I have a situation where a major company wanted to do manufacturing and ship all of its product out of country. Sat down with the railroads. They quoted us contract rates higher than their tariff rates. When we pointed that out to them, they went home and cancelled the tariff and said "now you have to deal with us."

Now we got the contract done. It took a year and a half, but those are the kinds of things that we're faced with in the field every day. What captive shippers desperately need is a recourse to effective regulatory remedies that force market dominant railroads to moderate their rate gouging, by ensuring that the rates on captured shippers are reasonable.

Board members, what's needed here is the guiding hands of this Board, to provide surrogates for rail competition, for those shippers that do not have rail competition afforded them. Clearly, the railroads' goal is to prevent the Board from considering, let alone proposing for public comment, any changes in the current rules and policies affecting rail competition.

The railroads argue that there no new circumstances warranting reconsideration, contending that their improved financial health with revenue adequacy achieved or imminent for the Class 1's is unrelated to the effectiveness of rail competition. We heard it this morning.

They argue further that re-regulation is, in any event, the way the Board should address the industry's improved financial condition. ARC and our groups certainly agree that yes, the STB jurisdiction over unreasonable rates is important. We discuss that in our opening comments and in our reply comments.

But the railroads' claim that the railroad rate remedies are adequate, and obviate the need for increased rail competition is just untenable. Rate remedies are far from perfect, even for the coal shippers.

The captive shippers virtually receive all of the rate relief from the ICC and the STB since 1980. The ICC and the STB remedies for non-coal shippers have been non-existent for much of that period.

And because they're not being utilized does not mean it's a perfect system. In fact, the Board should not assume that the railroads will never drive shippers out of business. ARC members who operate or used to operate 26- and 52-car grain facilities have seen their enterprises disappear because 100 car elevators are more efficient for the railroads.

Similarly, the same amount of electricity can be generated from fewer power plants, or the same number of cars can be built with fewer factories, or the same number of chemicals can come from fewer factories.

It's not safe to assume that the railroads will not use their pricing power to encourage or force the shutdown of facilities that they see as less efficient from a transportation perspective.

We see markets, whole markets in the west, major markets for export of grain, where the railroads have cut off access by eliminating interchange rates. So as long as the same volume moves by rail, they're fine with it.

Let me see if I can capture the railroads' arguments in three sentences. The railroads argue that government intervention is necessary to ensure they earn adequate revenues.

At the same time, the railroads argue that no government intervention is necessary to limit their monopoly power. If anything is changed by this Board or Congress, the future railroad system will collapse, because of sufficient or insufficient reinvestment won't occur, and the sky will fall.

So even though rail competition was called for in Congress in 1980, let's go back to 1980 for just a second. Railroad bankruptcies were here. The railroads said you can't do anything about the captive shipper problem, because the railroads are too weak. We need to get stronger.

1996-1999, last of the major railroad mergers. The railroads are saying they will be more robust, efficient and competitive in the future, but the railroads say they can't do anything about it, about the shipper issues, because they need to complete the consolidations and get financially stronger.

2011, railroads are the fifth most lucrative industry in the United States. Railroads say you can't do anything about now, because of the requirements for future reinvestment. If not now, when? Thank you, Mr. Chairman.

CHAIRMAN ELLIOTT: Thank you, Mr. Whiteside. Next, we'll hear from the National Association of Wheat Growers, Mr. Hurst.

MR. HURST: Sure. Chairman Elliott, Mr. Mulvey and Ms. Begeman, members of this Board, my name is Wayne Hurst. I'm a wheat, sugar beet, dry bean and barley grower from the Burley, Idaho area.

I currently serve as president of the National Association of Wheat Growers, and have served in the past as an officer of the Idaho Grain Producers Association.

I also serve with the Alliance for Rail Competition, and I represent wheat farmers with the BNSF Ag Rail Business Council. I am honored and pleased to be here today on behalf of the National Association of Wheat Growers, and farmers across the country.

The National Association of Wheat Growers is a federation of 21 state wheat grower organizations that work to represent the needs and interests of wheat producers before Congress and federal agencies.

We are grower-governed and grower-funded. We work in areas as diverse as federal farm policy, trade, environmental regulation, research and like today, transportation. Members of the Board, railroads are vital to agricultural production and to the value chain.

They are extremely important to us, and in my experience the people who run them are good, smart, hard-working Americans, much like American farmers. In fact, many of those I have worked with over the years have farm backgrounds.

But those facts do not take away from the reality that there are billions of dollars to be made each year in the railroad business, and the pressure to maximize that profit is very real. Agricultural producers are price takers rather than price makers, with little control over the price they receive for their products.

They are unable to past cost increases on to customers, and must absorb those costs because of a lack of market power. In most cases, our grain is priced on the three electronically traded wheat futures markets here in the U.S.

However, this is not the price that we as farmers receive, because marketing and transportation costs, what we call basis, are then applied. In most cases, this basis is subtracted from the wider-set futures price, to give the available cash price at the local grain collection point.

Increases in transportation costs result in larger basis, and therefore lower cash prices that come back to the farmer. For agricultural shippers with no cost-effective alternative to rail, and located far from end use markets, rail is the only transportation available.

Wheat and grain growers know that an effective railroad system is necessary for the success of the wheat industry. However, they continue to face many problems with rail rates and services. Study after study has shown that with each successive rail merger over the last 30 years, there has been a substantial reduction in rail to rail competition.

Over time, rail customers in the United States have grown more captive to single rail carriers. As captivity levels rise, a larger and larger share of the cost of transportation has been shifted to rail customers and to state and local governments.

Helping our members find solutions to these freight problems remains one of the National Association of Wheat Growers' top priorities. I will talk today about rates and service, and specifically how rail captivity interacts with these. I will also describe the effect we believe a proactive and empowered STB can have on finding solutions to these problems.

Since the passage of the Staggers Rail Act of 1980, the degree of captivity in many wheat-growing regions has increased dramatically, and America's farmers continue to experience both service issues and ever-higher freight rates.

We have had continuing rail equipment and boxcar shortages since the railroads started aggressively consolidating and merging in the early 1990's. We continue to have grain piled on the ground in many states in the late summer and fall, due to the lack of rail equipment availability.

Twenty years ago, there were multiple transcontinental railroads servicing agricultural regions. Today, however, whole states, whole regions and now whole industries have become completely captive to single railroads, as a result of many railroad mergers that were allowed by this agency.

At the time, those merging railroads promised greater efficiency and more competition. In the wheat industry alone, there are substantial pockets of captivity in at least 14 states, stretching from Texas to the Pacific Northwest, that are primarily attributable to the effects of mergers.

In these areas, the rates are higher and the service levels are not the same as service that is provided in areas where there is rail to rail competition. In October 2007, the Government Accountability Office issued a report, GAO 07-94 entitled "Freight Railroads: Industry Health Has Improved."

The concerns about competition and capacity ought to be addressed, confirming what we in the captive shipper industry have been stating for years. Those areas that are captive pay the highest freight rates, yet receive some of the worst service. The Christiansen study confirmed the high freight rates in captive areas.

An extensive USDA study further revealed that the GAO correctly established the link between single railroad access and elevated percentage of tonnage above the threshold for rate relief.

In our own studies within the grain industry, examining the RVC levels on rates to common destinations of the Pacific Northwest, we find large areas moving at rates considerably above the threshold, confirming the findings in the GAO study, the Christiansen study and the USDA study.

For most of us, rates remain high. Farmers experience and suspect it, and both government studies and work by independent consultants confirm it. Lower prices and incomes hinder farmers from borrowing funds to purchase fertilizer, seed and machinery, thus reducing economic prosperity in rural areas.

Higher transportation costs also affect the competitive position of U.S. agriculture products in highly competitive export markets. The rates agricultural shippers pay for rail transportation can facilitate or inhibit American competitiveness in world agricultural markets.

This point is of particular concern for wheat producers, since about half of our crop is exported each year. I have come to realize in my meetings and exposure to the railroads that they are under internal and external pressure to maximize profits, because as monopolies they can.

I have heard division managers

speak of expectations within their companies, to deliver profits. It's also obvious that their stockholders and lenders expect large returns, and have been receiving them. Warren Buffet didn't buy the BNSF because he thought it would be fun to own a railroad. He is very much aware of the power the railroad has in controlling its ability to produce revenue.

When I testified a few years ago before the House Transportation Committee, a few days before the hearing I was out hauling hay, and I got a call from a guy from the Bank of New York, asking me why I was against the ability of the railroads to attract capital.

The investment and banking industries play a huge role in this issue, and the excess rates that we farm families pay go directly to those investors, to the pension funds and bankers involved.

There needs to be a mechanism to protect the captive shipper in this equation, much like, I would say much like a governor on a tractor. I believe that within the current system, that mechanism should primarily be a proactive STB.

Farmers are willing and expect to pay their fair share of costs, to get our goods to the market. But we in most cases pay far more than we should. As a farmer, I liken it to shopping for a new pickup. Say a truck on the lot is marked $30,000. At that price, the variable costs are paid, you might call it 100 percent of RVC.

The factory fixed costs are paid, another 30 to 40 percent of the RVC, and the investors receive a return on their investment, roughly 40 percent of RVC. So if the pick-up at $30,000 pays all the labor and other bills, including the return on the investment, if I have to pay $50,000 because I have no other choice, that's 300 RVC you might say. Something needs to be addressed. Something's not quite right.

On a brighter note, it has been my

understanding and experience in recent years that generally speaking, service has improved. The economy is slowed, and railroads have had the capacity to meet service needs.

Railroads have gradually realized that many past complaints were service-related, and they affected the handlers' profitability. So they may have made moves to mitigate these problems, while transferring the extra cost directly to the customer, the farmers.

In other words, improved service or faster delivery times helped the handlers and the farmers but we, not anyone else, have paid the bills for it. I am very concerned about what will happen to service when the economy becomes more robust, and competition for priority service increases.

We agricultural producers truly believe that a healthy and competition rail industry is essential for continuing viability on a rapidly-developing world market.

However, with continuing service issues and increasing rail rates, coupled with a regulatory agency that does not meet the needs of shippers, it is increasingly difficult for agricultural producers to remain competitive.

The proposals outlined by this Board, such as terminal access and bottleneck might mark progress in dealing with these specific issues. But they will not solve captivity problems. The distances for us are too great for these remedies generally.

Farmers believe that both railroads and shippers would be better off with more competition. We fervently believe that a strong, proactive STB can provide a host of benefits, where competition cannot physically be created.

We believe that the STB needs to be the facilitator and the catalyst for increasing competition in this historically strong industry of grain handling. We believe the railroad industry can survive and prosper in a competitive environment, and indeed, we know from history that competition breeds innovation and efficiency.

Finally, as a farmer, as a taxpayer, and as a shipper, I encourage you to take a proactive role in addressing shipper concerns. I appreciate again the opportunity to speak before you today, and I look forward to continuing a discussion about these issues.

CHAIRMAN ELLIOTT: Thank you, Mr. Hurst. We will next hear from Mr. Keith from the National Grain and Feed Association. You have ten minutes.

MR. KEITH: Yes, thank you very much Chairman Elliott, Vice Chair Begeman and Commissioner Mulvey. On behalf of NGFA, we appreciate the opportunity to testify at what we consider to be a very important proceeding. We thank the STB for initiating this dialogue on rail competition.

Our association has about 1,000 member companies, and own and operate some

7,000 facilities nationwide, both shipping and receiving. We have exporters, we have flour milling, soy processing, feed mills, corn mills, dry ethanol plants and feed operations.

We think agricultural shippers are very much in a unique situation in the transportation markets, as there is not a lot of heavy volume shipments from point to point. there's great diversity in shipping points and receiving points throughout the marketplace. This is one of the reasons we're quite interested in trying to resolve the reciprocal switch situations, where they are problematic and creating barriers to entry into markets.

Competition is very important in the rail markets and the national economy, we believe. The U.S. rail industry was in drastic financial shape in the 1970's. The main reason for this was that regulation by government did not allow innovation and market forces to govern the railroads' actions in the markets.

We're in a much different situation, a much improved situation today, and we have considerable market freedoms for the railroads to run their businesses. We think that's a very positive development by and large.

Given the positive factors that have contributed to rail markets' success, we would certainly discourage the STB and Congress from adopting any changes that would further reduce competition in that marketplace. Competition is good for industries, we believe. We think it's healthy for those industries and the employees they hire.

It maintains a competitive edge that helps companies succeed long term. Encouraging competition in our mind is not re-regulating. In the United States, where there are relatively short hauls and trucks can compete, rail rates do tend to be lower, and export movements where there are competitors that have access to barge transportation, you certainly see lower rates than you do otherwise.

But so there are locations from which agricultural shipments originate, where there is adequate competition in some markets. There is adequate rail to rail competition too. Agriculture is not just after low rates.

But we see other things that we need in the marketplace. We certainly need good service, reasonable rates, reasonable business terms, and we also need a cost-effective method to resolve disputes. I'll talk to that in just a moment.

From my perspective, we think a major benefit the STB could provide is to review policies relating to switch charges. We've seen switch charges in some cases that have increased over $500 per car, or roughly 500 percent of variable cost.

One idea that we have is that you don't set absolute rates on switch charges like the Canadian system, but you set a benchmark maybe of 180 percent of variable cost and beyond that, becomes -- the burden of the proof shifts to the carrier, to justify it being reasonable.

We do believe that carriers do not want to be re-regulated, but we also believe they should not have a completely free hand in cutting off existing physical and economic access through closures of switch points. To allow such autonomy on switch charges, we think, would have a strongly negative impact on the competitive fabric of the entire nation's economy.

Since 1980, railroads have lost market share in our business. In 1980, they handled 50 percent of the commercial rail volume. Today, they handle about 35 percent. It varies a little bit, but that's kind of a long-term average.

Our industry does not want this industry, the rail industry, to lose more volume. We don't like the downward trend of that business. We need railroads to carry grain. I mean major production areas in grain are 1,000 miles from port, and often 1,000 miles from their utilization points if it's domestic business. So we need the railroads.

Our view of revenue adequacy as kind of a -- has become a less important term than it was certainly back when the Staggers Act was passed. We think it often creates unnecessary barriers to the business dialogue between the shippers and the railroads, and it creates problems on solving market access challenges.

Lastly, we think that carriers and shippers alike need better access to problem resolution. I think the Commissioners understand that NGFA has a private rail arbitration system that we use between carriers and grain and feed shippers, and it's been very transparent. It's very useful, we think, to creating a better business dialogue within the industry.

It doesn't solve all problems. But I think one thing that it does do, and the STB might want to consider this going into the future, is that it allows for final resolution. There is an appeal process through our system to go to one appeal, but once an arbitration is done, you can't appeal it in court.

It's my understanding that the STB may not have the authority to create an arbitration system that would have the final decision-making authority, that decisions would likely still be appealable through the STB. In any event, we would stand ready to work with the STB when trying to establish a better voluntary system of problem resolution.

Again, we appreciate very much the STB conducting this review of rail competition, and we appreciate the opportunity to be involved. Thank you.

CHAIRMAN ELLIOTT: Thank you, Mr.

Keith. Thank you panel, for your comments. Just a few questions. First of all I'd just thank you, Mr. Keith, for your comments about the arbitration that you have available with the NGFA, and we appreciate your comments in the arbitration proceeding. They were very helpful, and we look forward to moving ahead with that proceeding as we analyze the comments in the future.

Just kind of the same question I had to the other panel of shippers. I hear a lot of statements about railroads that they aren't competing, and I've heard some statements with respect to, if we open up access and the railroads aren't competing, that's not really going to be helpful.

So that I pose the same question to you that I posed to the other panel. If you had your choice, bearing that in mind, what would you rather have? Would you rather have more access, or would you rather have more aggressive rate proceedings that maybe gave you a better avenue to come to the Board? And maybe there's something that's less expensive, where not so many resources are involved.

So I'm curious to hear what the shippers think on that, just based on their comments.

MR. HURST: From our perspective, you know, it's ultimately just I think better rates, frankly. That's the bottom line. You know, right now, I think most of us are being served fairly well by the railroads and they're efficient and they're our partners.

But we're paying for it, and there are forces, like I say, at work that are driving high rates and maximizing profits, and we need somebody that we can access fairly quickly and inexpensively and effectively, to say "that's enough."

MR. WHITESIDE: Mr. Chairman, it's interesting, because on the one hand, we hear from the railroads that you can't change anything. But real reality is the more avenues, the more methodologies we have, gives us the ability to compete, and to negotiate.

One of the things that we find, and I share Kendell Keith's ideas on arbitration, a very robust arbitration system would be extremely helpful. In fact, we have many members in ARC that like final offer arbitration, like they have in Canada. But the whole point is that when I talk to the lawyers involved in final offer arbitration in Canada, they say we don't use it very much.

I said why? They said because we can negotiate, because we have it. If we can negotiate if we have strong access. We can negotiate if we have strong capabilities of resolving rate issues. The more tools we have, the more resolution we will have in the field with our partners, the railroads.

We need the partners. We need the railroads. You know, one of the things that's most interesting, I did a survey one time, and

I asked our members how important are the railroads, and what they said was they're more important to us than they are probably to themselves, because we have no other alternatives.

So the more tools we have, if you will embrace those tools and make them strong, guess what? Then, we won't be here.

MR. KEITH: I'd say on that we believe we need a reasonable small rate case standard process. I don't think that people are going to use it too much in our industry, even if its was very advantageous. So I think the access probably is more important to us.

We prefer not to litigate if at all possible. But to set up a system where you have access to litigation, and it's reasonable litigation, then it does encourage people to talk. It does work. So Terry's right about that.

CHAIRMAN ELLIOTT: Okay, thank you. I'm aware of some areas where you only have one railroad that's really available in the state, and Montana comes to mind.

I know there have been some things done between the ag groups and the railroad involved, but what do you have in mind? It seems that there really isn't an availability as far as any type of access up there, because there really is only one railroad.

Do you have any ideas in mind as a way to solve that issue?

MR. WHITESIDE: Mr. Chairman, I think I would go back to what we just talked about. Working with our partners, the railroads, is important, and there's been some progress.

Is it a total solution? I liken it to growing a garden. You need lots of tools. You need hoes and rakes and shovels and whatever, and it's one of the tools that's working for us.

But I think the most important thing is having a strong STB presence, saying look, here's a reasonable small rate case procedure that you can use; having arbitration, a strong arbitration provision; having --

I mean I don't think well, terminal access, for example, is going to work in Montana. There aren't any. It's just -- it's too far. North Dakota is not going to work; it's not going to work South Dakota. It probably won't work in major portions of Colorado.

But having those tools gives us the ability to sit down and develop a comprehensive policy with the railroads. The railroads are not totally unreasonable. The railroads are doing exactly what they're allowed to do.

And you know, I've sat down with farm producers and I've said look, if you could go and sell to an elevator down there and get a better price than anybody else, would you go do it?

They said yes. I said would you feel guilty about it, even for a second? They said no. So they're doing what they're allowed to do. What we need is some help with some various different tools, to be able to build the garden. I hope that helps.

MR. HURST: Mr. Chairman, if I may, I've been associated not directly in the Montana workings, but I've been exposed to it quite a bit. In fact, there's some talk about trying to do that on a national level. But my experience is that it has been, I think, helpful in some people's views.

But there have been -- in the few cases that have been worked on, there have been some winners and losers, and there's great political and economic risk involved, and it's limited to a small group geographically, and currently only wheat growers are involved, but there are other shippers as well.

So we need, I'd say, some

widespread board or something to be accessible to all players and all folks involved.

CHAIRMAN ELLIOTT: Just one final question. You've mentioned having access to a simplified rate kind of case system, and various groups have advocated for raising the limits on the simplified SAC and the three benchmark.

Do you have any ideas on that, as far as how high you would like to see the limits go, or are the limits okay, or is it the process that's not working?

MR. WHITESIDE: We need them higher, and I'm going to get in trouble no matter what I say to you. So at least double where they are now. We have to get them into the range where -- you see remember, under all of them, we're going to end up with 240, 250, 270 kind of numbers, so -- for our RVC.

So we need them high enough that, and long enough that they can -- we can take an origin destination pair, and it makes sense to litigate it. Will we litigate it? Let's hope not. Let's hope that the possibility of litigating it gets us to rate resolution or service resolution wherever we are.

But we've got to have them at least doubled, and I'm sure that some of my friends behind me will say no, we've got to have them more higher that that. But I think at least doubled.

MR. KEITH: We've got a policy position of raising it to $3 million. We think that -- the problem in the grain markets is if you litigate a particular point to point movement, you don't know how long that movement's going to be economic, just by the market pricing.

So really, trying to evaluate what the case is really worth is quite difficult for agricultural shippers.

CHAIRMAN ELLIOTT: Okay. I don't have any further questions. Vice Chairman.

VICE CHAIRMAN BEGEMAN: I thought

your questions were really informative and your answers were very helpful. I think it's great that NGFA has been so successful with its arbitration process, and the reason you've been successful is that the industry has agreed to participate.

So I'll really be interested when industry representatives come back before us as to you know, is there a way that we could get you to participate in the arbitration process here? We have one at the Board, but it's never been used. I know the Chairman has been working to try to get it reinvigorated or invigorated for the first time.

But whatever we could do to try to resolve cases or actually avoid the cases but actually resolve a conflict prior to it becoming a case, we should all try to be working toward.

Really, I think the only question that I have, because I've kind of heard from all of you guys over the years and it's been very informative to some of my thoughts on all of this, has to do with simplified rate processes. You know, when the STB was established, since it was established, it finished the simplified SAC process, established the three benchmark process.

Really, the mediation process has, I think, really taken off in the last few years, and there's been some solutions to kind of reduce caseload, etcetera. Are those avenues sufficient? Is it just that we need to maybe consider increasing the thresholds, or is there another proposal out there that we haven't thought of? Do we need something even more super-simplified, three benchmark? Have any of your customers or any of you utilized the processes?

MR. KEITH: It's still pretty complex, and it's not low cost to bring a case. I mean it's nothing like a SAC case. But it's several hundred thousand dollars to bring a case is not uncommon. So there's still quite a barrier there.

But the fact is once you create a process, it just sets the stage for people to do business, you know, and try to work things out better. So we think it's an important step. We think it's not quite as rich as it should be to make the process really work.

In terms of mediation versus, I think the mediation process of the STB is helpful today. I don't know that we've had many members use that process.

But on the arbitration side, if the arbitration element becomes one more layer in problem resolution and everything gets appealed to the STB anyway, then I'm not sure it's that helpful, and maybe that's the big discouraging factor for STB arbitration today.

MR. WHITESIDE: I think on arbitration too, we have to guard against a process that the railroads have used before, and it's what I call "gaming the system." They come in with arbitration at 400 percent of variable, and we come in at 180, 200.

They're hopeful that they can get a 300 percent decision out of that arbitrator. So they come in very high, just to be able to get it down to where they wanted it anyway. So I think that's the problem. That's why final offer makes a lot of sense when they use it in Canada, because they both come in with their final offers, and the arbitrator has to pick one or the other.

Wherein our arbitration process, the arbitrator picks somewhere in between, and it leads itself to a gaming process. That's of concern. But I think those kind of things can be worked on by this Board, and we can set up a procedure where it becomes a tool.

But I share with what Keith's saying. If what we're doing is starting to layer different things that can be done, it just becomes a time-consuming process and it doesn't really resolve anything.

CHAIRMAN ELLIOTT: Commissioner.

COMMISSIONER MULVEY: Thank you. I just last week was out visiting agricultural interests in Indiana. I was hosted by the Soybean Council, and got to see a number of soy processing facilities and it was very interesting. But what I was told out there is somewhat different from what I've heard here today.

For example, they didn't have very many complaints about rates. Soybean prices are particularly high right now, I think. Overall, there is a lot of satisfaction with prices for agricultural commodities, and so railroad rates weren't the issue. The issue I kept hearing about was service, that too often the railroads will call the shipper up and say oh, we need to have your cars loaded by tomorrow.

So the shippers call in their people, have them work at time and a half and overtime rates. The shipper pays all those extra costs, and then the railroad doesn't show up. Either the locomotives aren't available or crews aren't available, and this seems to happen time and time again.

I was wondering if that was any of your experiences, that the problem today is more service than it is rates, at least today. Terry.

MR. WHITESIDE: Commissioner, no. I think it's rates, more than service issues. The situation you describe I've heard complaints from many elevator operators, where the cars are delivered on Friday night and they have to have them out by Sunday morning.

So they've got to call the crews in on the weekends and then the railroad doesn't pick them up for another week. That happens. But you know, those are complex problems. I think if you get the rate problem solved, then we'll start worrying about the service problems.

But sometimes the rates have to be solved before the service problems become an issue, and it's not the other way around. So I think in general in the west, we're seeing issues -- the conversations I have with most of the wheat commissions and most of the farm producers are about rates and basis points right now.

MR. HURST: And I would concur. However, service has been a big issue. I mean for years, if you wanted to hear four-letter words, all you had to do is call up an elevator, and ask them how the railroads are treating them. You got an earful in a hurry. That was common.

Now, for example, just this last winter, I called up an elevator operator and said "How are the railroads?" He said "You know, service is not bad. You're just paying for it." That's what I'm hearing. Also my exposure, frankly, with the BNSF and from what I understand the UP.

They have been working hard internally to improve service, and I believe that they have. At least that's what I've seen. I mean internal workings, that's what I was impressed with, and that's what I hear on the ground.

However, like I say, I mean they can't please everyone every time. That's just within the grain industry. Now you talk with some of our coal shipping friends and wow. You still hear a lot of four-letter words.

MR. KEITH: There have been some service problems in the east, and I think on one carrier more than the other major carrier. It's been the last six to eight months, and some of its power, some of its manpower, we understand. So I think it's being resolved, but it's slow to improve.

COMMISSIONER MULVEY: You mentioned about the shipments of the grain elevators becoming larger and larger, to handle the large unit trains, and there's been some complaint that the railroads encourage the elevator operators to build facilities to handle 50 cars, and then they've turned around and said now they want 100 cars or 120 cars.

But don't the shippers also benefit from these large operations, in terms of the economies of scale passed on to the shippers in terms of lower rates for loading cars?

MR. HURST: Yes. Yes, they do. Quite often, if they're fairly close to one of those facilities. I had a shipper friend in Colorado who's excited, that recently they got a shuttle facility there, and they're excited about their lower rates.

However, and I've heard the railroads say well, you know, if you're going to build a factory, you'd build it on a highway, on an interstate highway instead of out in the hinterland. But that's not where the wheat's growing. The wheat isn't growing on all the major railroads or near the shuttle facilities.

So getting it to those shuttle

facilities, still there's quite a bit of cost, and the small country elevators scattered out throughout the grain sheds throughout the country, play a very important role, and are very important to us.

MR. WHITESIDE: Commissioner Mulvey, you know, it's interesting. You were raised or at least were in the Palouse Empire for a number of years in southeast Washington. The small elevators, the smaller elevators that the railroads encouraged in the 90's, 80's-90's and even in the year 2000, are very important for the marketing of the pulse crops, the rotational crops, the seed crops and fertilizer crops. That isn't handled by the shuttles.

One of the worries in the country is as these go away, where are we going to market these optional crops? Rotational crops, if you don't know, are the crops that they grow in the off-years, because they don't have the moisture, or they need to rebuild the soil. So there are concerns.

Are people benefitting from the shuttles? No question about it. The concern we have is that maybe wheat is not quite the same as corn, because the production quantity is not as much, and there may be instances where these smaller elevators are going to be very, very crucial to being able to market the crops that are actually being grown.

COMMISSIONER MULVEY: I have one final question to Keith, and that is you mentioned a statistic that I quoted the other day in my trip out in Indiana, and that was that the rail market share in agriculture has declined from 50 percent to 35 percent.

Would you care to speculate as to why that has happened, since the railroads have pointed to an overall or fairly significant increase in their market share, from 30 to 43 percent over the last, at least since Staggers, why grain has -- why agriculture has gone down?

MR. KEITH: I think there's a number of factors involved. I think the industry has -- well, the ethanol business, for one thing, in the last five years has grown from virtual zero to using five billion bushels of corn. That's over a third of the crop.

They're not building ethanol plants very far from production areas. So that's -- a lot of that grain is trucked directly from the farm to that ethanol plant, or to a local elevator and then to the ethanol plant, and it never touches rail in some cases.

COMMISSIONER MULVEY: Right.

MR. KEITH: And the industry, I think, has relocated some facilities because of rail pricing over the years. So it's kind of taken away some of the market share that way. Barge movements are actually down slightly compared to 30 years ago, in terms of a percentage market share.

Barge used to pick up 20 to 22 percent of the market. Today, it's down to about 17 to 18 percent. But I mean we're just not exporting as high a proportion of the crop as we used to. Some of it's because of ethanol.

COMMISSIONER MULVEY: But you see that changing, obviously, with what's going on in Australia and now apparently Russia, with the locust problem. So I gather that international output is going to be down again, which will probably be beneficial to agricultural export markets?

MR. KEITH: Oh, I think the agricultural industry has a tremendous opportunity in the next five years, to pick up market share in export markets. Some of that depends on transportation pricing; some of it depends on production.

We see ways that we could plant more acres, but it kind of depends on what happens in the farm legislation and the administration. But there's going to be an opportunity to pick up market share.

COMMISSIONER MULVEY: Thank you very much.

MR. WHITESIDE: Commissioner, can I add one more thing?

COMMISSIONER MULVEY: Go ahead.

MR. WHITESIDE: We have whole states, though, that market 70-80 percent of their wheat export. Montana, North Dakota, Colorado. There are various states, and that's because they have very high quality wheats. So they are absolutely dependent on rail, and those percentages have not gone down in that part of the country.

We're seeing the rise of the new white wheats, the hard white wheats, and as they come on board, they're going to be identity-preserved marketed into Mexico and into the foreign markets also.

CHAIRMAN ELLIOTT: Thank you very much. We appreciate your coming today, and we will now call forward Panel VI.

(Pause.)

COMMISSIONER MULVEY: You can begin. The Chairman, I'm sure, will be back in a second. In the interests of time, I think we should probably just go on ahead, and I think we'll begin with Mr. Ward from CSX. Thank you.

Panel VI

MR. WARD: Well thank you, Vice Chairman Begeman and Commissioner Mulvey. I'm proud to represent the interests of key shareholders today, including the 30,000 dedicated employees of CSX. I appreciate the opportunity to share our grave concern about the matters before you today.

This is an extraordinary time for CSX and all North American railroads. We move more freight safely with record performance and the prevention of injuries and accidents. We work every day to make our railroads more secure from outside threats, and we're investing in our infrastructure at unprecedented levels, both to maintain our systems and to expand them for future demand.

That's why today's proceeding is so important. The nation is struggling to build and maintain infrastructure, and our industry is doing that with nearly all private investment, to ease the country's burdens. The nation desperately needs and is seeking new jobs, and we're producing them.

In January, this administration launched an initiative to remove or streamline regulations that hamper business, dampen investment or undermine job creation. We support that initiative. CSX is doing what the nation asks by investing $2 billion in 2011 to provide new transportation infrastructure, more than 3,000 new jobs, and an environmentally friendly solution to ease traffic congestion and reduce emissions.

We're doing the right things for the right reasons with the right results. I'd like to make three important points today. First, capital investment, job creation and the environmental benefits all line up with the goals of public policy.

We continue to hear from federal, state and local governments, and from customers and from communities we serve, that there's a need to get more freight off the highway and onto the rail system. That's what we're doing.

Second, we continue to make substantial investments in the quality, flexibility and capacity of America's more important transportation infrastructure. At CSX, we spent $8.3 billion between 2006 and 2010, and plan to spend another $2 billion this year on projects to improve service to our customers, extend market reach, replace aging assets and enhance the safety and security.

In fact, we recently committed to spend 18 percent of our revenues on average on capital projects through the year 2015. Finally, our commitment is based on the existing regulatory framework, with the expectation of improving returns as we make our railroad more efficient and more productive.

Any action by this Board to limit long term freight rail movements and force the opening of our private networks with artificially constrained profits, would scale down our investment plans and job creation. I just sunk for some reason.

(Off mic comments.)

MR. WARD: Sorry if I offended you. You pushed the button on me for that last remark?

(Laughter.)

COMMISSIONER MULVEY: We have a little switch up here.

MR. WARD: We compete vigorously against all of our competitors, but as the chart, which we hopefully will pull up here, the trucking industry has the greatest share of the traffic. It commands 67 percent of the total U.S. transportation market, based on tonnage.

Rail, on the other hand, currently holds a modest ten percent of the service transportation market. Customers often have sourcing or other options that further increase competitive forces. They can change sourcing for raw materials, or use their purchasing power to encourage suppliers, like railroads, to lower their prices.

We also face fierce competition from other railroads and rail truck transfer facilities, all the while creating competitive advantage for our customers. Over my career, I've seen the competition grow stronger. What's being sought here, in our view, is not more competition, but rather lower rates for a limited number of shippers.

The Staggers Act gave the railroads the ability and the incentive to increase investments in their infrastructure, investments that today make the U.S. freight railroads the envy of the world, and position North American commerce favorably on the global stage.

Look at what's happened since Staggers Act. The volume has doubled, capital investment is at historic levels, and the railroads' improved health means that they're able to invest not only in maintaining and replacing their assets, but expanding capacity to handle the freight demands of the future.

All of this new rail capacity eases the burden on publicly funded highways. You heard earlier this year about our National Gateway. Since that time, we've announced our intention to build a new intermodal facility to serve the Baltimore region, and to complete a major clearance project on the Virginia Avenue Tunnel here in the District.

That project alone is $160 million rebuild of a century-old tunnel, to enlarge freight capacity. Keeping what we have and building new capacity means more jobs on the railroads and the companies that support them.

As I noted earlier, we'll hire about 3,000 people this year. That's more than the 2,500 we have been hiring per year since the year 2005. However, if we can't generate adequate earnings to invest in our networks and equipment, to attract new employees and build businesses, it will not be possible to man our system as it presently exists.

I'd like to look for a moment at railroads in terms of capital spending as a percent of sales, and the corresponding return on assets. We'll look at this in the context of trucking and other industries, some of whom are represented by the companies or trade associations testifying before the Board in this hearing.

In the five year period between 2006 and 2010, railroads invested on average

16.9 percent of their gross revenue or sales. In turn, they earned a return on assets of just 5.3 percent. This highlights the capital intensity of railroads and the relatively low returns that are still not sufficient to justify replacing many assets.

Every other industry on the chart invested less and earned better returns than the railroads. The proposed rules that transfer earnings from the rails to the shippers will only serve to exacerbate this disparity.

We're proud of the National Gateway and other expansion projects, but a lot of our capital goes to decidedly non-glamorous but necessary items, everything from rock piles to cross ties. Every year, we have to maintain and replace basic infrastructure that is critical to operating safely and reliably.

As you can see on this slide, these are examples of the basic assets required to run a railroad. They're expensive to buy and to maintain. These decisions must account for significant costs of regular maintenance and upgrades.

Any capital intensive business such as railroads should be able to operate within a regulatory framework that provides the ability to earn returns sufficient to justify continued investment. Otherwise, railroads will be forced out of capital spending plans and reduce employment.

Some of those testifying claim that railroads are driving manufacturing offshore. That's beyond belief. It's clearly in our interest to retain customers and to attract new ones.

For example, the Board's record indicates that some chemical shippers say that they're being forced to relocate their facilities abroad because of burdensome rail rates. Don't fall for it.

The truth is the chemical

manufacturers are in fact expanding their facilities and their production capacity within the U.S., and they're doing it on the railroads. We're attracting new business to CSX, and those customers are creating new jobs.

This slide shows last year's results. If you look further back, the results are even more impressive. Since 2006, more than 600 new or expanded businesses have located on CSX and connecting shortlines. That represents more than $18 billion of customer investments, and more than 21,000 new jobs.

That doesn't just happen by accident. CSX has a highly successful industrial development program to recruit new businesses. Our efforts are supported by the communities we serve, and those communities are often eager for new jobs, new sources of public tax revenues and much needed economic activity.

Finally, this is what rail congestion is projected to look like less than a decade from now on our current course. To demand that the freight industry take on unprecedented feats of transportation, economic and environmental performance, and then to impose new mandates and reassert the onerous hands-on regulation, is an attempt to go forward and backward at the same time.

It's the wrong direction toward the past and away from the future. I've spent most of my career right-sizing our organization, as well as rationalizing our network and our equipment.

The railroad renaissance has changed all that. Today, we're adding employees, expanding our network, and purchasing new equipment to the benefit of our country and our customers.

We can do amazing things for our country. I know, because we already have. We're converting freight from the highways to rail; we're reducing traffic congestion that costs billions of dollars in wasted time and travel and fuel; and we're improving the quality of the air we breathe, and continue to provide an essential link for the U.S. military's logistic change to troops abroad.

In closing, I'd ask you to remember two important numbers. 500. We can carry a ton of freight almost 500 miles on a single gallon of fuel, and 18. We will spend 18 cents of every revenue dollar on America's transportation infrastructure through 2015.

The next few years could be a great opportunity for our nation if we align our policies and vision. There's a lot on the line. We've got to get this right by adhering to the tenets of the Staggers Act, and the principles of balanced regulation we've been operating on over the last 30 years. Thank you.

(Laughter.)

CHAIRMAN ELLIOTT: Thank you, Mr.

Ward. We appreciate your comments. We'll next hear from Kansas City Southern, Mr. Haverty.

MR. HAVERTY: Okay. Chairman Elliott, Vice Chairman Begeman, Commissioner Mulvey, I'm Mike Haverty, executive chairman of Kansas City Southern. I started in the rail industry 48 years ago, 1963, as a brakeman/switchman on the Missouri Pacific Railroad. I've been president of the Santa Fe Railway and I've been at Kansas City Southern now for 16 years.

I've seen the good and the bad days in this industry. I was around at the pre-Staggers era and saw an industry on the verge of bankruptcy and nationalization. I also see the benefits of the Staggers Act and the rail renaissance that has followed. My main message to you today is be careful about what you do in response to this hearing.

The ancient oath of Hippocrates, first do no harm, certainly applies to these proceedings. Given the actions the STB has taken in recent years to provide even better protections for shippers, you should let these improvements to your rate, service and complaint process, a process that allows for specific remedies to specific problems, to work.

Recent decisions in favor of shippers show that the process is working. KCS is a vital competitor to the larger carriers, especially for traffic to and from Mexico.

KCS also provides important rail to rail competition with respect to chemical traffic and grain movements from the heartland regions of Iowa, Nebraska, Illinois, Missouri and Kansas, to important markets in Mexico and the Southeastern U.S.

KCS also competes hard in the growing intermodal markets. KCS not only bridges transcontinental east-west traffic, but also handles cross-border international traffic to and from Mexico. No better example of what KCS is doing to better compete against larger carriers can be found than looking at our Rosenberg to Victoria, Texas line rehabilitation.

KCS took a line that Southern Pacific allowed to deteriorate, and spent over $170 million to rebuild it. It now serves a new intermodal shipper facility at Kendleton and Caterpillar has recently chosen to locate a new manufacturing facility on the line in Victoria.

This line would not have been built without this Board's actions, which have helped KCS remain an independent carrier to the larger systems. In spite of its investments and growth, KCS still remains the smallest U.S. Class 1 carrier.

As this slide shows, KCS' domestic annual revenue is about 1/18th the size of our two larger competitors in the west, and about 1/10th the size of the other two eastern carriers. Yet we compete vigorously in spite of our size disadvantage.

KCS also plays an important role as an interline partner with all the other Class 1's, and the vast majority of KCS' traffic is interline traffic. As this slide shows, approximately 85 percent of KCS' traffic is interlined with the larger Class 1 carriers.

Because KCS interlines the vast majority of its traffic, has connections with every Class 1 carrier, and has critical interchange points with these carriers, KCS is uniquely at risk of being short-hauled in any bottleneck pricing scheme and having its traffic cherry picked by the larger systems, if some form of forced open access switching or terminal access were to be adopted.

This could result in loss of an important rail competitor, with the potential breakup of the KCS system. So as I said at the beginning, be careful about what you do, and first, do no harm. The unintended consequences of overreaching could be even further consolidation of the rail industry, with even fewer independent carriers.

For shippers who face legitimate market abuse, there is an alternative. I am pleased to introduce Mr. David Konschnik, a former member of the STB staff, to discuss that in more detail. David.

MR. KONSCHNIK: Thank you, Mr. Haverty. Chairman Elliott, Vice Chairman Begeman, Commissioner Mulvey, I'm David Konschnik, and I'm honored to be appearing here before you today.

I began work at the ICC in 1976. During my years at the ICC and STB, I was involved in a full range of decisions made by the agency in railroad matters. I've seen what regulatory approaches have worked and what approaches didn't work, and I've always, especially since Staggers, been mindful of the agency's dual role, to allow the market to regulate rates and services to the maximum extent possible, while protecting shippers where there are market failures.

The balancing of these factors is challenging, but in my experience, the agency has tried hard to provide a level playing field for all participants. KCS has retained me as an independent expert, and not as an attorney in this proceeding. The views expressed here are my own.

I've reviewed the initial comments and the reply comments, and in my view, the comments do not support a change in the STB's approach in matters of competition and access. It seems that the vast majority of the concerns expressed are about rates. That was in the comments; that's been confirmed here this morning.

I believe the Board has processes in place to deal with those concerns. While I understand concerns, I can't support at this time calls for reversal of the *Midtec* or bottleneck precedents. They were correct interpretations of the law.

The underlying statute on which those decisions were based remains unchanged. Congress has had several opportunities to change the law so as to reverse these precedents, and has declined to do so, which indicates to me that the Board has struck the appropriate balance.

Thus, I would not support a change at this time, but instead the Board's existing procedures for rate and service complaints should be given time to be applied. I've seen firsthand how the agency has been responsive to shipper concerns in making changes.

The Board has been one-minded and flexible in considering concerns, and in trying to improve the processes and make them more efficient and less costly where possible, without sacrificing fairness to the parties in individual cases, all while endeavoring to remain faithful to the Congressional charges contained in the Staggers Act and the ICC Termination Act.

Here are some of the things that Board has done to address the shippers' concerns. The Chairman mentioned some of these this morning; Commissioner Mulvey also talked about some of the things in revenue adequacy and cost of capital.

In the SAC process, the Board has eliminated consideration of product and geographic competition in making market dominance determinations. The Board has adopted mandatory non-binding mediation, to be conducted immediately after the filing of a rate complaint, and improved the discovery process.

The Board has made changes to procedures to speed up cases, including elimination of the ability to make movement-specific adjustments to URCS. In many respects, these changes sacrifice some of the accuracy of the original system, in order to simplify the process and reduce the expense for all of the parties involved.

Indeed, there have been several SAC cases over the past few years that have found in favor of the shipper, and sometimes that yielded large amounts of rate relief. In the non-SAC area, smaller shipments in 2007, the Board adopted simplified standards for the rail rate cases.

In the service area, the Board has improved both its formal and informal procedures for addressing service complaints, and has improved its rail customer and public assistance programs.

To sum up, the Board has made many changes to shorten and simplify rate procedures, and to increase shipper access to remedies for perceived abuses of market power by railroads. These changes have dramatically improved these processes, and should significantly reduce litigation costs.

The changes appear to be working.

According to comments filed in this proceeding, since adoption of the simplified rate case standards, chemical shippers have prevailed in seven of eight cases that have been brought under the three benchmark methodology, and of the rate cases that have reached final resolution since that time, 92 percent have entered either into settlement or a finding that the challenged rate was unreasonable.

The Board can adjust its procedures in the future if shown to be necessary. In the meantime, a case by case approach is best and safest. Any broad-brush approach to competitive access at this time poses significant dangers that could easily present effects adverse to both railroads and shippers.

I respectfully urge the Board to resist the relatively few but nonetheless fervently expressed calls for a change in rule or approach by the Board in matters of access.

The best approach, it seems, is for the Board to continue to handle these matters as they arise, based on the specific facts in individual cases.

Thank you very much for allowing me to appear here today.

CHAIRMAN ELLIOTT: There's a lot of pressure on Mr. Young, let me tell you. We'll now hear from Union Pacific Railroad. Mr. Young, you have ten minutes.

MR. YOUNG: Good afternoon Chairman Elliott, Vice Chairman Begeman, Commissioner Mulvey. I appreciate the opportunity to testify here today. I appreciate the opportunity to testify here today.

As you know, Lance Fritz, our executive vice president of Operations, was to be here with me today, but I thought it best that he stay in Omaha, given the unprecedented flooding we're facing.

As many of you know, we're looking

at floods out there in the Midwest that are going to probably break the 150 year mark. So his job is to keep the railroad open and continue to provide the great service that we do to our customers here.

I would ask you to allow us to submit a written copy of the testimony from Mr. Fritz. He will outline what you've heard today here several times, the potential consequences of access.

Now you know my background. I spent about six, seven years raising money on Wall Street, and I'm going to give you a little bit different twist here from somewhat of an investor perspective. I'm going to focus on two closely related issues, and they are related, competition and investment.

Union Pacific invests so that we can compete effectively for our customers' business. But to continue to invest, we must also deliver competitive financial returns to our investors. Shippers proposing new access remedies say they are trying to increase competition, but railroads are already subject to intense competition.

Each year we lose and must replace over ten percent of our business. We continually struggle with other railroads, trucks, water carriers, to win and retain business. Sometimes competition's easy to see, because one carrier takes traffic directly from another.

For example, just a few days ago, Kansas City Southern and UP won a significant coal movement from the BNSF. Our reply filing gave other recent examples of traffic switching between carriers. Other competitive actions are just as important. We compete by increasing the value we offer customers through high quality, reliable service and innovative products.

I'll just give you one example. The H.J. Heinz Company. We've been working with them to redesign their supply chain, using refrigerated rail cars to ship traffic from highway to rail. Again, there's a box car product taking business off the highway, going to rail.

We helped Heinz become more cost-effective, competitive and environmentally friendly by reducing its fuel use, CO_2 emissions and costs, and this year Heinz won the frozen food industry's Sustainable Supply Chain award. Successes like this show why you can't measure competition by looking only at rates. You also have to look at the value we provide.

Similarly, you cannot just look at whether traffic shifts between carriers. If our service creates enough value for our customers, they keep their business with us, give us more business, and are willing to pay for the value we provide.

Competition is what drives us to invest. It's why we poured $30 billion into our network from 1999 through 2010. It's why we plan to spend $3.3 billion this year, $1.9 billion to replace and renew existing assets, and over a billion dollars for new growth capacity.

This is the highest capital spend in the history of Union Pacific Railroad. Competition is why we have committed to invest 17 to 18 percent of our revenue annually over the next several years, assuming the regulatory environment will allow us the opportunity to earn adequate financial returns.

In short, competition is why we devote so much of our creativity, energy and resources to improving service, and expanding our network. As our earnings have grown, I've kept my commitments to our customers. So have our investments. We can't afford to ignore customers, and our customers, at least most of them, recognize our efforts.

Our customer satisfaction scores have been marching upward. In the first quarter of this year, we earned a record score of 91. The picture of a complacent monopolist that some parties paint does not fit with our approach to service, investment and growth at Union Pacific.

Proponents of new access remedies are not seeking more competition. They want policies that will shift revenue from railroads to shippers. These policies will also have the unintended consequence of increasing our operating costs, eliminating efficiencies and consuming network capacity.

The predictable decline of railroad earnings means that these policies would have a serious negative impact on our investment plans. Capital spending would decrease immediately, just as our nation is looking for railroads to provide more transportation capacity.

This would reverse the progress we've made during the last 30 years. This is financial reality. If regulation prevents us from generating competitive returns on the replacement value of our capital investments, our shareholders will not allow us to continue investing at the levels we have planned. They will require that we return more cash to them directly, rather than investing in future growth.

Several parties in this proceeding say that stock buybacks and dividend payments are evidence that we're already earning more than we can profitably invest. They argue that we can easily spare this supposedly excess revenue without cutting back in capital expenditures. That's simply not true.

Stock buybacks and dividend payments are not evidence of excess profit or lack of investment opportunity. Every company must balance between providing investors with immediate returns in the form of stock buybacks and dividend payments, and investing capital for long-term value appreciation. We can't ignore shareholder demands that we allocate some of our cash to stock repurchases and dividends.

Every one of the publicly-traded non-rail companies have filed comments in this proceeding, and that has more than $10 billion in revenue. Bought back stock, UP dividends during the last three years. During that same time frame, almost two-thirds of the S&P 500 companies repurchased shares, and nearly three quarters pay dividends to shareholders.

These are mainstream practices for delivering financial value to shareholders, not a sign of excessive profits as some commenters claim. We must compete for capital with other companies that provide the same type of returns to their investors.

In fact, as you can see from this slide, comparing how cash spent on shareholders and capital investment has been allocated by Union Pacific and all S&P 500 companies, Union Pacific allocates a higher proportion to capital spending than to dividends and stock buybacks combined.

In 2009, while we continued to invest significantly in capital expenditures, we had no share repurchase at all, while the S&P 500 companies allocated 19 percent to share repurchases. It's critically important for the Board to recognize that using regulation to force down revenue and earnings will increase, not decrease.

Shareholder demands that we return cash to them instead of investing it. Our investors have questioned our need to reinvest 17 to 18 percent of revenue on an ongoing basis. In their experience, this is a significant amount of money for a company to invest.

But recently, they've been encouraged by our progress in growing our financial returns. They're willing to stick with us as long as they see the opportunity for more attractive returns in the future. They expect our capital spending to pay off through higher stock prices, stronger dividends and share repurchases, which would increase the value of their investment.

We're just beginning to meet those expectations. If regulation reduces Union Pacific's prospects for revenue growth, our investors will insist that we provide returns through higher dividends and more share repurchases now, rather than investing and growing the business in the future. Our capital expenditures will decrease.

As I said, this is a financial reality. Earlier this month, I met with shareholders and prospective investors at a major equity conference in New York, where shareholders are very aware of this proceeding and its implications. They have a fiduciary responsibility to the pension funds, endowments, trust funds and individual mutual fund investors who entrust money to them.

If Union Pacific cannot provide competitive returns, many of our current investors will redirect their investment to companies that are not forced by regulation to reduce revenue.

The investors who replace them and those who remain will not be satisfied with lower returns. They will press Union Pacific's managers to reduce investment base and cut costs by taking drastic actions, such as slashing capital expenditures, selling assets and cutting jobs.

We all know the significant challenge our company faces to find the high replacement costs of transportation infrastructure in this country. If our economy is to succeed and thrive in the global marketplace, shippers will need the rail network to carry more of the nation's freight.

The Board should be considering how it can encourage more private investment in railroads, not policies that will reduce such investment. With that, I'd be happy to take questions.

CHAIRMAN ELLIOTT: Thank you very much, Mr. Young. Thank you, panel. Vice Chairman?

VICE CHAIRMAN BEGEMAN: Thank you all, and especially Mr. Young. We certainly would have understood if you needed to cancel today as well. We know that you have a very serious situation going on, as does BNSF. If there's anything that we could do besides staying out of your way, please let us know.

Certainly we've gotten the collective message which has been sent for years from industry, of sort of do nothing, make no changes, we need to reinvest, we need to earn adequate revenues, etcetera. You've also clearly taken a very serious interest in this proceeding, not only by showing up here today but through all your lawyers and the submissions and tracking of what's going on here.

I recognize you're telling us to make no change right now that even though you've been sitting through this process and hearing a lot of sort of uncomfortable complaints (at least if I was on the receiving end, I would be a bit uncomfortable). If the Board is to do nothing, what can you do? What can you do to address some of the concerns that we've been hearing here today?

I know that we've talked a lot about competition and if railroads are competing. Can there be more of a use of, I guess they're called Rule 11 rates? Shippers have some legitimate concerns, and I'd like to know what more can be done so that some of these complaints can go away?

MR. YOUNG: I'll take a shot at it first. Vice Chairman Begeman, I'll tell you. What I experienced, I spend a significant amount of my time out in front of customers, probably a third or more. My experience in front of the decision-makers in the field making those decisions every day or senior people is quite different from what we hear up here.

Granted, I haven't met a customer today that will tell me "thanks for the price increase." They want lower prices. I would also like to have lower energy costs. I would like to have crude oil at 30 bucks a barrel, not 110. I'd like to have steel prices I'm paying that are up 300 percent over the last ten years.

I'd like to have my health care costs drop down to single digits. I'd like to have lower regulation costs that this industry's facing. But when you get through the discussion on the pricing, it quickly moves to this. What are you doing to invest and provide new products and great service for me in the future?

I have been in hundreds of conversations with the senior leaders, and many of these companies are represented here today, and I always start with the price question, because I want to have the discussion. But their biggest concern is when they look to the future, and they look at what's happened with transportation infrastructure in the United States, and we know the story, their biggest concern is that we're not going to accelerate capital in this business.

My goal is you have a -- if you have a specific issue, and I'm not going to argue that we don't see some, we work with our customers. We very much work with them. I want them to grow. Putting a customer out of business or making them non-competitive in a market, that's exactly the opposite of our mind set. I need their business volumes for us to grow.

MR. HAVERTY: What I might say is that I think what a railroad can do is what I was taught many decades ago. You need to provide safe, efficient and economical service.

In other words, cost-competitive

service and on time, and that's really what it gets down to. In our case, I think that we certainly have been able to do that. We have not had any rate cases against us, and we have not had shipper complaints, and I think that's what needs to be done.

MR. WARD: I guess I'd like to make a few comments on that. One, you'll notice that the people who are here are those that want something to happen, i.e., their rates being lower, and the impression you get is there's this great discontent.

I'm similar to Mr. Young. When I talk with customers, we have many, many happy customers. You'll notice over 100 customers who are not unhappy actually took the time to file comments in this proceeding. Normally, people who are unhappy don't do that.

So clearly, there are a number of happy customers out there. I will remind the Board that the Christiansen study, when it looked at it and said there was one, no abusive market power by the railroads, and they did note on the potential reciprocal switch was discussed earlier, that that would be the least onerous.

They also did note that what will probably happen with that is it would lower the rates for a few selected industries, and with the resulting impacts one of two things. Higher rates for others, and/or lower investment. So clearly, even the Board's own independent study said there's not an issue here of market abusive power.

So I think we have a selective group of shippers who basically want you to take your power to reduce rates, when there's already a process in place to do that. We've been very pleased with your mediation process.

At CSX, we've had three separate cases that were brought, where the customer felt like the rates were not appropriate, and through your mediation process we reached resolution every time.

So there are procedures in place for those that don't feel like they're being treated fairly, and I think that we should continue to use those.

VICE CHAIRMAN BEGEMAN: What are your thoughts on the Board's arbitration process, and getting that to function? Are you willing to participate, such as you do with the National Grain and Feed arbitration process?

MR. YOUNG: Well, I think the processes you have in place today have been -- in fact, I commend you for the changes that you've made in the STB over the last seven or eight years.

I think you have to be careful making a wholesale change in terms of mediation, and I would again encourage our customers to look at what they can utilize today, that's within their control.

The first point is start with the negotiation at the local level. We've had very few, if you look at over the last four, five, six years, where we got to that point, because again, my goal is to help a customer grow. Now that doesn't mean that you may not have had a few situations you couldn't reach that agreement that's out here. But I think we have to be careful about wholesale changes, saying we're going to offer a new mediation process.

VICE CHAIRMAN BEGEMAN: Well, there is an arbitration process that's been established years ago. It's just that it's never been used.

MR. YOUNG: I think it probably hasn't been used because again, we're getting a lot of the issues resolved, at least for the Union Pacific, out at the local level.

MR. WARD: At CSX, we have over 4,000 customers, and the vast, vast majority, three thousand nine hundred and eight-some we've reached a nice agreement with, and we work in a cooperative way to grow the business. So by and large, I think we do have good commercial relationships with the vast majority of our customers.

VICE CHAIRMAN BEGEMAN: Could you go just a bit into the reciprocal switching issue you brought up, as far as the Christiansen study, etcetera? I know we haven't really talked about what a standard would be. It's just sort of a generic concept of if there were a change or a requirement for more reciprocal switching.

What would the actual impact be on your ability to provide your service?

MR. WARD: One, we will have experts from the other railroads talking about the operational aspects of it tomorrow, and I'm not the expert to do that. But clearly, there's significant issues around the capacity to be able to do this reciprocal switch work, and continue to provide the service and capture the efficiencies of the single line service.

Secondly, if you think about it, what it does, I mean Ramsey pricing and the ability to differentially price your product is a key element of the Staggers Act and your policies over time. What you'll start doing is start breaking that down. Without the profits that are available through the Ramsey pricing, we do not make returns sufficient to continue the investments we're making.

Even today, with that ability, we're not yet revenue adequate as an industry. We're making progress toward that. So if anything, what that would do is start moving us backwards, away from our ability to have that revenue adequacy, to make those investments.

I'd like to reinforce Mr. Young's comments about the capital markets will clearly not allow us to continue to do that, if we're seeing reduced profitability. So that to me would be the major impacts.

MR. YOUNG: And I'd like to

comment. We're about ready to substantially increase the amount of investment in terminals and industry treks. This is our carload network that's out here. We're confident, when we've looked at what our ability to get our returns up, that it can justify investments.

Now these are investments you look at, that are 30, 40, 50 kinds of investments that are there. To bring in or to put on the table uncertainty with reciprocal switching, I would have to step back and question how do we think about those investments.

You do need some certainty in this industry. When we're making -- the investments we're making today are when we look at the future, five, ten, fifteen, twenty years out. You talk about bringing in a cost-based method that's out here, you have to be careful of that.

I think that's a solution. It doesn't take into account stranded costs you have in an investment. It doesn't take into account the replacement costs going forward. It would be disruptive, in my mind, on a wholesale basis.

Again, we haven't defined how far you want to go or how broad, but again, we are -- my customers use the carload network. What they're looking for is even more investment in that terminal to industry segment.

That at least in the Union Pacific Railroad, particularly with the Southern Pacific, had been ignored for years.

VICE CHAIRMAN BEGEMAN: Is the concern primarily whether or not you're paid sufficiently for that access, or do you have more of an operational concern, or is it a combination?

MR. YOUNG: It's both. I mean think about -- and you'll have the opportunity with the operating folks here tomorrow. But you clearly, one of the ways you can provide great service and improve your efficiency is you have density. We can move blocks of traffic all the way into the CSX and Norfolk Southern off the UP Railroad.

You start stripping that volume out, where we're short-hauling ourselves, you end up with less efficient and you have more handling. So there's an efficiency issue there. My concern is the decision on making investment in the future. The investment is generated by the over-the-road mode.

Investment in terminals would be very, very difficult to make for just handling the switch. The rates would be phenomenally high. Where we make the money is in moving that car over the road. So that has implications, then, on the profitability when you look at a particular geographic area.

VICE CHAIRMAN BEGEMAN: Mr. Haverty. I'm sorry, I interrupted you.

MR. HAVERTY: I agree with what Jim said. I think it is a combination of both price and service, and I do think that if a reciprocal switching agreement is in place today, and for some reason it's cancelled, I think that if the shipper thinks that they are not being treated fairly, then they have the right, I think, to come to the Board.

But I think to say that we are going to just open up access to all reciprocal switching is in fact an open access concept. I agree with Ed Burkhardt earlier that testified.

I was interviewed by folks from England prior to them privatizing their system, and this is right outside Santa Fe. They said we're trying to figure out whether we should have open access or how we should do it.

I said if you have open access, it will be a disaster, because nobody's going to make any money, and you are going to have a safety record that is going to be horrible. Guess what? Nobody made any money. They had all kinds of accidents and they renationalized the railroad in England. I'll tell you what. I don't think we want to do that here.

MR. WARD: Well, I'd like to make one comment, Commissioner Mulvey. You made a comment earlier that about 50 percent of the reciprocal switches on CSX have been closed down. As best we could do through technology to try to understand that better, our initial read is that is not true.

We have basically, when a business has gone out of business, we have closed that reciprocal switch but no others have. I would double-check that and confirm that with you. We could not verify that fact.

VICE CHAIRMAN BEGEMAN: Go ahead.

CHAIRMAN ELLIOTT: Commissioner.

COMMISSIONER MULVEY: Thank you. Mr. Young, railroads, especially the European ones, have historically invested in segments of the market where competition is present, and you mentioned how competition is a driving force in your investment decisions.

In the UP, including the PRB you double-tracked to increase intramodal capabilities, etcetera, competition drives investment, and if that's the case, why would you stop or reduce investment if additional competition is developed in other segments of the market, say due to changes in regulatory policy which promoted more competition? Wouldn't that spur on competition?

A lot of the studies show that competition is the driving force of innovation. Studies, of Japan for example, demonstrate that the Japanese had more competitive firms in the industries where they had the most innovation.

That's what gave them their advantage, rather than government subsidies. So wouldn't competition drive more innovation at Union Pacific and more investment?

MR. YOUNG: Well Commissioner Mulvey, I think it's a function of how you want to define competition. My biggest concern is that we have artificial competition interjected into an industry that doesn't reflect the type of reality on replacing assets and return of capital that the market requires.

That is the key when you look at this, where you're going to have -- we're not allowing the market to work here. We have made investment across our network. We don't differ in shape between a single serve or an open location. You run a network, you have to invest.

We've made huge investments along the chemical coast, where you have some of the highest industries there that are single serve. By the way, it's also an industry -- in fact, our largest chemical customer, I don't you may have noticed here the other day, announced a $1 billion expansion in chemical production on the Gulf Coast. A lot of that's on the UP Railroad.

So it's great to say competition.

I understand what's out there. My biggest concern is how we define it, and if it's an access provision that doesn't reflect the substantial cost of replacing assets or sunk assets, you're going to see this industry go backwards.

COMMISSIONER MULVEY: Some would suggest that if you had more open access, that the owning railroad would be able to charge the efficient component price. So the owning railroad would at least be compensated for any loss of traffic. Would that be something that you would be willing to consider, if you had --

MR. YOUNG: Oh, we had talked about that actually with Chairman Rockefeller, in terms of the consideration there. But the fact is we couldn't get to that point, in terms of the logic. That's why it broke down. But it really does reflect again, when we're making investments, I'm double-checking the sunset quarter today.

You know, it's going to be, when we're all said and done, about a $3 billion investment between LA and El Paso that's out here. So again, I think you have to ask yourself the question. To me, you know, Chairman Rockefeller, obviously I didn't agree with everything he said. I did agree with several points he made.

He said the nation's facing a huge issue in terms of infrastructure in the future. Railroads have got to be part of it. I think we all agree with that. We also said the STB needs to think the 21st century. I agree with that.

To me, what that means, if you look at where we were, and Commissioner you know this, pre-'80, going bankrupt, '80 to 2000, an environment of substantial productivity, pricing to consume excess capacity and then 2000, we hit a point that we woke up one day and we were tilt, and UP Railroad probably fared the worst in 2003, where we had demand exceeded capacity.

You're in a world now that I think you have to ask yourself the question how do we incent more investment? How do we think about replacement costs going forward?

COMMISSIONER MULVEY: Mike, you mentioned about the return on investment that CSX gets, versus we've heard from before that railroads were in the top ten percent of all industries in terms of earnings, and your numbers suggest that it's somewhat less than that. You're more in the middle, I suppose, rather than being on top.

If that's the case, can you identify any investments, needed investments that you're unable to pursue at this point, with the revenue and capital that you have today? Are there any things you're postponing that you would do if returns were better?

MR. WARD: Well, I think you know our industry well enough to know, Commissioner, when we start our capital planning process every year, we're spending $2 billion this year. It's the most we've ever spent. The request list from our department was about $3-1/2 billion.

So there's always many very good, justifiable projects, but quite frankly we are constrained by the financial markets, as to how much we can afford to spend. So you'll notice that at CSX and the industry in general, as we have earned more money, we have invested more money, because I think we have a lot of very good projects to invest in.

So clearly, I mean, I think the employees of CSX, if I told them we could spend another billion dollars, would have no trouble finding the ways to spend those monies on cars, locomotives, facility expansions. As you know, you mentioned about giving trucks off the highway.

We're spending significant capital. We just opened $175 million intermodal terminal up in northwest Ohio. A lot of our growth capital is around the intermodal, which is growing at least twice the rate of the rest of our traffic. So we could find plenty of ways to spend more.

I don't know how that measurement of us being in the top ten percent of profitability, what that means or where it came from. I do know our returns are actually, while we've gotten much more profitable in the last five, six years, we're almost approaching the average for American industry.

MR. YOUNG: Commissioner Mulvey, can I comment on that a minute? I think you have to be careful about that statement, ten percent.

Unfortunately in this industry, when you look at book value of assets, you look at operating margins and return on capital. The challenge, investors look at cash flow in this business. They look at future cash flows discounted back. That's one way they look at a valuation.

The reason they do that is because there's such a significant spread between the cost of capital, replacing assets, and what you have on the books. Example. UP this year, $3.3 billion in capital. Depreciation is $1.4 billion. To give you some perspective on the pressure, we're like Mike. My number is 3.3 billion. The actual request list, and they had good projects, was over four billion.

The real question I believe we've got to ask ourselves is how much do we need, what should that rate be to meet the country's needs in the future. My belief is even though the industry has a record investment this year, it still doesn't come close to what is projected out there.

One last item. It wasn't a coincidence that I came out of my annual shareholders meeting on May 1st and announced a new $3.3 billion all-time record capital, and the same time we increased the dividend.

That wasn't a coincidence, in terms of the shareholder support.

COMMISSIONER MULVEY: Thank you. Yes, numbers are always interesting. They can be spun a whole bunch of different ways. For example, we had the railroads' percentage of tons compared to trucks. By using ton miles, you get a different result. So depending on how you're measuring it. Revenues, sorry to say, would yield an even lower percentage. So it really depends upon how it's measured.

I have one question also for Mr. Haverty. You argue that you're much like the shortlines, that you think KCS should be treated differently from the other Class 1's with regard to any kind of access remedies. You indicated that KCS provides an important competitive balance.

But if KCS, and the other carriers that might provide service on shorter hauls still exercise pricing power, why should the remedy be different from KCS than for the other Class 1's, if indeed you have the same kind of strength, pricing power strength.

MR. HAVERTY: You know, I think the point that we tried to make is that because we are smaller and we clearly do connect with all the other railroads. In fact, we have the only railroad in North America that connects with every other railroad in North America.

But if you go to total open access, because we're so much smaller and don't have the longer hauls that some of the others do, what we are concerned about is that they can come in and cherrypick our business, and basically put us out of business. Then we are no longer really a viable competitor, and today, we are a viable competitor.

COMMISSIONER MULVEY: I think the average length of haul for all railroads, Class 1 railroads right now is 919 miles. That's according to the AAR's Yearbook of Railroad Facts. Do you know what it is offhand for the KCS network, including the Mexican portion?

MR. HAVERTY: With the Mexican portion, that has increased now to -- we're up probably about 750 to 800 on that kind of a haul. When we had just the U.S., it was less than 500. It was about 450.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN ELLIOTT: I don't really have any questions. I just have one thought. There's obviously a difference between what the shippers are saying and what you're saying to us. I think that fight has been going on since the Staggers Act has basically been put in place, and it's probably been going on way before that, for the last 100 or so years.

I don't know if there is a certain way of resolving it, especially taking out all the contingencies and things that could possibly happen if we do some kind of access remedy. But I did notice in one of the filings -- and I ask people to bring ideas to me -- one of the filings brought up an idea of a pilot project with reciprocal switching. Obviously, there would have to be some kind of ability to control that project, like in any type of experiment.

But I would wonder, in the interest of maybe finally resolving this thorny question that people have been fighting about, would the railroads be amenable to something like that?

Of course if it were possible that it could be controlled in some manner, would they be amenable to taking a look at a pilot project and seeing if it creates useful competition, and if in fact what the shippers have been saying all these years is correct?

Or if it really shows what the railroads have been saying is correct, that they're not going to be able to invest properly and especially with respect to reciprocal switching areas, when you bring something, somebody else in, using your own property, there's really no incentive to invest, if it starts deteriorating as a result.

So that's my question: would that be something that would be of interest to the railroads?

MR. WARD: I'll be glad to go first, Jim. No, it would not be of interest to the railroads.

CHAIRMAN ELLIOTT: I should have made it a shorter question. Why is that?

MR. WARD: Well, I think for some of the reasons you noted, that terminal infrastructure, as Mr. Young said, that you make your money on the long haul, but terminal infrastructure you would not do of its own accord.

So you're going to be turning those assets over, increasing the operating complexity, which you'll hear about tomorrow, and I think as Mr. Hamberger noted earlier, they do have that in Canada, and some of the customers up there are still unhappy, because it's about rates. It's not about access, and you have remedies in place to deal with rate issues in the current regime.

So I think it's a solution searching for a problem that already has a solution, according to procedures.

MR. YOUNG: I think that the issue you run into is what signal are we sending to the markets, in terms of, you know, experiments in this industry, I think, can be a real problem, in terms of what you expect in the future.

You know, if we're running an experiment, I can guarantee you when I'm in New York talking to the rating agencies on bonds, they're going to be asking where is this going, what does this mean.

I would argue you have it within your control today, in terms of looking at the competitive issues in many of these areas. I would ask you to think about competition in many of these areas transloading. It was touched on a little bit. It's one of the fastest-growing businesses we have.

I know the BN is doing it, because they've been very effective taking business from us. So you've got to, I think, be careful when we think about rail to rail. That is a form of truck to rail. But it is very, very effective, and we see it growing very high in the business.

CHAIRMAN ELLIOTT: Now would the markets, people that you're talking to, the analysts, if you, I mean if we came to some solution and the only thing we were looking for was the correct solution, the solution that worked, as opposed to having proceedings like this every 15 years, which seems to be what we do, wouldn't that settle the markets better than just having this unknown out there?

MR. YOUNG: Here's what the markets want. They want our returns to consider the replacement cost of assets. So you have to think about that, and I know we have debated it for a long time.

But the fact of the matter is, the reason that my shareholders are not reacting negatively today to the $3.3 billion investment is we've delivered reasonable returns, but the focus is on the future.

They're questioning when you're putting $3.3 billion into the business, are you going to be able to price and earn the kind of return on capital that you need going forward. That return on capital number, when you think about the replacement cost of assets in this business.

You know, last year, UP reported about ten and a half percent. If you take a reasonable methodology, you know, depreciated new, in terms of calculating a return, it's about half that. That's their concern. They see this significant requirement, and unfortunately we've been living off the past.

Chairman Elliott, you know, I've got a project on the Mississippi River.

103 year-old bridge, Sling Sand Bridge (ph). It's closed four to six hours a day on one of the busiest rail corridors in the world. We're going to replace that, if the government helps us get the permitting done. It's a $400 million investment. Those are the types of things that are out there.

MR. WARD: Just to reinforce that idea, I know you have some Wall Street experts coming to speak to you, to this hearing. The first question they ask me is what about replacement costs? I mean that is constantly in their mind, because they are looking at these vast sums that we're going to have to do to replace these older assets.

CHAIRMAN ELLIOTT: Thank you very much for coming today. We really appreciate you taking the time. It's five to 2:00. I think we're going to take a 45 minute break, since we're going a little slower than we thought -- a very verbose bunch.

So remember to take your badges with you, because you'll have a difficult time getting back in. So thank you.

(Whereupon, at 1:57 p.m., a luncheon recess was taken.)

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

2:46 p.m.

CHAIRMAN ELLIOTT: All right. Why don't we get going again? We're going to start with Panel VII. We'll start out with Consumers United for Rail Equity, Mr. English. You have ten minutes.

Panel VII

MR. ENGLISH: Thank you very much, Mr. Chairman. I appreciate that. I am Glenn English. I'm the chief executive officer of the National Rural Electric Cooperative Association, and also appearing here for CURE, Consumers United for Rail Equity. I am accompanied by CURE's executive director and counsel, Bob Szabo and Mike McBride, both of Van Ness Feldman.

Mr. Chairman, back in 1980, when the Staggers Act was passed, I was a member of Congress. I remember very well Harley Staggers bringing that legislation to the floor, and certainly I remember very well the vote that was taken at that time, the promises that were made.

I've got to admit something to you this morning, Mr. Chairman. I voted against the bill, and let me tell you why. Because of the fact that Alfred Kahn had promised us much the same thing in rural areas regarding airline deregulation, and since that was first implemented and the time that vote was taken, what became very apparent was that rural America was not going to benefit, that rural America was in fact going to be hurt. That was one of the primary concerns that we had.

If you recall, we had a lot of promises about competition, and those promises of competition didn't come about. What we had was consolidation, and what we had were airlines dropping service. What we had was in fact areas that were not well-served ended up paying more.

I think we look at what's happened under the Staggers Act, certainly contrary to the intent. We've gone much in the same direction, that we have fewer Class 1 railroads, we have less competition, and those of us from rural America who are classified as standard shippers in fact are taken advantage of.

Since the legislation was passed, and I do want to point out that Harley Staggers did recognize and take note of the fact that there were areas of the country that would not likely experience competition, and he wanted to protect those areas. He put provisions in the law to do that.

But we've been told by some of your predecessors, certainly shortly after that Act was passed, that carrying out that provision simply was not going to be possible. That in fact, what we had to do is to first look at the financial well-being of the railroads.

Therefore, we found ourselves dealing with rules and regulations that did not carry out the intent of the Act, but instead were intended to make sure that the railroads got adequate revenue to be able to meet their needs.

We all understand the dire straits railroads found themselves in. We all recognize and understand the railroads are critical to this country, and those of us who are stranded shippers, by the various definition, don't have any other way to go. So we want to see healthy railroads in this country.

But we dealt with this for over 20 years. But in the last ten years, what we have seen is a recovery by the railroads, and they have done it very well financially. I think contrary to some of the testimony that you heard earlier, I think without question if it falls into the category of what I remember some used to say about the electric utility industry, it's almost in the same category as what they called the "widows and orphans fund."

What they mean by that is there's very little risk, and an opportunity of good steady revenue. Certainly that is what we have seen, is great stability and we have seen people investing. We have seen people recommending to investors they invest in railroads because of the financial security and certainly the financial return that they're promising. They're in great shape.

And if anything else is needed, probably the one man who's recognized in this country as being great on investing his money in the right place and his company's money is Warren Buffet. Certainly his investment in BNSF, I think, underscores the fact that he sees this as a very fine investment.

In fact, it's my understanding that Berkshire Hathaway received a dividend in the neighborhood of some several million dollars, and their profitability increased by 30 percent. So that gives you some idea about the health of railroads.

The point that I'm trying to make here, Mr. Chairman, is that a promise was made 30 years ago. We spent 20 years dealing with the health, financial health of railroads. We spent 20 years trying to put the railroads in shape so they would be able to deliver not only for our members, but for America, and I think without question they're in that shape.

The promise was made during that 20 year period that once the railroads were on their feet, we would have actual competition, and we would be assured that we would receive fair treatment. I think without question, now is the time for that promise to be kept.

I would hope, Mr. Chairman, that you would take into account not just, as we heard today, the financial profitability of railroads. Think about the impact that this has on people, real people. Those of us with the electric cooperatives, we serve rural America. We serve some of the folks that are low income. We serve areas that depend on economic development.

We find that without question, many of those folks are struggling during these times of economic difficulty. Electric bills have an impact. They spell the difference.

We have testimony from a gentleman in Nebraska, talking about the fact that the impact that it has on his electric bill is going to determine whether he can eat once a day or once every two days.

That's a real impact. Those are real people. I know that you have received correspondence from real people, talking about what your decision is going to mean to those folks.

You have ways in which you can deal with this. From a regulatory standpoint, there's no question that there are barriers there that are quite frankly loaded, have been loaded to provide for the financial well-being of railroads.

To put stranded shippers on an unequal footing, work to their disadvantage. Now is the time to put everybody on an equal footing, Mr. Chairman. Let's have some real competition.

Let's address the rail to rail competition issue, the bottleneck rule and certainly that heavy burden of proof on the reciprocal switching needs to be dealt with, and paper barriers. All of these are challenges and issues.

I know that others have argued against addressing those issues, saying that you don't have the authority to do so. They have difficulty pointing out where in the law says you don't have authority. It seems like you have a lot of authority when it comes to rates.

I would suggest and urge this Commission that they have a responsibility, if they think they're lacking any authority, to go to the Congress and see if the Congress isn't willing to expand it, if you feel it's necessary. I don't think it is. I think you can deal with it under present law. I think you can in fact address the reality that now is the time to carry out the promise of the Staggers Rail Act.

Now is the time to make that apply to all people in all parts of the country. I think now is the time to prevent the kind of abuse that we've seen taking place in the name of the financial well-being of railroads.

I appreciate very, very much you allowing me to testify, Mr. Chairman. I have written testimony for you, and I hope that all that written testimony will be made part of the record.

CHAIRMAN ELLIOTT: Thank you, Congressman English. We'll next hear from Western Coal Traffic League. You have ten minutes. Are we short of a mic, or are we all right?

COMMISSIONER MULVEY: I think that mic on the end may work, but I think it was not turned on. Make sure it's turned on.

MR. PFOHL: Chairman Elliott, Vice Chairman Begeman, Commissioner Mulvey, I'm Peter Pfohl. I'm counsel for the Western Coal Traffic League, and I'm appearing today on behalf of WCTL's president, Dwayne Richards, who has submitted testimony in this proceeding, but unfortunately is out of the country and asked me to appear in his place today.

I'm joined today by Ken Baseman of MiCRA, an economic consulting firm. Ken and his colleague, Dr. Frederick Warren Boulton, also submitted testimony on behalf of WCTL. We will biding our time and I'll start. In his testimony, Mr. Richards reviews the state of competition for Western Coal since the 1970's.

The most recent period of the last seven years is really the focus of the testimony. In my first chart -- there we go. In this first chart, I'm not sure if you can read it all that well from there, it's on the record as well -- Richards Chart 3 reflects a significant change in the market during this period, with a near tripling of Powder River Basin rates between the years of 2003 and 2010. This is for competitive shippers.

Dr. Willig said this morning that just because rates are going up doesn't mean there's a problem. Well in this respect, the railroads contend that increased costs are the cause of skyrocketing rates. But cost increases aren't the real explanation, which is reflected in the next chart.

This is Richards Chart 6. This chart reflects the fact that even while variable costs have increased in recent years, revenues have increased even more, leading to an annual Western Coal contributions today approaching $3.5 billion.

The next chart, which is Richards

Chart 9 on the record, shows that while rail costs have increased by 2 mils per ton miles for Western Coal shippers, market rates have increased by 14 mils, reflecting an enormous growth in carrier contributions. In sum, Western Coal shippers paint a troubling picture of the state of competition today, highlighted by a near trebling of market rates, with no meaningful correlation to costs.

Business no longer changing hands for competitive coal shippers, and so-called competitive rates approaching and exceeding even captive rates, which is reflected in the last chart here.

What do the railroads say in response to this evidence? Well, UP and BN do not deny these numbers, but they still contend that they vigorously compete. But as proof, BN merely states that we win some and we lose some, and it cites the recent loss of some unrelated intermodal traffic.

UP says it has specific proof of pervasive competition, but offers a grand total of four examples over seven years of business changing hands. And even those few examples don't hold up, as none of the three public examples furnished involve head to head competition.

Furthermore, each of the shippers in the three public examples cited by UP have now refuted the fact that competition exists for those movements on the record in this proceeding. So what are we left with? The answer is no or virtually no examples of Western Coal traffic, where UP and BN compete head to head, that's changed hands in seven years.

That's truly a remarkable fact, given the numerous customers and hundreds of millions of tons involved. Dr. Willig said that these facts are inflammatory, but in the end, all but admits that the duopolists aren't competing. He says no worries though; from an economic perspective, the market has simply settled down, and efficient match-ups have been reached between carriers and their customers.

This is a very telling conclusion, I think, which we respectfully submit is a problem. Market equilibrium is nothing with today's market, is something that does not satisfy coal shippers and should not satisfy the Board.

WCTL respectfully submits that there's a substantial competitive problem involving the largest segment of Western rail commerce, and it needs to be addressed. So what to do? The principle request that the WCTL seeks in this proceeding is a change in the Board's market dominance determinations in rate cases, through the issuance of a policy statement.

That statement would clarify that under the Board's market dominance rules, even a shipper with two carrier access can bring a rate case if the rates that it's receiving exceed 180 percent of cost. This is consistent with Congress' directive in the 4R Act, that market dominance should be a threshold test, and even customers that in oligopic markets should be able to bring a case before the agency.

That concludes my statement, and I'll turn my remaining time over to Mr. Baseman.

MR. BASEMAN: Thank you Chairman Elliott and Commissioners. I'm pleased to be here. If you can go back to the first chart, the one with the price history over time. Yes, thank you.

What we have here is if you look from roughly 1990 through 2004, nominal prices are fairly stable, and during this period, there was rapid growth in coal shipments out of the Powder River Basin. It increases, it almost doubled over the period. So clearly investments, debottlenecking, whatever, is occurring to accommodate dramatic growth.

In 2003, in an investment call with New York analysts, the top executives of UP indicated that these prices, the prices as of 2003, were adequate to cover their all-in costs, and they also indicated that they had just completed a major capacity expansion in the Powder River Basin and on a going-forward basis, incremental capacity was going to be easier to come by.

What that tells me as an economist is in rough numbers, we've got a fairly competitive, stable situation, stable for a long time, supportive investment, and it's confirmed by the statements that the UP executives made to the investment analysts.

So when Dr. Warren Boulton and I looked at what happened to prices after 2004, we were looking around for explanations, possible explanations for prices going through the roof. We concluded that the most likely explanation is either tacit or explicit collusion -- we won't worry about explicit collusion here; that's kind of real felony stuff and DOJ worries about that.

But in terms of -- so I'll just call it collusion. But I'm not sure what Dr. Willig thought was inflammatory about all this; maybe it was the suggestion of explicit collusion.

In 2009, BNSF's CEO, in another conference call with New York, was asked about a fear that price discipline might be breaking down, because it had recently won some business from UP.

His reaction to that question was not "this is inflammatory; I'm offended by the notion that I would be worried about price discipline, and might be holding off on trying to win customers."

His reaction was no, no. There's an explanation for that. It was an anomaly. We actually -- maintaining price discipline is something that you shouldn't worry about, Mr.

Analyst.

So there's certainly a lot of evidence that the price increases are consistent with the change in behavior around 2004. You'll recall that in 2004, there were the public pricing pronouncements and the announcements of a change from contract to tariff that wasn't carried through. But the net result of the change in market environment around 2004 was also move away from long-term contracts to much shorter-term contracts.

So in looking for other explanations, if you look at the change in variable cost. Peter showed you the chart on that. Variable costs don't come close to explaining this. Look at investments, the new investments being made later, later than 2003. Explain the price increases.

Mr. Koraleski in this testimony, or in his statement, indicated that UP had invested something between 375 and 500 million dollars between 2003 and 2011 on Western Coal or Powder River Basin coal capacity improvements.

UP's share of the increased contribution over this period was something in the order of 750 to a billion dollars a year. You don't need that kind of an increase in contribution margin to cover 375 to 500 million dollars in investment. Thank you.

CHAIRMAN ELLIOTT: Thank you, Mr. Baseman. Now we'll turn to the Concerned Captive Coal Shippers. Mr. Loftus, you have ten minutes.

MR. LOFTUS: Thank you, Mr. Chairman. Chairman Elliott, Vice Chairman Begeman, Commissioner Mulvey, my name is Michael Loftus. I'm appearing on behalf of the Concerned Captive Coal Shippers today.

The members of that group are American Electric Power Service Corporation, the City of Grand Island, Nebraska, Duke Energy Corporation, Dynergy, Inc., Intermountain Power Project, Progress Energy

Carolinas and Progress Energy Florida, Seminole Electric Cooperative, Inc., South Carolina Public Service Authority, and South Mississippi Electric Power Association.

Collectively, those entities ship -- I just triggered my chair -- shipped --

CHAIRMAN ELLIOTT: I think Mr. Ward snuck up on you.

MR. LOFTUS: Yes, in excess, well in excess of 100 million tons of coal annually by rail, and they're extremely concerned about the issues the Board is examining in this proceeding, and they thank the Board for initiating this proceeding and holding this hearing.

I'd like to make two points very briefly, the first being that the Board's competitive access rules clearly should be modified. The 1985 competitive access rules have failed to serve what was clearly their intended purpose under the statute, and should be modified.

We agree with the Chairman's suggestion that 25 plus years without any results indicates that fact that these rules are not working, and differ strongly with the suggestion that that record indicates that they're working just fine.

The second point, the Board has the authority to change its own rules. There have been arguments made by some of the railroads that that is not the case. We have addressed those arguments in detail in our comments, but we want to simply say here we believe it's very clear Congress has done nothing to limit the discretion that was afforded to the Board under the statute.

It clearly has, in our view, for the reasons set forth in detail in our comments, authority to reexamine and change its competitive access rules at this time. We believe there are good grounds for it to do so.

I'd like to turn now to the

proposals that the Concerned Shippers have made to the Board in this proceeding, and first, we believe that it is appropriate that the Board adopt simple, readily ascertainable bright line standards, to administer 49 U.S.C. 10705 through routes.

The proposals that we have made recognize the statutory consideration of the carriers' revenue needs, and they do in a very explicit manner, that the Board is well familiar with.

The specific proposal is that the Board prescribe an alternative through route under Section 10705, where the revenue to variable cost ratio for an existing routing exceeds the STB's RSAM level, or in the case of a situation where a proposed new routing would be shorter, in that instance, we suggest it would be more appropriate to look at the RVC greater than 180 level.

In each instance, you would be looking at the revenue to variable cost ratio under the existing routing, as opposed to the alternative being considered. Now point out that in the Board's most recent decision in 689 sub number one, the average RSAM level for the Class 1 carriers is 280 percent of variable costs, and the RVC greater than 180 is 240 percent of variable costs.

These are both numbers that are very substantially in excess of the jurisdictional threshold. They both entail very substantial degrees of differential pricing that would be allowed to the carriers before these standards wold be triggered, in a manner that would expose the carrier to the possibility of a competitive through route being established with another alternative.

Now we respectfully submit that these standards constitute appropriate means of administering the very general language of Section 10705, i.e. "desirable in the public interest," "adequate," and "more efficient or economic."

The proposed reliance on RVC calculations and revenue adequacy measures is consistent with the statutory language itself which, as noted, contemplates recourse to economic considerations, and has the added benefit of establishing a link between through route relief and the financial standing of the carrier in question.

Now we know and draw your attention to page 78 of our opening comments, where we quote language from the Board's 2011 Entergy decision, where it looked at the level of the rates there involved, in evaluating whether competitive access relief might be appropriate, and we point out that if it's appropriate to look at how low the rate is for that purpose, it is equally appropriate to look at how high the rates are.

We also point to a statement in the Board's *Ex Parte 688* proceeding, where it asked for a comment on revenue adequacy in the context of competitive access relief.

This morning, Mr. Sipe, in responding to a question about the Concerned Shippers' proposal, suggested that this would not be an appropriate approach, because it is not a conduct-based standard.

We differ strongly with that view. We think it is very definitely a conduct-based standard. It is focused on perhaps the most pertinent conduct you should look at in this context, which is the degree of pricing power that the carrier is exerting.

If you look at the relationship of the rate under the route that's being challenged, in relation to RSAM or RVC, 180 we think it's very appropriate in that context. The Concerned Coal Shippers also had proposed that absent an agreement between carriers, divisions on prescribed through routes should be set on a mileage pro rate basis.

Further, the Concerned Shippers have proposed that the existence of a prescribed alternative through route should not defeat a market dominance demonstration, and a SAC case regarding the existing routing, and that the existing routing likewise should not defeat a market dominance demonstration on the prescribed routing. Thank you very much.

CHAIRMAN ELLIOTT: Thank you, Mr. Loftus. Commissioner?

COMMISSIONER MULVEY: Thank you. On these charts that you relied on, I guess it's Richards Chart No. 1, are those in real or nominal dollars, from 1983 to 2010? Are those in real or nominal dollars in that chart?

MR. BASEMAN: Those are nominal, I believe.

COMMISSIONER MULVEY: In nominal, okay. Could you, would you accept that railroad costs were -- we have that Christiansen study that suggests that rate increases were not a function of railroad market power, but actually were reflecting cost increases.

Is there any evidence that railroad costs for moving Western Coal were rising considerably during this period, which would explain why you had this increase, beginning in 2005, as opposed to the relatively flat period before that? Or alternatively, is this when long term contracts began to expire, which would also explain the railroads trying to play catch up, by raising the rates as the contracts expired?

MR. BASEMAN: Well, these are contracts currently being entered in each year. So it's not a blended rate, where the rate falls because of prior contracts, and then they expire and then they raise. These are all, these are apples to apples, in the sense that they're new contracts each year.

So something happened after 2004 for new contracts, and 2006 was very different than 2003 for new contracts. On the cost issues, we looked at the increase in variable costs, and this was on a -- these are on coal shipments, and the increase in price was seven times the increase of what it would have taken for 100 percent passthrough of variable costs.

Looked at Mr. Koraleski's reports on what UP invested after 2003, and the magnitude of the revenue increase is far, far in excess of any sort of reasonable recovery requirement on those investments.

The other thing I would -- I'd like mention, you mentioned long-term contracts. The other thing that happened in 2004 was there was a sharp reduction in the contract length, and that's one of the things that the coal shippers are not happy about.

That's kind of, to me an odd thing to happen at that time. The general theory or story that the railroads are telling is we had to make very, very substantial investments to replace old capacity and build new capacity during this period of time.

Ordinarily, and especially if you think about it in kind of as if or contestability basis, what you'd expect is the reason shippers want long-term contracts, that's a way of adding up their demands and getting more aggressive pricing from the railroads.

The reason railroads in this circumstance would want long-term contracts, is they're anticipating making major new long-term investments, and they would like, ordinarily like the protection of long-term contracts. So it's the -- to me, there's a strong tension in the theory, that what happened in 2004, 2005, 2006 is related to the need for substantial new investment.

It should be longer-term contracts and not shorter. That's what you're really concerned about, and it also seems that much of UP's investment, anyway, in Western Coal had been made just prior to that period. So the investment's already been made, without having the benefit of long-term contracts to protect it.

COMMISSIONER MULVEY: Thank you. The railroads also began at the time ruing the fact that they did not include fuel surcharges or the ability to increase rates to reflect higher fuel prices in the longer-term contracts, and I think that made them more skittish about going for long-term contracts.

That's also the time, I think, when they began expressing concern about the coal dust issues, and that it was costing them more to maintain the PRB coal pipeline, if you like, than they thought it was. I'm just wondering if that was also reflected in why these nominal rates began to increase so dramatically after 2004.

MR. BASEMAN: When you move to short-term contracts, in a period where capacity is tight, the natural thing that's going to happen is prices are going to increase dramatically. So the question is how natural is it that you're moving toward the short-term contracts?

There's an advantage to the railroads, knowing that if we move right now, we're going to get higher prices, because I'm not going to bid very much to take business away for a one-year contract, when my capacity's tight. I may bid a lot to take business away on a ten-year contract, when I can build capacity around this bottleneck that I'm looking at for the next year.

You're right. There are other things they have to negotiate on a long-term contract. But the bigger you believe the story is supposed to be about the need for investment, the more there should have been, you know, a deal to be struck, that would have had prices quite a bit less than, you know, 22 mil per ton mile.

COMMISSIONER MULVEY: You alluded also to the possibility of tacit collusion, which is always, of course, difficult to identify. But to the extent that you have traffic from the mines shift from one Western railroad to the other Western railroad during this time, would that suggest that the railroads are competing, if indeed mines are shifting from BN to UP or vice-versa?

Or have you seen a relatively high degree of consistency? This is the railroad serving these mines, this is the railroad serving those mines, and you don't really see shifts in traffic. Mines are captive, and yes.

MR. BASEMAN: The testimony of the coal shippers is the degree of switching decreased dramatically after 2004. So there was -- whatever, there is some switching after, with some contested interpretation as to whether the switches really amount to competitive switching. But there's some switching after. There was a lot of switching before, okay.

When you think about tacit collusion being supported by basically customer allocation, we don't require -- it's not required that there be no switching. You know, George Stigler won the Nobel Prize in part for his theory of oligopoly, and he explicitly was worried about this problem, thinking about this problem.

He said it was I'm in a cartel. My cartel member here next to me, he's going to want to cheat on that cartel. At what point do I decide that I'm losing more business to him than really makes sense, if he's honoring his commitment to me? Once I decide if he's cheating or he's cheating too much, then we revert to competitive pricing, all right.

But the test statistic is not if I lose one customer, I know he's cheating. You know, there are a whole variety of other reasons why customers might switch.

So it's really -- let's put it this way. The answer from the railroads, that they can identify there or four cases in the last seven or eight years of customer switching, does not reject the theory that there is a very effective agreement, tacit agreement going on.

You would expect some switching, just because it will be some stuff at the margin, and you don't -- at the first contested volume or customer switching, I don't go from 22 cent cartel price to an 11 cent competitive price, because I'm giving up a lot, based on the suspicion, based on one or two or three shippers.

So I think the important piece of evidence is that there was a decline in the -- there was a, to the shippers, a very notable decline in the extent to which customers would switch.

I would agree with you that, and I would agree with Dr. Willig's general comment this morning, you'd expect, as railroads and coal mines and utilities line up, that the incumbent's going to have an advantage.

But if, you know, it used to be

for every 100 contracts that came up, you know, 20 or 25 switched or now it's one or two switching. That's a big difference, and Dr. Willig's notion that this could all be consistent with a kind of general sorting out of which mine belongs to which utility belongs to which railroad, and once they figure that out they stop switching.

He qualified that appropriately by saying as long as the basic situation doesn't change. But the basic situation changed a lot. Prices traveled and contracts went from five to ten years to one to three years. So there's a lot going on that's not being held constant.

COMMISSIONER MULVEY: I think you would also accept that a sophisticated game player in this, if you were doing tacit collusion, would not go to zero switching. You'd want to have some, although minimal switching, in order to at least give the appearance that some competition still existed, that it's not a zero.

MR. BASEMAN: I would agree with that. Yes, absolutely.

COMMISSIONER MULVEY: Mr. English, you made some comment about deregulation. Wouldn't you credit Staggers for resulting in a substantial improvement in railroad financial health and the overall health of the railroad industry, and similarly, wouldn't you credit the Airline Deregulation Act of 1978 with lowering overall fares around the country, and eliminating the substantial cross subsidies in aviation that existed from urban major markets to lightly traveled rural markets before 1978?

MR. ENGLISH: Well first of all, let me just say that no question, the financial health of railroads has been vastly improved since 1980. There's no question about that. What I'm saying is we've made a huge contribution, I'm talking about the captive shippers, to that financial health.

It has arrived at the point, we were always told that once the railroads were healthy financially, then we would fully implement Staggers. I guess what I'm here before you all today is with the hope that in fact you're going to prove me wrong after 30 years, with regard to my vote.

So far, looking at it from the standpoint of people living in rural areas, stranded shippers, people that I represented back in 1980, I haven't had reason to change my vote. But I think you can certainly take care of that.

The other aspect of that, if you get into airline deregulation, we took a look at that about ten years after the fact, and certainly I think everyone assumes that airline rates are lower. This was about 1988, somewhere in that period. But the ticket that you were buying in 1988 wasn't available in 1977.

If you were buying in same ticket

in 1988 that you bought in 1977, namely going in that day, purchasing the ticket, lay your money down, or if you bought a ticket to go in and get your money back, no, no, it wasn't cheaper. It was more.

So basically what we have is kind of a bait and switch on the product. We were selling a different product in 1988 than what we were selling in 1977, as far as the airlines are concerned.

You know, the whole point here is I believe in competition, and certainly I think the Staggers Act, as it was passed, if I felt it was going to be fully implemented the way it was intended, the way Harley Staggers intended, you know, I think we probably wouldn't be having this hearing here today, or at least perhaps we wouldn't be before you. At least we wouldn't have near as much complaint about it, let me put it that way.

So this isn't going to solve all

the Captive Shippers' problems, going on the laundry list that I mentioned of corrections. But the one thing that you can do is you can reduce substantially. Certainly, Vice Chairman Begeman mentioned a pilot program. Well, that sounded like a wonderful idea to me. Why not do a pilot program, you know?

Why not put all these statements to the test? Let's find out what's really going on here? Let's have a real legitimate pilot program and let's check this thing out. It makes a lot of sense to me.

But I was very disappointed to see railroads say "Oh my goodness, no. We couldn't do that." That might be pretty hard to control, I assume, is what their fear was. It might come out the wrong way.

But I think a lot of this, and I can understand the Board's concern, apprehension about disturbing the recovery or the well-being financially railroads and investments that we need in this country, and we agree that investment needs to be made. But somewhere in here there's a balance to be struck.

I think we've arrived at the point, and that's the reason I commend you all for having this hearing, because I think what you're doing is you're looking at this from the standpoint have we arrived at that point we need to make some adjustments, need to tweak it just a little bit.

Your predecessors may have had very good reason, but I'm not sure that reason's here. So again, I commend you for this. I think pilot programs are great. Let's find out what in the heck we can do that isn't going to disrupt the financial well-being of the railroads, but at the same time bring a little more Harley Staggers into this law.

COMMISSIONER MULVEY: Well, the railroads argue that open access would undercut differential pricing, and that differential pricing is key to the railroad's ability to make those higher returns, to allow them to invest in the infrastructure. I think we would all agree that railroad service as well today is probably a lot better than it was in the pre-Staggers era.

Differential pricing implies you're pricing on the elasticity of demand, and I guess because coal shippers probably have the most inelastic demand and are most dependent on rail, wouldn't the expectation be that they're the ones who will be socked with the highest rates?

MR. ENGLISH: Well, that's the reason I think a pilot program. It would be interesting to find out whether that's what happened or doesn't happen. I know we in the electric utility business, we have transmission lines, and we've got folks using those transmission lines, and we have prices that are instigated to make sure that there's recovery of the cost of operating that line.

You know, I can't see that it's that different as far as the railroads. It looks like you could use a system that would be similar to that, that would achieve that. I can fully understand and appreciate where the railroads are coming from.

Golly gee, if I were in their place and making the kind of money that they're making, and got the kind of security that they've got, I wouldn't want any changes either. But basically, they said "don't change."

But I remember before the Staggers bill was voted on, everybody was talking about railroads are full on for deregulation. We've got to get deregulation. We'll have the investment money and we'll be able to fix this and recover financial health.

Now we're back the other way, when the regulations are to their benefit, and that's, like I say, a little honesty here, the predecessors stacked it that way. We understood it that way. You know, they don't want any change. They like the regulations just as they are. So they want status quo.

I'm just saying that look at the stock on Wall Street. Look at their financial recovery. Look at their financial dividends. Look at how well they've done, and let's get down to a little real competition.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN ELLIOTT: Thank you very much for your comments. Also, I'd like to commend the group for coming to us with some ideas. I appreciate that. I know when I started talking about this hearing, I encouraged people to bring ideas to us, and I believe that you have done that, and that is greatly appreciated.

I'll start out with the question I've been asking all the shipper groups, and I think I might know the answer from one of the groups. But I mean there's especially this Western Coal. You've made some statements that you don't see the railroads competing, especially since 2004.

I guess the question that I've been asking is since the railroads aren't competing, is access going to really help if they're not competing?

So the question, final question is whether or not it would be better to focus on improving the rate process and regulations through that method, or should we focus on open access. So I throw that out to the panel.

MR. PFOHL: Well, I'll start. Tomorrow, you'll hear from two of our members. One is OPPD, Omaha Public Power District, and the other is Ameren. Those are two folks, OPPD spent considerable sums in doing a build out, building itself competition. Ameren has competition at many of its plants.

They are finding today that the competitive markets are troublesome. So the bottleneck gets you to competition, potential competition, and the concern that our group has is that the competitive markets are producing rates that are every bit as high as the captive rates.

It's somewhat ironic that we're here before you today, to ask you to allow us to bring a rate case to the agency, to demonstrate that if we can prove market dominance, that there's not effective competition between the two duopolists, that we can come before you and have our day before the agency.

So our first suggestion is to do the quick, easy fix. If a duopoly-served customer can prove market dominance, and they're getting two bids that are over 180 percent, they are effectively captive. They should be able to come before this agency and bring a rate case.

We also are generally supportive of some of the solutions that have been suggested here. We support the Concerned

Captive Coal Shippers' proposal. But our first order of business is to support the quick fix, which is the change, the clarification on the market dominance standard.

CHAIRMAN ELLIOTT: Let me ask you, just before I get to the other panel members on this question, but with respect to the 180 number, would we have some kind of statutory issues there with respect to the quantitative versus the qualitative?

I assume you're kind of jumping over the qualitative with the 180 number, which makes some sense. But at the same time, would we struggle on getting that past the court?

MR. PFOHL: Well, I think if you look back at the 4R Act, and we put in the record a portion of the Congressional history on the 4R Act, Congress explicitly stated, even in oligopic markets, a shipper should be allowed to have access to this agency.

We think the support is there. We think that perhaps the railroads would try to litigate the issue, but we believe that you have full support, and if you take a look back at what we put on the record on support for that, you'll find that, as well as the quantitative test, the 180, the qualitative test will meet that as well.

Lack of competition from the two, effective competition from the two carriers, and that's what we're talking about here.

CHAIRMAN ELLIOTT: Thanks, Mr. Pfohl. Anybody else want to try that one on?

MR. LOFTUS: If I may, the Concerned Captive Coal Shippers group responded to the Board's request for comments and proposals that might be of help, and they truly did try to fashion a middle ground. You know, I can present a lot of good arguments as to why the proposals we've made is too generous to the railroads, as opposed to other approaches that might be proposed.

So when you asked earlier today, you know, is there a middle ground, we tried to find one, and we tried to rely upon something the Board itself had fashioned, as usual, in that regard. I think that on behalf of those shippers, you know, they would like the opportunity to try to obtain a competitive result in those circumstances.

I think what you have heard from Mr. Pfohl is competitive shippers who, you know, would prefer to be treated like captive shippers in the context of competition that isn't in fact functioning. But that's not the focus of our comments.

CHAIRMAN ELLIOTT: Thank you, Mr. Loftus.

MR. ENGLISH: Mr. Chairman, I learned a long time ago that in order to find middle ground, you've got to have two parties that are willing to reach a compromise.

In all honesty, we don't have two parties that are willing to reach a compromise. We don't even have people that are ready to try out a pilot program to try to find a compromise, to try to find out where the ground is that we can all agree on.

I think that's part of the dilemma that you have. We would wholeheartedly agree with you and support you to find that middle ground, find some way in which you can bring a little relief to the captive shippers, give us some access, help rural America, you know.

I remember the ads that we've had from the railroads, talking about all the jobs they're going to create. I believe all the Class 1 railroads together have got what, 200,000 jobs, something like that. You go to rural America, you've got millions of jobs. I can't help but wonder how many jobs it's cost rural America because of the problems of shipping for captive shippers.

That's where the real problem is, and those products that have no choice, that don't have barges, don't have trucks, this is it. This is the only game in town. It would really help, I think, help the job situation if in fact we could move forward here and open it up and try some pilot programs and let's see what we can do.

Let's remove some of the regulation that's impeding the kind of competition that Harley Staggers envisioned. Let's move ahead and see if we can't encourage our good friends with railroads to come to the table and reach a real compromise, a middle ground, and I commend you for doing it. I appreciate it.

CHAIRMAN ELLIOTT: Thank you. Vice Chairman?

VICE CHAIRMAN BEGEMAN: I just have a couple of questions, and primarily I think right now I'm going to start out with Pete. Help me understand the last chart, which is showing that the competitive rate is actually higher than the captive rate that they -- sort of at the 2010 period?

Because we've been hearing from everyone else that we need more competition, we need competition, we need competition, with the expectation that your rates are going to go down. This is showing, at least for coal or western coal, that's not the case.

Is this just a unique phenomenon for this particular year? Do you have a sense of what the next year's or the next few years out is going to be? Is this just for coal, or is this actually happening with other commodities? I'm not quite sure what we should take away from your chart. Is competition bad? Or do you just want -- you want competition, but you want to be able to challenge the competitive rate too?

MR. PFOHL: What we want is competition that works, and what we're seeing here is that from the period of 2004 forward, competition isn't working. This is what Western Coal Shippers told the Board in the UPSP merger, that we were told that two is enough. The carriers will continue to vigorously compete well into the future for all business.

They did, immediately following the UPSP merger. But after a period of time, when the markets matured, and there was equilibrium, this is clearly a signal to us that the carriers find it in their best interest not to effectively compete anymore.

We don't see any reversal, absent changes to this phenomenon. That's why we're here asking for the option of a possible fix through a rate case. We wouldn't be asking --

VICE CHAIRMAN BEGEMAN: Access through the market dominance determination?

MR. PFOHL: Through the market dominance, to be able to bring a rate case. So we're left in the position where our members who have competition are envious of those that are captive. The market's turned upside down, and you'll hear about it tomorrow more. You can ask specifically the two of our members why is this happening? What have you seen?

They put in their testimony the last ten years what's happened in the competitive markets for them. I would suggest you follow up with them --

VICE CHAIRMAN BEGEMAN: And is this coal-specific -- I mean you've talked to a lot of your companions out here. Is it --

MR. PFOHL: Right. I can only speak for coal today. It's probably easier for Western Coal. You have the Powder River Basin, the South Powder River Basin, the largest coal reserves in the country, 300 million tons a year, where there's two carriers and where they serve destinations.

It's fairly easy, in terms of unitrain operations going from Point A to Point B, for the carriers to possibly get together or tacitly decide to allocate the market with the Powder River Basin. It's probably easier there than it is elsewhere.

So we think that we hope this isn't the sign to come with other commodities. But perhaps it is. The facts and the circumstances of the market line up just right in this market for the railroads.

VICE CHAIRMAN BEGEMAN: And do you have an estimate about the extent to which shippers don't currently have access to the Board because they have competition? How many more shippers would have access based on your proposal?

MR. PFOHL: Well, in terms of how many folks have competition at destination I guess is what you're asking.

VICE CHAIRMAN BEGEMAN: Well, you were also saying, though, they have a case to prove.

MR. PFOHL: They would still have to prove -- they would have to prove the two carriers are each providing rates above 180 percent, the jurisdictional threshold. The qualitative test would still be there. You'd have to prove on the facts and circumstances at hand. For this business, we're competitive. We've got one rate well above 180. We either didn't get a second rate or the rate was so incredibly high, there is a lack of effective competition.

It goes back. It is a fact-based test, effective competition, and what we're asking you to do is to clarify that, based on the facts and circumstances of any case, a customer can come before the Board and make that burden of proof of effective competition, even when there are two carriers serving them.

VICE CHAIRMAN BEGEMAN: Mr. English, I've had the pleasure of talking with Bob Szabo many years of my career, and so I'm going to kind of give you a tough question in some ways.

MR. ENGLISH: I thought maybe you were going to give me a softball.

VICE CHAIRMAN BEGEMAN: No. Well, maybe it is. It might be a real easy one, and by the way, I don't get credit for the idea of the pilot. That was the Chairman's idea.

MR. ENGLISH: Oh, the Chair. Mr. Chairman.

VICE CHAIRMAN BEGEMAN: It was his idea.

MR. ENGLISH: My apologies.

CHAIRMAN ELLIOTT: I apologize to her.

VICE CHAIRMAN BEGEMAN: Well, he liked the idea if it was okay with the group.

CHAIRMAN ELLIOTT: No. I'm speaking of the looks.

VICE CHAIRMAN BEGEMAN: Of all the proposals that you have thrown out, what is the one thing that you believe that the Board could do, that would have the most, the best impact, in terms of helping captive shippers, but with the least harm to the industry.

MR. ENGLISH: Oh my goodness. You're asking me to choose among my children here, Madam Vice Chairman. That's tough to say, and keeping in mind that as you know, we are all areas of the country, all across the country, this coalition is, and certainly my own membership is so different, parts of the country, I'm sure, would find different remedies helpful.

For us and looking at our situation with coal, certainly the bottleneck situation is a heck of a problem and always has been. But you know, to say one would be more helpful than the other, I'm not sure that that would apply to all of our members, and they would all agree with it.

I think again, we're back to this -- and the reason that I've tried to speak today in more general terms, because as you know, Mr. Szabo could give me all kinds of technical information that I could include in the testimony. I think there's something to be said for us to step back and say where are we in time, you know, what is this all about?

We're not in 1980 and we're not in

1990, and we're not even in 2000. We're in a different era today. I understand the purpose of the railroads trying to poor-mouth it before this Board about how terrible their situation is financially, and how everything would go to pot if you make any changes.

But there's just too much evidence on the other side that points to the fact that they're in good shape. There's also no question as to what the intent of the law has been for the past 30 years, and I don't think we can say the intent has been fully carried out.

That having been said, Harley Staggers recognized, with regard to the price issue, this is one that your predecessor, the Interstate Commerce Commission, if I remember correctly, was given jurisdiction to protect, stranded shippers from abuse. So we do have that kind of situation.

I doubt that Harley Staggers ever envisioned you're going to be down to what, five Class 1 railroads? I doubt that he ever thought that would be the case. This is also part of the reason that we would say that part of the remedy lies in the Congress. We still, I know Chairman Rockefeller was here and his legislation he's talking about. He's trying to tweak and adjust things.

But the issue we're talking about, that Peter was talking about, I would suggest, may fit more into a solution of antitrust law. How do we find ourselves in this kind of a situation where we've had competition and now we don't have competition, you know? Why are railroads treated differently as far as anti-trust laws are concerned, and the Congress is looking at that.

So I think there's not one remedy that's going to be a magic bullet and solve all these problems. There's not one of the proposals that I suggested here that is going to solve all the problems. I think there's a balance to be struck here. I think there is a middle ground, Mr. Chairman. I think you're absolutely right. We simply have to find it, and I think without question this Board has adequate authority to address that.

If you don't, then I would strongly urge you to talk to the Congress about that, and we're going to be talking to them about some of these other areas in which we can give you a little more help. But we're not interested in harming the railroads.

We want to see the railroads make investments. We want to see the railroads having an adequate profit. We need them. We need them. We can't afford to have it otherwise. But you know, I'm hopeful that you all, you know, give them a little bit of a carrot, don't put away the stick.

Bring them to the table and point out to them if they're not willing to reach agreement, then you all have to take, use your power to do the best you can in getting that middle ground and solving this problem, and carrying out the intent of the law. Thank you.

CHAIRMAN ELLIOTT: Thank you very much for your time and your comments. We greatly appreciate it. Thank you.

(Pause.)

CHAIRMAN ELLIOTT: We'll now hear from Panel VII. That is the American Shortline -- VIII, whatever. I was trying to go backwards. Panel VIII, American Shortline and Regional Railroad Association. You have 30 minutes.

<u>Panel VIII</u>

MR. TIMMONS: Thank you Mr. Chairman and Commissioners. Good afternoon. It's good to be here. Mr. Ogborn and I were just jockeying over who got the pneumatic chair. So we'll see.

I'm Richard Timmons, President of the American Shortline and Regional Railroad Association. ASLRRA is a national trade organization of about 1,000 members, consisting of 550 Class 2 and Class 3 railroads, most of which are small and locally based, as well as 500 vendors and suppliers to the small railroad industry.

On behalf of our members, I thank the Board for inviting testimony on the current state of competition in the railroad industry. Now the shortline paradigm looks like this. It hauls low volume general merchandise traffic. There are no economies of scale here; the railroads are just too small.

We've got a small number of customers. The average number is about 25. The top three move about two-thirds of the carloads that those small railroads carry, and our average, they move about 14,000 carloads annually.

Now the loss of any of these customers has an immediate and dire impact on the small railroad that's affected. They also have a small commodity base, so their top customer moves about half of their carloads on an annual basis.

In general, they move short distances, are engaged in numerous switching operations from small yards and terminals. They operate at low speeds, can't set their rates generally and subject to intense competition and diversion to truck, transload, barge. What that generally generates, of course, are high fixed costs.

That results in thin margins, and anything that impacts those thin margins threatens the shortline railroad. So increased regulation, whether that's mandated, trackage rights, terminal access, reciprocal switch, bottleneck, is a real threat to the small railroad.

Reduced rates by any means threaten the small railroad. Now to be sure, market power and anti-competitive behavior is not a backdrop of the picture that I just outlined, and I might remind you that shortlines earn less than five percent a year of national freight revenues.

Now if the shortlines find themselves with terminal access, reciprocal switch or bottleneck conditions, what basically is going to happen is the customers are going to be cherry picked off; they will experience very quickly reduced revenues.

Obviously, the remaining customers are going to pay more. The fixed costs will get worse; the margins will get worse, and that results in a downward spiral.

Keep in mind that the shortline customer base is thin enough, so that they don't have a whole lot of absorption ability or recovery. So once you strip off a customer or two that falls into that top category, you've really done some damage to the small railroad, and have a very, very difficult time offsetting that.

Unlike their Class 1 brethren, who can absorb some of that maybe, small railroads can't absorb any of it. I leave you with this thought, that predictability for the small railroad industry is absolutely essential.

The better the predictability, the better off the small railroad is. It permits them to concentrate on rights and terminals that really have a payoff, improves reliability for shippers and railroads.

They understand asset requirements, and their investment decisions are easier and more effective, and they get greater productivity. Now I urge you to retain the current regulatory structure.

But if for some reason the STB decides that changes are necessary, the Shortline Association requests that any changes not adversely harm our customers, community, employees and the shortline railroads themselves.

I thank you for this opportunity for permitting us to present our views on the small railroad industry, and the important issues that we hope that you will take very seriously, and we'll be ready to answer any questions that you may have at the appropriate time. Thank you very much.

MR. OGBORN: Mr. Chairman, Vice Chairman Begeman and Commissioner Mulvey, thank you very much for giving us this time here today, to talk with you today about our concerns and our views on some of these important issues.

I'm here today in a joint capacity, first as chairman of the Shortline Association, excuse me, and then as managing director of OmniTRAX, which is a holding company that manages shortline railroads around North America, as well as other transportation-related companies.

So I'm here to talk a little bit about both the Association views on things, and how, on the other hand, it affects directly operating railroads that are shortlines. One of the things I wanted to point out is that although we're all part of the rail national network, we are different than our Class 1 partners.

I may be stating some of the very obvious, but I think it's important for this record, for it to be reflected that we are different. First of all, our cost structure is markedly different than that of the Class 1's. We have high, fixed costs, much higher than the Class 1's.

Second, we're basically small entrepreneurs, who are basically retail operations. We haul freight the first mile and the last mile, generally speaking, in the rail network.

So we are out every day hustling for business at the retail level, so that we can pick that up and deliver it to the Class 1 interchange partner, or take it from them and deliver it at the last mile.

We compete every single day with trucks, with barges, with transload facilities and even with our Class 1 brothers and their transload facilities. That is very important to understand in relation to how we are out there every day in the competitive world.

We serve light density, largely rural lines, that would not be there today but for what happened in 1980 with the Staggers Rail Act, and the transfer of the light density lines and the customers on them to us. It's a struggle every day for us to be out there, and as Mr. Timmons pointed out, we have an average of 25 employees in our members, and we operate over an average of 99 miles.

So we're not out there as the big guys. We're the little guys, and that's who I'm here for, on behalf of today. If I may use an analogy, we're the HO trains to the Lionels. It's that much of a difference, and it's very important as it relates to, and I will extend my remarks on this as I go forward. But I want to give you some examples, and I would use one.

In my testimony there are others. I talk about the entrepreneurship of our small railroads. But the one I want to talk about is one of the OmniTRAX-managed railroads. Mr. Chairman, you've been out to the one that I'm going to speak of. It's the Great Western of Colorado. That railroad built track, spurs, industrial leads and all of the accoutrements that go with an industrial park that was developed.

We were able to, in conjunction with the industrial park, to bring to that industrial park a wind blade manufacturing plant, a bottling plant and an ethanol plant. That was done simply by paying attention to what was happening in the marketplace, what was needed and it is now currently served by two Class 1 railroads in interchange with us.

I'm going to come back to that, because that's an important fact when you talk about competitive access. But my point is that by doing that kind of entrepreneurial activity, that railroad, as well as all 550 of our shortline members, go out every day and do that.

In that case, it brought over 2,000 jobs to northern Colorado, totally unrelated directly to the railway, but certainly directly related to the transportation system in our burgeoning wind energy and other related activities.

Competition from other modes of transportation can easily divert that traffic. All of that traffic that moves in and out of that industrial park, for example, is subject to truck diversion.

It certainly is subject to, if there's forced competitive access, diversion. We have two connecting Class 1 railroads that could come in, under a forced access provision, and take that traffic away from us, leaving us with one small, very unreliable small shipper that doesn't ship but about a 100 cars a year.

We would have the common carrier obligation to continue to serve that shipper at a great loss, with the same kind of high fixed costs that we have going forward, whereas the more remunerative traffic would be moving on some other railroad. We think that's fundamentally unfair to have that kind of traffic cherry-picked from us.

We do have this day-to-day struggle that I mentioned every day going forward, and so do all of our other 550 members. We submit that these regulatory changes that are being proposed, would have a very adverse and marked effect on our small railroad operations.

We are not the ones that are abusing any market power. In fact, we have no market power. We are the first and last mile of the system. We do not control the rates. We do not control anything other than the local services that we provide, in large part.

We are in the railroad industry,

the part of the industry that came about because of the changes that were put in place by Staggers, and the regulatory regime that's in place today.

Any change to that would be adverse to us, and we are saying that the current standard, whether it be a showing of anti-competitive conduct, if you will, before any kind of draconian measure is put into place to do a forced access, would not be in the best interest of us, the national rail system, or our small communities and small shippers that we serve.

We believe the same is true as it relates to the bottleneck cases. We think that that is another area where the current regulatory regime is adequate to respond to specific problems that may appear in the system. We do not, as the small railroad industry, see that kind of activity happening on the communities and shippers that we serve.

So we think that rather than

engaging in any experiments, where there would be open access by any definition, would mean that we would suffer loss of revenue, loss of traffic, loss of customers. Those customers would in turn lose the local connection and activity that we provide for them, because as one of our members said, even if you only want one carload, we'll come pick it up. That's the kind of business that we're in.

We're fearful of losing that for ourselves and for our customers, and I know that Mr. Martland is going to be talking more about the economic effects of this, but I wanted to lay the predicate for you in relation to what it is that we are concerned about as a small part of this industry.

We did not want to be overlooked, because we don't want to be swept up in the "all railroads are the same," because they're not. I got the feeling this morning, like I was Dorothy and Toto, and here comes this whirlwind, and we're going to be blown away with the whole thing, without any reference to what is needed for our segment of the industry.

I think that has to be given consideration. It's working as it relates to us. There should be an anti-competitive behavior pattern that is discernible and proven before anything is changed as to access, and we think the bottleneck provisions in place are workable. Thank you.

MS. CLARK: Good afternoon, Chairman Elliott, Vice Chair Begeman and Commissioner Mulvey. Thank you for letting me speak today. My name is Sharon Clark, and I'm Vice President of Transportation for Perdue AgriBusiness in Salisbury, Maryland.

Perdue supports the position of the American Shortline and Regional Railroad Association in this proceeding, regarding the state of competition in the railroad industry, and the likely impacts of potential increased regulation on shortline and regional railroads.

Those railroads provide key transportation services to Perdue, and they do so in an efficient and price-competitive manner. The regulatory policies of the last 30 years have been an important component in the revitalization of the nation's rail transportation system, and have enabled shortline carriers to maintain service on lines that otherwise would have been abandoned or downgraded.

Changes in policies that do not preserve, protect and enhance shortline rail service are inconsistent with supporting a vibrant agricultural industry and the broader public interest.

American agriculture supports a complex, integrated system and plant and animal production practices that satisfy human food needs, sustain the economic viability of farm operations, and enhance the quality of life for society as a whole.

The U.S. is the breadbasket to the world, with U.S. farmers shipping more than $100 billion of their crops and products overseas. Farmers are a direct lifeline to more than 24 million U.S. jobs in all kinds of industries, or approximately 17 percent of the U.S. workforce. Today, the average U.S. farmer feeds 155 people.

In comparison, in 1960, the U.S. farmer fed just 26 people. Importantly, to keep up with population growth, farmers will have to produce more food in the next 50 years than has been produced over the past 10,000 years combined.

The shortline and regional railroad network, which canvasses rural America, is imperative to U.S. agricultural growth. Perdue is proud to be part of American agriculture. Since its founding in 1920, the Perdue Companies have grown into the third largest poultry company, and among the top 20 grain companies in North America.

FPP Investments is our parent corporation. FPP stands for Franklin Parsons Perdue, and we operate two businesses: Perdue Foods, Incorporated and Perdue AgriBusiness, Incorporated. Perdue originates trades and processes more than 250 million bushels of grain and oil seeds, and more than two million tons of soil meal and feed ingredients annually.

These products support multiple businesses, with sales to both domestic and international customers, and feed, pet food, food, fertilizer and the renewable fuels industry. We operate more than 80 facilities, including 47 rail-served facilities in 13 states.

Of these 47 rail-served facilities, 23 of them are served by 16 different shortline or regional railroads. On any given day, we're in communications with over 40 shortlines who are either originating or destining our product. We use rail service to transport in excess of over 60 different types of commodities, and last year we shipped nearly 50,000 rail cars of product.

Perdue has built a transportation network which includes vessel, barge, truck, rail and container. Transportation is a critical component of our product pricing and customer service offerings.

The availability of reasonably-priced and accessible rail service is absolutely essential to the economic well-being and continued growth of our company, our customers, our farmer partners in the communities in which we operate.

The rail services provided by our shortline and regional carriers are responsible, reliable and price-competitive. We view our relationship with our shortline and regional railroads as a mutually productive and beneficial partnership.

Perdue is acutely aware that things could be different, for us and for many other shippers who use shortline railroads. Before the start of the rail line spinoff movements in the 1980's, rail line abandonments, rail line embargoes and slow orders on lines were rampant across the country.

Many shippers like Perdue faced the very real prospect that their facilities, located on lighter density lines, would permanently lose their rail service.

We believe that the shortline and regional railroad industry, and the regulatory regime that allowed it to flourish, are primarily responsible for this turnaround, and for saving rail service to many communities and shippers.

Perdue has directly and significantly benefitted from those revitalized services. We would be very concerned with any regulatory changes that would jeopardize the continuation of rail service by shortlines and regionals over the lighter density lines.

At the same time, we are well aware of the challenges that the shortline and regional railroads continue to face in operating the lighter density rail lines, with high per car fixed costs and potentially non-competitive traffic mixes.

Recent regulatory initiatives that have had a material impact on shortline operations and therefore the customer include revised federal railroad hours of service rules and positive train control requirements. Another wave of abandonments is not inevitable, but it is a real possibility.

Shortline and regional railroads need to retain the financial strength and viability to make future investments in their lines, so that shippers like Perdue can continue to have access to the North American rail network.

In focusing on competition in the railroad industry, the Board cannot look past the more basic question of service availability. The shortline and regional railroads that serve our facilities must compete effectively and continually for our business.

We use rail service more extensively now than in the past, because service has been competitive and efficient. But more importantly, fundamental market changes in the agricultural industry are changing our traditional sourcing locations and our traditional destination markets for many of our commodities.

We do not see more government regulation of shortline and regional railroads as necessary to assure competitive and efficient rail service. We are more concerned that increased government regulation will have the opposite effect, undoing the hard-fought efforts of shortline and regional railroads to revitalize declining rail lines and gain traffic that was moving by other modes.

Providing competitive access for two railroads for some interests cannot come at the expense of jeopardizing existing shortline and regional railroad access for others.

Rail lines that are viable under current shortline ownership and existing regulatory policy could easily become something else if revenues are diverted from smaller carriers and investment in lighter density lines is strangled.

We do not wish to return to the days when abandonment was the preferred option for branch lines, and we do not believe the Board wishes that either. We urge the Board to consider the interests of small railroads carefully in this proceeding, and to assure that the critical role played by those railroads in the transportation system is not harmed.

We appreciate the Board's consideration of our views on this matter.

MR. MARTLAND: Good afternoon. My name is Carl Martland. I've been actively involved in rail research for more than 40 years.

I've worked with all the major railroads in North America. I've worked with some of the commissioners on various transportation studies over the years, and I've had many opportunities to study cross-profitability, utilization, and other major concerns, competitiveness of the Class 1's, the shortlines and the regional railroads.

I'm here on behalf of the ASLRRA. They asked me to study two questions. First, what are the special characteristics of shortlines, more than 500 shortline and regional railroads, that distinguish them from the Class 1's, and second, how do these differences affect the regulations that are being discussed today?

We've heard the basic points, that the shortlines do not have, cannot achieve economies of scale. They have high fixed costs. They have a limited traffic base and strong competition. I think what I can add is that the -- we actually did some research.

The Shortline Association, in response to this request for information from the Chairman, asked me to help them design a survey, and we obtained information from the members about the matters that are of direct interest to this proceeding.

My verified statement has 14 new exhibits, with data that has never before been published about the state of the industry, and I will review some of that here, but there's much more detail in my verified statement.

The first conclusion, average costs are very high for small railroads. They're high because the railroads have low traffic density. First of all, employees. Small railroads, these are the median values, 18 employees, and they have 1.5 million ton miles per employee, a number that is meaningless to me, except that it's 15 percent of the productivity achieved by the Class 1's.

Equipment. Average expenditures were $15 per thousand revenue ton miles for the small railroads, versus about $7 for the Class 1's.

Track. This is a very, very big area for the small railroads. The average expenditures over a three year period were just about $4 per loaded car mile for the small railroads, more than four times as high as 83 cents for the Class 1 railroads. So just maintaining the track is a very, very big expenditure for the small railroads.

Yards. Small railroads, except for some of the major intermediate lines in places like Chicago, generally have very small yards, if they have any yards at all. They don't have the volume to justify efficient switching.

Together, this means that the fixed costs are high. A train requires a crew, even if there are only a few cars. You need locomotives. You need to maintain the track, the wood ties deteriorate in the cold, in the snow and the heat, and the brush must be cleared, snow removed and washouts filled in, even if you're only going to run a single train on the line every once in a while.

Conclusion 2. Small railroads primarily serve truck-competitive traffic. The major commodities that the Class 1's serve include coal.

Fewer than eight percent of the small railroads serve any coal at all. Intermodal, the fastest-growing segment of the rail industry as a whole, little or no traffic is handled by any of the small railroads. The terminals are on the large railroads.

Automobiles, a big traffic segment for the large railroads. There are only eight small railroads that handled auto parts or new automobiles in 2010.

So what they are carrying is the

general merchandise traffic, everything else, the onesies and twosies and 10's and 20's that is highly truck-competitive. It's subject to diversion to a different transload facility, to a barge, to a truck, to an intermodal terminal on one or more railroads.

In the survey, of the railroads that do not handle any coal, which was almost all of the smaller railroads, 90 percent of the traffic was truck or barge competitive. There's no question that these small railroads are competing for traffic every single day.

Third conclusion. The small railroads are serving customers on light density lines, which is pretty obvious. They're small, they're low density. Investment, however, still an issue for these shortlines.

They are trying to upgrade more and more of their track to handle the larger cars, the 286 cars. So they do need revenue, they do need profits in order to continue to invest.

They serve customers where there's just a few large customers. The typical small railroad has three customers that account for two-thirds of their carloads, and the single commodity, this is the largest commodity, accounts for about half of the total carloads.

So these small railroads are highly dependent on one or two or three major customers. Light density lines also imply, light density measured in terms of revenue per mile. They average about $80,000 per mile. Class 1's are about 500,000 per mile.

So their track expenditures per mile of track are almost half of their total expenditures per mile, and they don't have a huge revenue basis on these lines, that they can use to offset the loss of a single customer or a substantial reduction in revenue.

Conclusion 4. These small railroads face higher average costs of rail operations, not because they're inefficient or poorly managed, but because they have to operate on light density lines. It's not because of a lack of competition that they charge what they have to. Their rates are based upon covering the costs of the operation.

We've had some discussion of how the different proposals for reciprocal switching and such things. That suggests that well maybe a mileage pro rate could be used to allocate the revenue among the different lines. This is totally inappropriate for small railroads.

We heard from the Class 1's that the terminals have a disproportionate amount of the cost. Those are the terminals that are large, handling 2,000, 3,000 cars a day. We're talking about small railroads, where the big yards are handling maybe three or four or five hundred cars per week.

So the fixed costs that they face

are disproportionately larger, and a pro rated mileage fee would be totally inappropriate for them.

My fifth conclusion, which others here have already stated, is that the small railroads must cover these fixed costs, even if the traffic is diverted. The wood ties still deteriorate. They don't care about reciprocal switching or other kinds of access. Those fixed costs will be very high.

I'd like to read the final couple of paragraphs so I say this precisely. But this is kind of a summary. Requiring lower rates, whether by reducing rates charged by small railroads or by reducing rates charged by Class 1 carriers that share revenues with the small railroads, will damage the financial position of any small railroad that is struggling to cover fixed costs, and earn an acceptable return to the owners.

By the same token, permitting bottleneck or other rate complaint challenges, which are limited to the small railroads' portion of the entire OD route, would yield results which are distorted and totally inappropriate for application, due to their disproportionately high fixed costs of operation, and the fact that their costs are not embodied in URCS.

The traffic they handle is highly susceptible to diversion to other modes. Restricting the ability of these railroads to handle this traffic or increasing their costs is likely to have anti-competitive impacts, especially since small railroads have limited pricing power.

Legislation or regulations that allow open access or that limit small railroad revenues will hinder the ability of small railroads to handle time-sensitive, service-sensitive or price-sensitive traffic. Just to reiterate, these roads typically receive more than half their revenue from the top two or three customers. Loss of even one customer would be very severe. Thank you.

CHAIRMAN ELLIOTT: Right on the buzzer. Vice Chairman?

VICE CHAIRMAN BEGEMAN: You know, I really don't have any questions, other than one, and maybe one that the Board's staff can help get an answer to.

To what extent, if at all, have shortlines had a rate challenge or a practice complaint or issues brought to the Board, as compared to all the other carriers?

MR. TOBIN: In our initial comments, we indicated that there have been in a very long time, four rate complaints, all of which were settled and dismissed within three, four, five months.

There have been a couple of instances where the rate complainer felt the need, by virtue of having to do origin to destination, rate complaints to include the shortlines, but they were dismissed within a couple, three months.

So really the Board's experience is that there have been virtually no rate complaints against shortlines and regionals. Oh I'm sorry. I'm Miles Tobin of Fletcher ad Sippel, attorney for the ASLRRA.

VICE CHAIRMAN BEGEMAN: Thank you.

CHAIRMAN ELLIOTT: Commissioner.

COMMISSIONER MULVEY: I have a few questions. General Timmons, your chief argument seems to me that the shortline industry should be exempted from any competitive access policies that the Board might consider. What about shortlines that are parties to paper barrier agreements, where the shortline is largely doing the bidding of its Class 1 partner?

If the shortline is shielded from competitive access regulations in that instance, isn't that benefit largely going to be going to the Class 1's?

MR. TOBIN: The short answer is no. The revenues that are generated by the shortline, a particular shortline, as several of the panelists have indicated, are critical to the fixed costs of that particular shortline.

If the Class 1 is allowed, under any scenario, to cherrypick, whether it's through reciprocal switching or direct terminal access, putting aside the operating issues, which are not insubstantial, simply the diversion of revenue, not permitting that shortline to spread its costs over all of the industries, its fixed costs over all of the industries on its line, it is going to be devastating.

I should also add that, even though this isn't -- as the Board has indicated, not a paper barrier proceeding, nonetheless, as we indicated in our earlier comments, the shortlines have worked with the Class 1's to develop the railway industry agreement, which has allowed shortlines in a host of instances to access a second Class 1 carrier and use that second Class 1 carrier, even where there's been a paper barrier. That's been very successful.

COMMISSIONER MULVEY: Although as you mentioned, this hearing is not addressing the paper barrier issue; it's not one of things we're exploring at this hearing. In your pleadings, you noted a survey, which I'm not sure if that's the same survey that Dr. Martland was dealing with, on paper barriers, because I know in the past we've asked about how many there were out there, and we were told nobody knew.

But in the pleading, it does say how many paper barriers are out there, and it would be nice if you could share with the Board that survey, what the goals of the survey was, and what the results were. So if you could, could you produce a copy of that survey to the Board? Michael? Try again.

MR. OGBORN: There we go. There's no light here, so I'm handicapped. There are two different surveys. The one that Mr. Martland was speaking of is in relation to the tables that he has in his testimony, and in the original comments that were filed.

The paper barrier one was done a couple of years ago, and it revealed there were about 90, approximately 90 shortlines that were subject to paper barriers.

COMMISSIONER MULVEY: Okay. Well, that was -- in response to a question on that, about that long ago, the question was -- maybe that survey was done in response to that, that people did not know how many paper barriers were out there. But if you know now, it would be interesting if you could share that with the Board, because we've been told that nobody knew how many paper barriers were out there, and how extensive they were.

MR. OGBORN: Sure. We can share that.

COMMISSIONER MULVEY: Thank you. Oh, yes sir.

MR. TIMMONS: We can share that, but informally, I think that number is pretty clearly 90 or fewer. Maybe significantly fewer from when that last number popped up.

COMMISSIONER MULVEY: And it's also true that they're filing under our exemption guidelines, waivers given on the barriers when the shortlines have asked for waivers. I believe you have shared how many waivers have been granted. There have been a substantial number of waivers granted over the years for railroads that have paper barriers; correct?

MR. OGBORN: The RWIG keeps that on a monthly basis, and we have shared that. We would certainly update it and share it again.

COMMISSIONER MULVEY: Okay, thank you. Small railroads also argue as you did a few moments ago that they can't afford to lose a single customer due to forced access, because they have few customers to begin with, and a single one tends to contribute more to a shortline's overall financial health than is true for the Class 1's.

But aren't the shippers on the shortline railroad no less entitled to access to the Board's procedures or processes? I mean from their perspective, does the fact that a shortline is a smaller, monopolist matter if the shipper is still being subject to monopoly pricing practices or monopoly product services? So should they be treated any differently, simply because they're smaller?

MR. TIMMONS: Well, I think the competitive opportunities are extensive in the shortline world. So shippers have the opportunity to go to trucks, and we've seen that in any number of instances, barge to some degree, and particularly of late transload facilities.

So shortline customers are not insulated, and certainly have the options to go in several different directions if they're not comfortable with the rates that are being charged.

COMMISSIONER MULVEY: So you would say for shortlines, there are fewer monopoly positions, if you like, and therefore overall less monopoly power than say a Class 1 might have?

MR. TIMMONS: I would say that's clearly the case.

COMMISSIONER MULVEY: By the way, Sharon, I want to thank you for hosting us, I guess it was about two months ago, at the Perdue facility out on the Eastern Shore. That was very, very helpful and very enlightening. So we really enjoyed that very much. So thank you for that.

I want to also thank Michael Ogborn for his service on RSTAC over the last couple of years. So again, thank you again for that.

Let me see here. Michael, you

said that the shortlines have no market power at all. I guess that's related to the monopolistic question. Did you mean to say no market power or that they have market power, but it's nowhere near as great as say, for a Class 1 railroad?

MR. OGBORN: I would say that in most instances, it is closer to no market power. But in some, there may be some occasions where they have a little, but nowhere near the Class 1's.

COMMISSIONER MULVEY: That's all I have for the panel. Thank you.

CHAIRMAN ELLIOTT: Thank you, Commissioner. I don't have any questions. I think not because I'm disinterested; it's because I hear your distinction and I think for the most part, I'm sure there are some exceptions. But for the most part, I agree with it.

I thank you very much for taking the time in giving such a diligent comment, and also for actually bringing a shipper with you. That's something different in this forum. So thanks.

COMMISSIONER MULVEY: Mr. Chairman, I have one more question I'd like to ask.

CHAIRMAN ELLIOTT: We have one more question.

COMMISSIONER MULVEY: One of the things that we're dealing with right now is we are redoing our uniform rail costing model. We have heard that this model was particularly problematic for shortline railroads. Do you have any suggestion as to how we might address the special needs of the shortlines?

Because right now, what we're doing is we're applying these cost ratios, these cost numbers that are gotten from the large railroads to the shortline operations, and the feeling is that's not appropriate. Do you have any suggestions as to how we might meet the needs of the shortlines in redoing the URCS process?

MR. TIMMONS: Let me just start that off. Some others may have some ideas on this. The issue for us is to be involved, and we've been anticipating involvement in this process for several years. So our involvement at bringing some expertise to the table as these URCS matters are discussed, I think, is enormously important.

So whether there's a formal organizational structure that draws us in and permits us to participate, or whether it's just by query, whichever way would best serve your interests and ours would be welcome.

MR. OGBORN: And to date, the extent that we've been involved is through our SAC, where we have identified a lot of the problems. I'm not sure we have a lot of answers yet, but we're going to continue to work on that white paper.

COMMISSIONER MULVEY: Dr. Martland?

MR. MARTLAND: Well, it slipped. I would say that main distinction is that the fixed costs, especially the track costs on the smaller railroads are very high proportionately in total. So you would need to consider the total cost of the track and how that might be allocated.

COMMISSIONER MULVEY: We are wrestling with that, so thank you.

CHAIRMAN ELLIOTT: Thank you very much.

(Pause.)

CHAIRMAN ELLIOTT: I wrote that up this morning, Mr. Schick.

COMMISSIONER MULVEY: They're down here as TBD.

CHAIRMAN ELLIOTT: All right. We'll now begin with Panel No. 9. We'll start out with Mr. Schick from the American Chemistry Council. You have five minutes.

Panel IX

MR. SCHICK: Good afternoon

Chairman Elliott, Vice Chairman Begeman.

CHAIRMAN ELLIOTT: I don't think it's on.

MR. SCHICK: Good afternoon Chairman Elliott, Vice Chairman Begeman and Commissioner Mulvey. My name's Tom Schick. I'm Senior Director for Distribution at the American Chemistry Council. It's my pleasure to be able to participate in this public hearing on behalf of ACC's member companies.

They rely on America's railroads for the safe and efficient movement of a wide array of chemical products, to make our lives better, healthier and safer. I'd like to start out with three bits of background information for these comments.

Regarding jobs that have been talked about today, the business of chemistry provides more than 800,000 high skilled, good-paying jobs in this country. Regarding exports, which the Chairman mentioned many, many hours ago in his opening remarks, chemicals account for more than ten percent of U.S. exports.

Third, for context among shipper industries represented here, the commodity group of chemicals and allied products ranks second only to coal as a rail customer group, measured both in terms of traffic volume, that's tonnage originated, and in terms of the freight revenue paid to the railroads.

ACC appreciates that the Board has undertaken this important examination of competition in the rail industry. We participated as one of more than two dozen trade associations in the Interested Parties Coalition, which together filed comments on April 12th, and joint reply comments on May 27th, and of course was represented on Panel II this morning.

ACC and its members heartily endorse the comments and the detailed supporting information that was provided by the Interested Parties. Those comments are especially significant, because they reflect the perspectives of such a wide range of shipper industries including, but not limited to, chemicals, fertilizers, grain, coal, clay, glass, forest products, paper products, many others.

ACC members and their products and their customers who use those products are very different from those of other shipper industry organizations. But despite those differences, I want to emphasize that the views of the Interested Parties are unanimous.

As the Interested Parties have shown, competition between railroads has declined significantly in recent years. Second, the Class 1 railroads are now in excellent financial health. Third, the Board has the ability to change how it regulates railroad competition. Fourth, enhanced railroad competition would profoundly improve the U.S. economy.

Tomorrow, several of the ACC

member companies will provide you with their own perspectives on how the current status of rail competitiveness affects their particular businesses.

Today, on behalf of the entire ACC membership, my request is that the Board complete its careful evaluation of what has been shown on the record of this proceeding, then identify areas where meaningful regulatory changes can be made, and then proceed to enhance competition in the following specific areas:

First, inject needed intramodal competition within rail terminal areas, by revising the reciprocal switching regulations established many years ago; by reversing *Midtec* precedent, which requires anti-competitive conduct be established, and therefore limits the statutory provisions for competition in terminal areas; and generally to encourage rail to rail competition in order to allow market forces to play a larger role in determining rates and services.

Next, we recommend that the Board's current bottleneck access rules be changed to require the carriers to quote rates, upon shipper request, between captive origins or destinations and practical points of interchange in the national railroad system.

Finally, we ask you to consider how you might use your continuing jurisdiction over railroad mergers to reduce anti-competitive conduct and enhance rail to rail competition. Thank you for your interest and your attention. I'd be glad to respond any questions.

CHAIRMAN ELLIOTT: Thank you. Now we'll hear from the Chlorine Institute. You have five minutes.

MS. PICIACCHIO: Thank you. Good afternoon, and thank you for the opportunity to speak this hearing today, but most importantly, thank you for initiating a balanced hearing and for asking for solutions to the issue at hand. My name is Sharon Piciacchio. I am Vice President for Alkali and Derivatives Marketing Services and Cal-Hypo and Global Supply Chain for PPG Industries.

I am also chairperson of the Board Committee on Rail Issues for the Chlorine Institute, and I am speaking on behalf of the Chlorine Institute today. The Chlorine Institute has signed onto and fully supports the initial and reply comments of the Interested Parties regarding this proceeding.

Today, I will not focus on the legal issues at hand, nor will I focus on the safe rail transportation of chlorine, which really is at the core of the efforts of the Chlorine Institute. B ut I want to spend some time focusing on the vital importance of chlorine chemistry, and the rail transportation of chlorine, to reinforce the absolute need for reform of rail competition.

The U.S. economy depends on chlorine, which is an essential product in approximately directly 40 percent of U.S. industries, and indirectly probably in all U.S. industries.

The largest use of chlorine is approximately 40 percent of chlorine goes into the production of polymers, in particular polyvinyl chloride, and polyvinyl chloride, PVC, is used in building materials, such as window frames, vinyl sidings, paints, coatings, glass protection, electronic and medical devices and equipment.

Chlorine is also essential to approximately 93 percent of all pharmaceuticals sold in the United States, and it's involved in 86 percent of all crop protection chemicals. Chlorine is probably almost well-known for its use as a key disinfectant, for the protection of public health in water, wastewater treatment, swimming pool treatment and chlorine bleach applications.

Disinfection has played such a major role in increasing Americans' life. It's estimated that it has increased life expectancy by 50 percent during the 20th century, by virtually eliminating diseases such as cholera and typhoid fever.

Although disinfection is relatively a small usage of all of the chlorine produced in North America, it's only about six percent of that chlorine, but all of that six percent, nearly all of it, moves by rail, and it's shipped to the taxpayers and the municipalities that are receiving the chlorine.

Truck transportation is not a reasonable or viable option considered by most shippers of chlorine. Rail is definitely considered the safest way to move chlorine over land. If you would take a rail car and ship trucks, you'd be putting four and a half trucks of chlorine, unnecessary hazardous materials in our highways.

Because nearly all U.S. industries are dependent on chlorine to some extent, it is important that reasonable and competitive shipping rates are offered to producers, so that they may effectively continue to do business in the U.S. and serve U.S. consumers.

This has become very difficult due to the dramatic rise in the shipping rates for chlorine, and in part this increase is due to a lack of willingness by the railroad industry to provide or compete for service.

The average rate per carload has increased 133 percent between 2000 and 2009, compared to a 47 percent increase in the rail cost recovery index over that same period. Currently, the chlorine chemistry business supports the U.S. economy, with annual sales of more than 94 billion.

It employs over 160,000 Americans. It pays federal income taxes of 1.1 billion, and it pays 211 million in state and local taxes. The impacts of excessive rail rates can severely hinder the chlorine industry's ability to provide jobs and help power the U.S. economy.

As I previously discussed, chlorine chemistry is so widely used that the general public will be impacted through rising costs. The difference is that the general public is not aware or does not understand why their rates are rising.

When gasoline prices rise, they understand what's happening to their wallet. With this quick glimpse into chlorine chemistry and the impact that rail rates have on us, we ask the Board to comprehensively review its competition rules and precedents, and consider introducing competition into the railroad industry, so that other industries, including our own, have the ability to compete and thrive in the U.S. economy along with the railroads.

CHAIRMAN ELLIOTT: Thank you very

much. Commissioner Mulvey.

COMMISSIONER MULVEY: Chlorine is an input in so many commodities, and I've had many visits when I was on the Hill and here from the Chlorine Institute about the importance of chlorine. But I guess my question is what percentage of the total cost of producing and distributing chlorine is rail transportation?

Then beyond that is do you have any notion as to what that percent transportation of chlorine cost is in the production of the final product, because chlorine is a product, is an input, one of many, many inputs in creating, say for example, polyvinyl chlorides or other things.

So is there any way of getting to what the overall impact on these goods is, wastewater treatment facilities, etcetera, from increased rail rates?

MR. PICIACCHIO: Well, let me try to answer that as best as I can, and perhaps

I may use PPG, since I work for PPG as an example. But looking at the cost of freight in the actual product itself, and I'll use an example, and pretty close to averages.

Let's say published average price through the marketing journals for chlorine might be about $250 a ton. In the past, if you would go back to prior to 2004, the freight component of that price of that product, may range about ten percent, let's say $25 a ton to, you know, maybe a little bit higher than that, 10 to 20 percent.

We have seen that number escalate beyond 50 percent, and in one case, and I know Mr. McGarry will be speaking on behalf of PPG later tomorrow, we talk about the fact that that portion of the price of the product in one instance has gotten os that the freight completely consumes the price of the product. It's more than the price of the product itself, so in actuality you can't end up shipping it.

Now to get to the second part of your question, as to what part does the raw material chlorine play into the different end use segments, it really varies by the product.

You know, in some products such as chlorine bleach, it's made from chlorine and caustic. So you have both components. So it really depends on the product that you're talking about. So I don't think I can give you a straight answer on that.

COMMISSIONER MULVEY: Thank you.

CHAIRMAN ELLIOTT: Just one question. The same question I've asked each of the shipper groups, including the Interested Parties, but maybe you have a different perspective from your groups since. Just with respect to we've heard many comments saying that the railroads aren't competing, and as a result, my thought is that if they're not competing, that access would not be effective.

So the question is whether or not

you think access is really what we should be focusing on, or should we be looking at rate cases and regulation that's already in place, and trying to improve on that? I throw that open to both of you.

MR. SCHICK: I think our position at ACC is essentially the same as the position of the larger Interested Parties group. Given the nature of the issues that were teed up in this docket, which tended to focus on access issues, that's what we were primarily focused on in our comments.

No disrespect to the Board, and I do recognize that a number of changes have been made over the last five to ten years in the rate review process. But I don't think a lot of our member companies are super-anxious to come here for rate cases.

They would rather be able to work these things out, and to have some of the tools that were discussed this morning, even if those tools are never used here, to help balance their negotiations with their carriers.

CHAIRMAN ELLIOTT: No disrespect taken.

MR. SCHICK: Thank you.

MR. PICIACCHIO: I would reiterate the same for the Chlorine Institute and on behalf of PPG, that improving the use of the tools is really what we're looking for, because if you say that we're only going to focus on open access, and you really don't get the competition that you're looking for in open access, then you need your second tool, which is your ability to bring rate cases.

I agree with Mr. Schick. You don't necessarily want to have to bring a rate case. But if we do, we want a much simpler and streamlined process that allows us to actually bring them forward.

CHAIRMAN ELLIOTT: Thank you. Vice Chairman?

VICE CHAIRMAN BEGEMAN: This is

going to follow up sort of on a question that we had asked kind of the ag panel. But from your perspective, are you struggling more with the rates or the service, particularly on commodities chlorine and other TIH materials, which are a growing, difficult area.

I know that those commodities are getting more attention lately, and I'm not really sure where that's going to end up. But I'm just curious if right now service is actually becoming a bigger issue for you than the rate, or if it's just all too much tied together?

MR. PICIACCHIO: I will answer that in two ways. Let's talk about the service first. I will say that probably the different Chlorine Institute members might have different answers to this question.

As far as service, PPG, and I'm sure some of the Institute members, find the same thing. It can be very sporadic, meaning we can get very good service out of certain places, and we work with the railroads very well in understanding what the issues are and driving for resolution.

But there are situations where it's the same continuing problem. We just can't get the service that we need. We have found that you really separate the two issues, right? It's the service, and it's got its own unique things that we work on.

Service for one product versus a TIH really is no different, although there are different rules in place to ensure the safety and security of the shipment of the TIH products. I would not say our service varies from one product to another.

But if you look at the rates, the rates are the heart of the issue for us, if you look at it separately for -- I know for many of the Chlorine Institute members and for PPG, it's the escalating rate structure, and feeling that you have no ability to really do anything about it, because you run into a lot of obstacles when you look at trying to bring forward a rate case. So the rates are a serious issue for us.

MR. SCHICK: I think across the board, for chemicals, of course, we've got everything ranging from TIH products to their HAZMAT, to non-hazardous materials that are also products of chemistry. A lot of volume of rail movements of plastic pellets and soda ash and things like that that aren't even hazardous.

But all the companies have the same kinds of interests that PPG just described, service and rates. The rate issue is important, and it's not limited top articular products. It's across the board, or as I said in my remarks, if you look at what the Interested Parties came together on, you've got grain, you've got coal, you've got a lot of products in there.

CHAIRMAN ELLIOTT: Thank you very much for coming today, and I appreciate your comments. We'll now proceed with Panel No. X

(Pause.)

CHAIRMAN ELLIOTT: Yes. You're good. First, we'll hear from Transportation Communications Union. Nice to see you again, Mr. Scardelletti, and you have five minutes.

Panel X

MR. SCARDELLETTI: Thank you. It's a pleasure to be here. Good afternoon, Board members. My name's Robert Scardelletti. I'm the president of the Transportation Communications Union. We represent carmen, clerks, supervisors and some yard masters throughout the railroad industry.

TCU has about 40,000 members on the railroad. Whoops, I got the business too, but I'll just -- okay, thank you. TCU represents about 40,000 members, together with another 120,000 other railroad workers. So it's about 160,000, who are represented by 12 or 11 other national and international unions on our nation's freight railroads, including some shortlines and regionals.

The economic well-being of our members is our union's number one priority, which is directly connected to the financial health of the railroad industry. 98 percent of railroaders stay in the industry their entire working career.

Rail union jobs depend upon a financial, viable industry that can earn sufficient returns on its investments, which in turn provide the middle class jobs our country needs, the kind of jobs that allow Americans to pursue the American dream.

Railroading is a very capital-intense industry that requires huge investments, infrastructure and equipment. Since 1980, the railroads have invested over $480 billion in capital expenditures. To continue the quality of service the railroads provide, significant ongoing investments must be made in rolling stock, signaling equipment, repair facilities, tracks and in its employees.

These comprehensive and complex investments require railroads to be financially strong. Any STB regulation that would require two railroads to serve every rail customer would have severe economic consequences for the rail industry. They project possibly thousands of jobs could be lost.

TCU has seen firsthand experience or has firsthand experience with the unintended consequences of STB decisions that penalize railroads. Immediately after the 209 STB decision on the rate case brought by Basin Electric against BNSF, where the railroad was ordered to lower Basin's rail rates by $350 million, BNSF furloughed more than 100 TCU carmen members and other shop craft employees.

The timing of this decision couldn't have come at a worse time for the employees. It took place in the height of the worse recession in our nation's history. The

STB may have felt justification in providing relief to Basin Electric. However, it came at a heavy price to BNSF employees.

I witnessed firsthand the bankruptcies of the Northeast railroads in the 70's, which led to Congress passing the Regional Railway Organization Act, and subsequently the Staggers Act. Tens of thousands of jobs were lost.

I remember the day Penn Central declared bankruptcy, the banks would not cash my paycheck, because that's where I worked then. They got it straightened out, but on that day, they wouldn't cash our paychecks.

The railroad industry and its employees and this country cannot go back to those days. Any further shifting of regulatory balance towards shippers would result in job losses, less wages and benefits. Corporations who ship by rail may receive financial benefits from a new regulation, but such regulations by the STB would come at the expense of the railroad industry, the workers and their families, and would result in a loss of rail jobs as a result of government regulations, at the time when we need most of all in America these type of railroad middle class jobs.

Putting the financial health of railroads at risk would jeopardize our railroad retirement system, which right now is covering well over 550,000 railroad retirees and their families, who depend on those monthly checks.

As a representative of the employees, I want you to take into consideration that any decision you make that results in reducing the railroads' revenue, will absolutely have a dire consequence upon the employees who work in the railroad industry. Thank you.

CHAIRMAN ELLIOTT: We'll next hear from Mr. MacDougall on behalf of the United Transportation Union, New York State

Legislative Board.

MR. MACDOUGALL: May it please the Board, I'm here today on behalf of Samuel J. Nasca, who serves as the UTU's legislative director for New York State. He is a full-time elected official of the UTU, and is the longest continuously serving state director in the UTU. He's been in his present position since 1984.

The New York State Board has participated in numerous ICC and STB proceedings over the years. Initial and reply comments have been submitted. I'm not going to read from our comments. My request for time today is to summarize some procedural suggestions we have to improve the Board's process for resolving railroad competition disputes.

That's the second of the three subjects that Senator Rockefeller talked about today, procedures. Employees want to know what's going on. They don't want to be in the dark, and the first thing I'd like to do is congratulate the Board for making the submissions today publicly available.

That's not the usual situation. Ordinarily, when we have started to submit at a hearing like this, we submit them ten days in advance, but we can't see what the other participants are saying. This time, you started out with that procedure, but a few days before today, you allowed us all to see everybody else's presentations.

It's in the area of transparency that we have the suggestions. Before I get into transparency, I'd like to answer two questions that you've asked every witness up to now, and that is what about the railroads, do they compete?

The saying is they don't compete. Railroads have been charged with not competing for 50 years. I recall a book published in 1950 under the auspices of the Brotherhood of Railroad Trainmen called "The Railroad

Monopoly." It was published by the Public Affairs Institute in Washington, D.C. at that time, headed by Dewey Anderson.

The author was John Shott, and the book was mainly paid for by the Brotherhood of Railroad Trainmen. There the question was again do the railroads compete? The answer is they do compete. In fact, this book was written at the time of the [name] legislation.

It's just old propaganda that the railroads don't compete. Of course they compete. They compete not only point to point but you have potash produced in Canada, potash produced in Santa Fe, in New Mexico, Carlsbad, New Mexico. Different railroads served in different origins. The same is true for salt, sugar and a lot of commodities.

In respect to competition, I don't think the emphasis should be on competition too strongly, or not as strongly as it sometimes is today, or it has been in the past, and that's because too much competition in a recession can cause real troubles. We saw what's happened up in New York in the financial institutions.

Competition makes instability. In other words, instability is inherent in competition. Different markets get served, people get out of jobs, new things happen, and I think we should have some caution these days in dealing with competition.

Now as to suggestions for procedures, one of the questions asked was should the emphasis be on access or rate cases. I'll briefly say we haven't had a position on the rates. We did way back.

One of the unions, one of the sections in the UTU, along with the Chicago Board of Trade, had a position on rates, where they felt that the Board should use rate comparisons rather than the cost techniques. That was presented in the non-coal guideline proceedings back in 1996.

But up to now, we've had no

particular position. It had to be studied. But my guess is that the emphasis, as far as employees are concerned, would be better on the rate process than on the competitive access process. Thank you.

CHAIRMAN ELLIOTT: Thank you, Mr. MacDougall. No fire alarm today for you, so -- first, we'll hear from the Vice Chairman. Oh, there was a fire alarm when Mr. MacDougall was testifying at the last proceeding, cutting his comments short.

MR. MACDOUGALL: It's a long day, and it's nice to be here at the end.

VICE CHAIRMAN BEGEMAN: Yes, it is. Mr. MacDougall, could you just elaborate a bit on your comment about that instability is inherent in competition. Do you mean for the carrier --

MR. MACDOUGALL: For everybody.

VICE CHAIRMAN BEGEMAN: For the shipper as well?

MR. MACDOUGALL: Well, the best

article is one that's dated tomorrow by George Soros in the *New York Book Review*, where he goes into this subject, about instability, competition, and the cause of the financial crisis in New York was not due to the government action; it was due to the failure of the market up there. There's too much market competition.

So there's a danger, particularly in the recession period, of emphasizing competition too strongly. That's just the way the nature of competition is, that it causes instability. I got it from -- I don't get it from George Soros, but I commend it to your attention because it's a current issue out dated tomorrow, *New York Review of Books*.

VICE CHAIRMAN BEGEMAN: Thank you.

CHAIRMAN ELLIOTT: Commissioner?

COMMISSIONER MULVEY: Just briefly. Competition is generally a good thing, but it depends on the industry, and there are some industries where competition by itself, without any kind of oversight or regulation, can cause real problems.

In other industries, for example, industries like finance, competition can, as Mr. Soros points out, lead to some problems if there's not proper federal oversight. Mr. Scardelletti mentioned railroad retirement and the number of railroad workers who receive railroad retirement benefits, and he pointed out that railroad retirement is a pay-go system, and that the funding of the railroad retirement depends upon the number of people working, who contribute, and current contributions pay current benefits, which is unlike many other retirement systems.

Therefore, you bring about more of an equivalency between the importance of railroads and workers. It's not just the 200,000 currently working, but it's also the half million or more retirees as well. So it's nearly three quarters of a million people who are directly dependent on the state of and the health of the railroads.

I think that's an important point to make, because it was said earlier that the other industries that rely upon railroads have far, far more workers. So I think that creates some of the equivalency.

But I don't really have a question on that, but thank you very much for your testimony.

MR. MACDOUGALL: Can I just say one thing?

COMMISSIONER MULVEY: Yes.

MR. MACDOUGALL: The notion of efficient markets and rational expectations that competition is good and so forth, that has been, is being discredited. We're not rational people. A lot of things we do are irrational, and markets are not efficient. So competition is not necessarily always good.

COMMISSIONER MULVEY: Well, I agree. I said that. I think rational expectations goes beyond the idea of competition. Rational expectations is an extension of competitive market theory.

CHAIRMAN ELLIOTT: Well thank you very much, both of you, for your comments. I don't have any questions. I feel like I have a pretty good grasp of rail labor's interests. So thank you very much for coming.

Last but not least -- of course we have to do this again tomorrow, so Panel No. XI.

(Pause.)

CHAIRMAN ELLIOTT: You guys okay? Is it working? Okay, great. First, we'll hear from J.P. Morgan Securities. Mr. Wadewitz, you have five minutes.

Panel XI

MR. WADEWITZ: Chairman Elliott, let's see, okay. Chairman Elliott, Vice Chairman Begeman and Commissioner Mulvey, thank you for providing the opportunity to testify today. My name is Tom Wadewitz. I'm an equity research analyst. I cover the air freight and surface transportation industry at J.P. Morgan Research.

I've been a senior analyst for about nine and a half years, covering railroads and the broader industry. A few disclaimers first here. The views and opinions I share on the industry are my own personal views as a research analyst. They don't necessarily reflect the views or opinions of J.P. Morgan, my department or others at the firm.

In addition, the firm may have real or perceived conflicts in matters related to the topic or any companies I may mention during the course of my testimony. So if you'd like details regarding any conflicts, or conflicts with specific companies in the industry, please contact me. My phone number, you can't probably see that there, but it's up there, 212-622-6461, or you can email, if you want to, research.disclosure.inquiries @jpmorgan.com.

So in any case, I wanted to show you a couple of simple things that will illustrate what investors care about. I think a lot of it's pretty intuitive. My experience as a sell-side analyst in formulating recommendations on transport stocks, and speaking with institutional investors over the years, leads me to believe the following about what investors value in transport stocks.

So first, the value growth in that income and growth in earnings per share. Second, the investors value both absolute financial returns, strong returns, but also -- such as return on capital, but also the trend of improvement in financial returns.

So favorable earnings, growth performance and a broader trend of improving financial returns have been key factors that have attracted equity investors to the rail stocks over the past seven years. You see that, I think, in the first chart that I show up here, that looks at rail stock performance, which is in the bar chart, and then rail earnings growth in the line.

If you switch to the next one, the equity market is forward-looking. So if you offset it by a year, then the trend is more consistent. They move together, and also then if we flip to the next one, you can see that returns, which is the line here gradually moving up, are associated with times when the rail stocks are performing well.

Let's see. So volume growth, pricing improvement, productivity gains, these are the drivers of earnings performance, in addition to cyclical factors such as the economy. We think the rails benefit from secular growth opportunities, in particular converting truck freight to intermodal freight.

In the medium term, intermodal volume growth typically does require capital expenditures in capacity expansion, new terminals, new sidings, double track. So even though it requires meaningful capital investment, we think that the secular volume growth potential of this segment is attractive to investors and the rail.

So rail investors are not always against higher cap ex, if there are good reasons and growth to be had. If you look at productivity trends, I won't put up a chart, but in particular, employees costs are the greatest costs. So trends in revenue, ton miles for productivity were impressive for many years, but over about the last five years, those trends have stagnated.

Since 2004, if you look at the pricing trend, obviously as has been highlighted today, it's been pretty favorable. That's been a very important consideration for rail investors. In our opinion, significant changes to this favorable pricing trend would negatively affect the attractiveness of the rail industry to equity investors.

I have two quick charts here that,

scatter charts that, I guess, help you consider what drives valuation of the transport stocks. These are listed with the ticker symbols, so I apologize if you don't have the familiarity with some of these. This is my coverage universe.

But the first one shows forward PE valuation on the Y axis, and the ten-year realized earnings growth CAGR on the X axis. You see there's some relationship between valuation and earnings growth. The next chart, you'll look at the similar type of profile, and an even stronger relationship between returns on capital and the forward PE valuation.

So the names that get the best valuation, C.H. Robinson Expediters, J.B. Hunt, are models that actually realize the best returns, as well as the best growth. The rail industry has realized improvement in its financial performance over the past seven years, but its returns are still lower than for the five other groups of transport stocks we cover.

So if you look at this simple bar chart, the rail is on the left-hand side in the blue. The groups recover in the middle. Only the depressed LTL Group is worse, in terms of return on capital. Then on the dark bar, you see the S&P 500 industrial names and the average return on capital of about 15 percent.

So if you look at this in a comparison group, rail returns do not appear particularly strong, versus our coverage group or versus large cap industrials.

Just to wrap up with a few conclusions, regulatory stability provides support for rail investor interests and investment in the rail network, in our view. So we think that regulatory stability provides greater visibility to expected growth in financial performance.

This encourages investors to own

the stocks. This encourages management to invest in the system. The second point, uncertainty is a source of risk. So while the outcome may be favorable, if an extended process of considering change in regulation is pursued, that can act as a headwind to rail investors and also to investment decisions.

Rail financial returns, as I've shown, have improved materially over time, but they're still not particularly strong on an absolute basis. You can see that versus other transports and versus the S&P 500 industrials. Then the last point, investors value both earnings growth and financial return performance.

So that trends to drive incentives for the rail managements. If you look at the rail managements and their long-term incentive performance, or excuse me, their incentive plans on a long-term basis all have return components to them.

So clearly, their incentives drive

their behavior, whether it's investment or other things, and those, in terms of the multi-year incentive plans, all include returns. So we think returns are important. Thank you for the time.

CHAIRMAN ELLIOTT: Next, we'll hear from Wolfe Trahan and Company. Mr. Group, you have ten minutes.

MR. GROUP: Thank you. I have slides as well. You guys should have a copy of the slides in front of you.

CHAIRMAN ELLIOTT: Okay.

(Pause.)

MR. GROUP: Hello, yes. Thank you, Chairman Elliott, Vice Chairman Begeman and Commissioner Mulvey, as well as your staffs, for the opportunity to present today. My name is Scott Group. I am a transportation analyst at Wolfe Trahan, the leading boutique research firm on Wall Street, focused on freight transportation and the macroeconomy.

Our clients are primarily mutual

fund and hedge fund analysts, and portfolio managers, who invest in the public equity and debt of the railroads and other transportation companies. I'll make some comments for the record and submit the slides I plan to present to the Board today.

First, Slide 1 presents stock performance of the rails, relative to trucking stocks, as well as the S&P 500 over the past decade. On average, the rail stocks have returned 15 percent annually since 2000, well above the other freight sectors, including the trucks, which have gained six percent annually.

This also compares with the S&P 500, which has produced a one percent average annual decline over this period, because of poor returns in the early 2000's and in 2008. This slide also shows that rail stock outperformance has become increasingly pronounced since 2005, around when the rail pricing renaissance began.

Slide 2 then shows valuations for the large cap railroad stocks, and the S&P 500, on a forward price to earnings or PE basis. This shows that the rails have traded in a very tight and consistent range of 11 to 15 times forward PE, consistently below the S&P 500 from 1990 through 2007.

More recently, however, S&P multiples have contracted, while rail multiples have held firm. We believe the rails have traded at lower valuations than the overall market over the long term because they are more capital-intensive, and more mature and slower growers, without the ability to grow internationally.

Further, the rails remain a partially regulated industry, and we believe valuations would contract from current levels if investors perceived potential risk of rising government regulation of the industry.

Slide 3 tracks rail and truck pricing over the past 35 years, and depicts the rail pricing renaissance that began in 2004.

Since deregulation in 1980, rail rates dropped sharply over the following 23 years. Rail rates have subsequently increased materially since 2004, at an average annual rate of nearly six percent on an inflation-adjusted basis.

However, rates still remain down approximately 50 percent since deregulation. Moreover, the spread between truck and rail pricing has widened over the past 30 years, despite the trucking industry being much more fragmented, with inherently much more competition. We estimate that the top ten truckload carriers in the U.S. combined make up less than ten percent of the industry's total market share.

We believe higher increases in truck rates over the past decade partially reflect trucks being less fuel efficient, and requiring higher fuel surcharges as oil prices have risen.

(Pause.)

MR. GROUP: Slide 4 takes a closer look at quarterly pricing trends for the U.S. versus Canadian railroads. Note that we have removed the impact of changes in mix and fuel surcharges, as well as currency for the Canadian rails, to try and isolate same store pricing levels.

As shown, U.S. rail rates have consistently increased at a faster pace than Canadian rail rates over the past five plus years. While there are likely several factors that have driven more material rate increases for the U.S. rails, including easier comparisons and longer term contracts, we believe the regulatory environment today is more favorable in the U.S., as the Canadian rail system provides for mandatory reciprocal switching and final offer arbitration options for all shippers.

Due to consistently higher pricing

gains, the U.S. rails have attracted relatively greater private investment over the past several years, as evidenced by more material increases in their stock prices.

Slide 5 then displays capital spending trends for the U.S. rails since deregulation. Railroad cap ex is historically very dependent on the health of the industry, and railroads' capital spending has shown an extremely high 94 percent correlation with the industry's cash flow from operations over the past 30 years.

Further, this slide illustrates that rail capital spending has increased materially since the rail pricing renaissance began in 2004. The U.S. rail industry has averaged nearly ten billion of capital spending annually over the past five years, versus less than six billion on average for the prior five years. This represents more than a 60 percent increase.

Slide 6 presents a more granular

look at capital spending by railroads. We also show cap ex as a percent of total revenue for each of the Class 1 rails since 1996, compared to the average cap ex as a percent of revenue for the Dow Jones Industrial Average.

Over the past five and ten years, railroads have spent an average of 16.6 and 16.4 percent of their total revenue on capital spending. This is three times higher than the roughly 5.5 percent on average of the Dow Jones Industrials during those periods.

Also note that railroad spending increased as a percent of revenue during the global recession in 2009, while spending dropped for the companies in the Dow Jones. Lastly, this slide shows that rail cap ex is expected to increase more than 30 percent during 2011, and each of the rail managements has recently guided in investor conferences to materially higher capital spending in the next several years.

Slide 7 looks at each rail's

return on capital relative to the rail industry's cost of capital, as published each year by the Board. Rail returns on average have improved from a low of about six percent in 2003, to about ten percent in three of the past four years.

However, average rail returns have only exceeded the industry's cost of capital once in the 14 year period depicted in this slide. Norfolk Southern was the only rail to return its cost of capital in 2007 and 2008, while none of the rails earned their cost of capital during 2009.

Perhaps more importantly, the return calculations are based on the rails' historical book values, which are materially understated, with many assets, including bridges, tunnels and track that are now fully depreciated on the rails' balance sheets.

We estimate that the asset base for the rails would increase by roughly three times on a replacement basis, and this implies returns on capital in the low single digits. Thus, it appears to us that despite improved pricing and returns over the past seven years, the rail industry is not yet revenue-adequate on a long-term basis.

Slide 8 presents responses from a proprietary survey of more than 100 traffic managers that our firm conducted last year. We asked the customers of the railroads which potential regulatory changes they supported and opposed.

As shown, shippers in our survey overwhelmingly supported many regulatory changes, including an ability to challenge existing paper barriers, a reverse of the current bottleneck policy and increased terminal access. However, shippers were generally split in their support of a switch to a replacement cost methodology, and slightly opposed a larger STB with greater regulatory authority.

Slide 9 lists several of the key

reasons why rail infrastructure is critical, and becoming moreso for our nation's transportation needs.

Railroads comprise only about seven percent of total freight transportation spend in the U.S., but have become an increasingly critical line haul component of moving bulk commodities and consumer goods to businesses and consumers throughout the U.S., and between Canada and Mexico.

This has been accelerated over the past 20 years, with the rise of global trade and Asian imports into the U.S., which lend themselves to large, less expensive long haul moves on railroads, rather than other modes of transportation. The rails also provide a crucial element to meet rising export demand for U.S. commodities, including coal and grain.

We estimate that rails are nearly four times more fuel efficient than trucks, and with increasing highway congestion and oil prices, above $90 per barrel, the rails are one of the few alternatives to help decongest highways and make America more productive, safe and environmentally responsible.

Our survey work also suggests that rail rates are about 10 to 15 percent cheaper than comparable trucking rates on competitive lanes, while laying one mile of rail track is about one-fifth the cost of laying one mile of new highway.

Finally, Slide 10 lists some of the major multi-year U.S. capacity expansion projects currently underway by each of the major railroads. Most of the rails have hosted public analyst day presentations over the past year, and each has guided to material increases in rail cap ex and growth cap ex in particular.

In conclusion, we believe the rails are vital to the North American transportation network, and will be increasingly important to infrastructure, in order to alleviate highway congestion and promote a more efficient and environmentally conscious transportation grid.

While the rails have seen strong increases in -- strong earnings and stock performance in recent years, this is the most capital intensive industry of which we are aware. As a result, the rails have low financial returns on a replacement basis, and we believe rail returns would decline further if the Board were to implement material regulatory reform that reduced the rail's ability to differentially price.

In that scenario, a reduced pricing power for the railroads, we would also expect that shareholders would demand substantial reductions in rail capital spending. I thank you for your time, and welcome your questions.

CHAIRMAN ELLIOTT: Thank you very much, Mr. Group. Commissioner.

COMMISSIONER MULVEY: You came all

the way from New York, so I'll ask a couple of questions anyway. Earlier on, many, many hours ago, a statement was made that railroads are in the top ten percent of market industries in terms of profitability.

Your data seem to suggest that that's not true. Could you explain the difference? Where do you think that number came from? I think there was a *Fortune* magazine article, but I'm not familiar with that, and I was wondering if you were, either of you.

MR. WADEWITZ: Yes. I'll provide one thought on that. I mean if you look at margins as a measure of profitability, my guess is that that may be what the article was referring to. The margins in the rail industry are shrunk, and they are, let's say, 25-30 percent, and those are strong relative to say trucking or UPS and FedEx.

But the other side of equation you can't forget about is the capital intensity and investment base, right?

So while they may look attractive from an absolute margin perspective, if you look at financial returns and how much the amount of cap ex they spend, the capital intensity as a percent of revenue, then those two together give you the result that the returns are not that strong, as I'm sure you've also seen today.

So I think that's the problem, is that if you just look at margins, without looking at the other side in terms of how much they need to invest, then it gives you probably a bit of a false picture.

COMMISSIONER MULVEY: Is there a self-fulfilling prophecy at work here? I mean the railroads keep saying that if any change is made in competitive access or the bottleneck rate decision, or anything like that, then their ability, their access to capital markets will dry up.

Well, if there was any change,

that statement being constantly put out there, wouldn't in fact that statement be a self-fulfilling prophecy? Or would it happen, you think, without them saying it? Are they creating their own problem, if indeed anything was done by constantly pointing to it?

MR. WADEWITZ: Well, I don't know if I would necessarily frame it that way. But if ultimately you put in place those changes that do negatively affect pricing, which then affects earnings growth and returns, then there will be less interest from shareholders, land it will incentivize the managements to take a different course, right.

So in industries where returns are not particularly good, then shareholders will put more pressure on the industry to invest less. So if your desired result is less investment, then that can be a course that you go to.

But you know, if that's a component of the policy, that you want to encourage investment or allow investment, then it seems that the logic is reasonable, from my perspective, and that it's not something that necessarily would be immediate, although the market clearly does anticipate, you know, what may happen in the future. But it seems that that's a logical result, and not really a self-fulfilling prophecy per se.

COMMISSIONER MULVEY: Well, the other side of that is that we've talked about the possibility of experimentation, by having some open access in some places and then see what goes on for a certain period of time. Would the experimental process create a degree of uncertainty about what might happen in the long term, that could have a negative impact on capital availability for the railroads?

MR. GROUP: I would say, just from speaking with our clients and the investors, that if there were to be signs of increasing reform and increasing access for captive shippers, there would certainly be pressure on the railroads to reduce their capital spending, yes.

COMMISSIONER MULVEY: Okay. One final question I have, as you point out that the railroads cannot expand internationally, I guess Kansas City Southern being the exception, but is it also true, though, that the U.S. exports to the world. Certainly, if we're going to have more exports of anthracite coal or more exports of agricultural commodities, the railroads can still benefit from growth in international activity, even if they can't themselves build. Wouldn't you say that's correct?

MR. GROUP: I think that's fair, and we have seen significant increases in export coal this year, significant increases in export grain over the past several years, and the railroads have been spending to upgrade their networks to meet that export demand.

COMMISSIONER MULVEY: Thank you

very much.

MR. WADEWITZ: Yes. Well, in response to your prior question, I think that incrementally, there would be some effect. So if you do a test, if you do a pilot, then that may not dramatically change the investor view. But the margin, it probably does change the investor view a bit and adds risk.

So you know, some prior comments of large capital expenditures and risk to that incremental spend in a carload yard or whatever, I think there would be some greater pushback from investors, and it would encourage rail managements. On the project that's not the best project, then you pull back from that. So I think on the margin, it would potentially have some effect.

COMMISSIONER MULVEY: Thank you very much.

CHAIRMAN ELLIOTT: Vice Chairman?

VICE CHAIRMAN BEGEMAN: Mr. Group, can you explain to me how your shipper survey slide fits into your testimony?

MR. GROUP: Sure. We do a quarterly survey of traffic managers, and ask questions, ranging from expectations for volume, pricing, capacity. We ask questions about what's topical, and certainly last year, potential regulatory reform, particularly with the Rockefeller bill. That was topical.

So we ask these questions and I thought I would provide it to the Board. I know you guys are working towards potential solutions.

VICE CHAIRMAN BEGEMAN: But does it contribute to your conclusion at all, or is it just maybe more informative for us?

MR. GROUP: I think it was more informative, letting you know what shippers care about, and we had certainly heard from them and we have heard from the railroads. Our conclusion is that, at the end of the day, we don't think railroad returns are in any way egregious, and on a replacement basis, are still very low.

CHAIRMAN ELLIOTT: I have one final question, and this goes to the question that I asked the rail CEOs. This goes back to the proposal of a possible pilot project, and you mentioned -- and I don't know if you were here for that.

But I discussed the possibility of putting out there, as opposed to making some great regulatory change, instead possibly proposing a pilot project, where you dealt with reciprocal switching and see how it worked out, and the hope being that we would settle these issues that we've been fighting about for the last 30 years.

I guess my question to you is what effect do you think that would have on the railroad investors, if we proposed something of that nature?

MR. WADEWITZ: I mean I think it's, I guess I receive that question as being similar to the question that Commissioner

Mulvey asked, in terms of changes, pilots and potential incremental change. I think that on the margin, it would cause some portion of the investment community to have greater concern about regulatory issues.

So there would be some portion of investors that, you know, give negative feedback to the management. So I don't think a pilot would dramatically change the view on the railroads, and when STB changes things, you have hearings and you have inputs and comments, and it's a long process.

So it's kind of hard for me to say it would immediately have a dramatic impact. But on the margin, I think it would have some negative impact, and the feedback probably would potentially have some negative impact on the investment plans of the railroad managements.

You know, I think it's fairly clear how that's tied together. If you look at how rail managements are incentivized and returns, and look at the regular input that they get from rail investors.

CHAIRMAN ELLIOTT: Thank you.

MR. GROUP: I would agree with what Tom just said. The rails have talked over the past year about materially increasing their spending, going from 16 percent of revenue to 18, 19, and in some cases 20 percent of revenue, and a lot of that spending is on multi-year projects for growth five, ten years from now.

A pilot program would potentially lead to more material changes five, ten years from now. So I think it would lead some investors on the margin to question some of the increases in capital spending.

CHAIRMAN ELLIOTT: Thank you, both of you, for your patience today, especially going last, and thank you everyone for coming. One reminder before we shut down and come back tomorrow. For those of you who did -- I tried to make this clear early on.

But for those of you who did PowerPoints, we'd appreciate if you'd submit two copies of that to the Office of Proceedings. You can do that electronically, or you can also do that via mail, or you can do it in person.

But we would appreciate that for the record, and those should be in 8-1/2 by 11 form. Thank you very much for your attendance today and for all your help, and your insightful comments, and we'll go into a long recess until tomorrow at 8:30, where we will reconvene. Thank you very much.

(Whereupon, at 5:31 p.m., the hearing was recessed, to reconvene on Thursday, June 23, 2011 at 8:30 a.m.)