
RAILROAD-SHIPPER TRANSPORTATION ADVISORY COUNCIL

Washington, DC

WHITE PAPER I

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Under the Interstate Commerce Commission Termination Act of 1995 (ICCTA), Congress created the Railroad-Shipper Transportation Advisory Council (RSTAC) for the purpose of advising Congress, the Department of Transportation and the Surface Transportation Board (STB) on rail issues affecting small shippers and small railroads. During the past two years, RSTAC has reviewed a number of such issues and has submitted several recommendations to Congress and the STB.¹

The serious railroad transportation problems experienced in 1997 throughout the United States prompted RSTAC to analyze whether rail infrastructure continues to be capable of efficiently moving the volume of goods demanded by citizens. Our conclusion is that, due to a combination of factors, our rail system has reached the point of being capacity constrained.

Before reaching this conclusion, RSTAC held hearings and engaged in independent research to investigate complaints about lack of railroad service and its negative economic impact upon shippers and rail service providers. RSTAC hopes that this "white paper", which summarizes our deliberations, will promote meaningful transportation dialogue and lead to practical solutions that strengthen the US rail transportation system.

Capacity

In 1980, prior to the enactment of the Staggers Rail Act, the rail industry was near bankruptcy. Regulation impeded the railroads from operating their industries efficiently and pricing their services competitively. The result was a loss of market share to other transportation modes and disinvestment. Staggers deregulation strengthened the rail industry by permitting system and pricing rationalization. Since Staggers, the number of total Road Miles Owned in the United States has been reduced by 36%, yet the total tonnage has increased by 41%.

Post Staggers, the rail industry successfully created an intermodal business unit to market its excess capacity by competing for long haul truck business. Intermodal ton-miles have increased 109% since 1986 and in 1996 totaled 194 million ton-miles or 14% of total railroad ton-miles. Increasing intermodal business made sense in the 1980s because as long as variable costs are recovered, an increase in capacity utilization reduced the overall fixed cost per unit for the railroad providing such service. Thus, railroad balance sheets became increasingly attractive as railroads reduced excess capacity and reduced their overall cost per unit while increasing total revenues with the addition of the intermodal tonnage.

Buoyed by an expanding economy, total tonnage for other business units has also continued to grow. Since 1991, total railroad ton-miles have increased from 1,032,564,001 to 1,361,499,976 in 1996. Grain, coal and chemical traffic has grown as well, by 18%, 46% and 26%, respectively. This growth, when added to the 42% increase in intermodal traffic, has necessitated the investment of additional capital for computerized signaling and other technology to increase the track-carrying capacity of the existing infrastructure.

¹ Alternative Dispute Resolution Proposal, Recommendations of the Railroad-Shipper Transportation Advisory Council on Infrastructure Funding Issues, Recommendations of the Railroad-Shipper Transportation Advisory Council on Retention of the 40% Equipment Limitation, Recommendations of the Railroad-Shipper Transportation Advisory Council on User Fee Funding for the Surface Transportation Board

The events of 1997 confirm that, in general, the existing system has arrived at a critical juncture. The problems we have encountered, in our opinion, result from one or more of the following: the system in many places has reached its operational capacity limit, management lacks the expertise and/or resources to manage the current system or to increase its capacity, and federal regulations inhibit the efficient allocation of resources. In addition, many communities are demanding a reduction in railroad traffic through key interchange points which would further constrain the system. Whatever the cause, it is clear that today's demand for rail capacity outstrips the available supply.

Simple economic principles would argue that market forces should solve such a crisis: where demand exceeds supply, price would ration the demand. In other words, in a capacity constrained environment, you would expect to see the market place demand higher prices for the services provided. Instead however, in the railroad industry, we have observed an overall net *reduction* in prices and a general disintegration of service.

At the same time, in a capacity constrained environment, one would anticipate an industry to internally allocate its capacity resources to that business segment which provides the highest return. Evidence would suggest that this is not occurring. Conventional wisdom would argue that a railroad cannot price intermodal rates significantly different than those offered by the trucking industry. Comparing intermodal revenues with those generated by other business units would indicate a less favorable return on investment for intermodal than for the business units that intermodal capacity seems to be supplanting. Granted, we have not been privy to specific railroad cost data but this same conventional wisdom leads us to believe that intermodal, on a per-unit-basis, consumes greater capacity than its return on investment appears to justify.

Investment

Since railroads primarily fund their own infrastructure costs, the public is generally not aware of the amount of capital necessary just to maintain industry plant and equipment, an amount that is staggering by any definition. According to the AAR, in 1996 over \$4.4 billion (including depreciation) was spent just for maintenance of existing infrastructure. An additional \$6.1 billion was spent for infrastructure improvements and for the purchase of rolling stock and locomotives. On average, it costs over \$1 million per mile to add additional rail capacity and this assumes an existing right-of-way that can be double or triple tracked. Therefore, to add significant rail capacity requires billions of dollars.

Even with, or in spite of, the existing "revenue adequacy standard" to determine whether carriers are making enough money to reinvest in their physical plant, Wall Street has indicated the Class I railroads and a few large regional railroads provide a favorable investment return and thus are attractive for investment. However, even with the success of some railroads, current earnings do not justify an investment sufficient to solve the capacity issue. Thus, if it is in the country's best interests to expand rail capacity, the question has to be asked: what changes must occur in order to provide an investment environment suitably attractive to solicit the necessary private investment capital?

As previously discussed, some believe that capacity problems could be solved by using the existing scarce infrastructure more efficiently. But, it can be argued that the market's ability to allocate access efficiently is hampered by a public policy which requires service to be provided at times without regard to its best economic use. Those service obligations transfer capacity away from what would seem to be its best alternative use. And given the current system capacity constraints, does it continue to be in the nation's interest for the economy to pay the cost of such resource transfers? If the answer to this question is yes -- as it has been in the past -- then should the costs of this policy continue to be borne by the railroads, shippers and consumers, or should there be a public sector incentive to pay this cost? Costs born by consumers are a hidden tax to the end user and income loss to the economy.

Post Staggers Railroad Consolidation & Role of STB

The Staggers Act gave railroads the "routing initiative", the right of a railroad to structure its rates for various possible routes and interchanges as it wished, in the hopes that the railroads would manage their lines more efficiently, ultimately eliminating unused and inefficient interchanges from the rail system. The "routing initiative" provided the desired effect. After Staggers, interchange points between railroads became fewer, more concentrated and, ostensibly, more efficient.

Deregulation also provided the economic incentive for system rationalization. In 1980, the country had 40 Class I railroads comprising 27 rail systems. Today, however, five mega-carriers handle 90% of the country's rail traffic.

It would seem that the effects of Staggers now far outreach even the recently modified statutory protections contemplated by the Interstate Commerce Termination Act. The extended market dominance of the remaining Class I railroads, coupled with their "routing initiative", allows these railroads to structure rates in a way that retains traffic on their lines, regardless of the efficiency or price of alternate routes. Existing law, which never anticipated current circumstances, appears to uphold this behavior and burdens the STB with the stigma of being at worst partisan and at best indifferent to shipper complaints. And, when combined with such burdensome and antiquated requirements as Market Dominance merely to qualify for redress in a rate case, it is not difficult to understand why many shippers question whether STB provides any potential relief.

Our view is that the STB has an important responsibility to balance the economic benefits of consolidation with the enhanced need for judicial oversight in a potentially noncompetitive environment. This requires sufficient funding and may require modifications to the Interstate Commerce Commission Termination Act so that the STB can evolve from being a minimalist, complaint driven agency to a readily accessible agency, with sufficient resources to provide judicial review and balanced oversight to the entire rail transportation system.

Communication

Many shippers have expressed frustration over a lack of communication with their carriers and have pointed to this lack of communication as an indicator of the seriousness of the deteriorating service in the rail industry. The basic problem seems to be general shipper perception that, even if local representatives eventually address their service concerns, the railroads have no efficient means to communicate and resolve the problem throughout their organizations. It appears at times that either carriers fail to understand their shipper's business or simply choose not to respond to their changing business needs and challenges. Exacerbating this perception seems to be the difficulty that many carriers have in communicating information, in a timely manner, to the shippers. The result, especially in an environment of railroad consolidation, is distrust and unprofessional business relationships which impede the very communication required for resolution.

Railroad industry consolidation is increasing shipper and small railroad concerns about economic captivity and lack of competitive alternatives. Poor service has been well documented during the last six months. Shippers, lacking competitive alternatives, feel powerless to negotiate terms such as demurrage rules, land lease rates and, in some cases, damage claims. Small railroads find difficulty negotiating service terms and car hire rates and at times are not provided enough equipment to service their customers. The result is a fear that their "service" provider can not only dictate the terms of their relationship but also determine whether they will remain economically viable.

Competitive Access

These concerns have led many shippers to embrace "competitive access" as the solution to rail industry woes. But, the definition of competitive access is highly subjective. Competitive

access appears to mean one thing to a coal burning power generation plant and quite another to a grain elevator. While proponents do not agree on how to define competitive access, they all firmly believe that it is the “key” to better service because they believe that it would reduce their dependence upon a single service provider.

Ultimately, in our opinion, the issue of competitive access is really an issue of capacity and investment. The current lack of capacity, with the service disruptions that result, is the primary force behind a shipper’s demand for access through “competition”. It defies logic that a railroad, or any other business, would deny service to a customer: no customer, no business; no business, no revenues; no revenues, no business. Yet, there is ample evidence that just such an unlikely scenario occurs. Shippers really are denied service or endure poor service from their railroad provider. Privately, shippers will agree that they are willing to pay more for consistent, predictable service. But what concerns any individual shipper is that the nearest competition, within the same industry or a substitute industry, will receive a better rate or better service thus putting an individual shipper at a competitive disadvantage. Our conclusion is that shippers as a whole would not object to rate increases if (a) they were applied across-the-board to competitors in like circumstances, (b) service improvements and expanded business opportunities resulted, and (c) shippers had access to some sort of cost-effective and timely regulatory oversight, oversight that would exact penalties for service that failed to meet certain predetermined standards.

Summary

The rail system has reached a point of being capacity constrained. There are a number of factors that contribute to this including (a) the efficient marketing of excess capacity, (b) the expanding economy, (c) the need to attract private investment capital, (d) the lack of management expertise and/or resources to manage the current system or to increase its capacity, and (e) federal regulations which inhibit the efficient allocation of resources. Furthermore, consolidation in the railroad industry is increasing shipper and small railroad concerns about economic captivity and a lack of competitive alternatives. This has led many shippers to embrace “competitive access” as a possible solution to the problems associated with capacity and investment.

Through this report, RSTAC has identified the leading problems raised in the debate over the railroad industry’s service problems. With these issues now identified, RSTAC intends to investigate solutions to the problems discussed in this paper. During this investigation, we intend to review the following issues raised by various segments of the industry:

1. Should Congress eliminate maximum rate regulation, including the market dominance requirement?
2. Should Congress empower the Surface Transportation Board (STB) to apply penalties against carriers who fail to meet minimum prescribed service standards? Such penalties would also apply to all carriers participating in joint and proportional rates.
3. Should the definition and enforcement of unreasonable discrimination prohibitions be modified?
4. Should there be new rules governing gateway access to alternative routing?
5. Should contracting be eliminated (with a provision for honoring existing contracts)?
6. Should STB appropriations be increased to provide the Board with funding sufficient to administer all duties assigned to the agency?
7. Should the revenue adequacy standard be repealed?

After its investigation, RSTAC will deliver its recommendations to the Congress, the STB and the Department of Transportation.