
RAILROAD-SHIPPER TRANSPORTATION ADVISORY COUNCIL

Washington, DC

WHITE PAPER #2

April 22, 1999

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 U.S. Department of Transportation and the Surface Transportation Board (STB) on rail issues affecting small shippers and small railroads. During the past two and one half years, RSTAC has reviewed a number of such issues and has submitted several recommendations to Congress, the Department of Transportation, and the STB, including our original White Paper in March 1998. The following is a continuation of our original work, expanding upon the conclusions submitted in the original White Paper.

Introduction

As Class I railroads have increasingly focused capital investment on high volume traffic corridors in order to increase capacity, some small railroads and small shippers have experienced erosion of their economic viability. The economics of density, critical for rail profitability, favor the large over the small. As a result, it appears that the interests of large railroads and the small railroad/shipper community are diverging.

Since its creation, RSTAC has been faced with a fundamental dilemma that has grown out of the post-Staggers era of consolidation and capacity constraints. What public sector role is appropriate to balance the need to preserve the economic viability of small shippers and small railroads without undermining the overall efficiency of the rail transportation system?

Our conclusions, supported in detail below, are as follows:

- **We must level the playing field in the distribution of public transportation dollars.**
A U.S. transportation system vision and long-range plan must be developed that directs the investment of public funds toward promoting an efficient, competitive and connective transportation network composed of truck, rail, water, air and pipeline alternatives. The allocation of public funding must be studied carefully, and funding mechanisms evaluated, so as to promote efficiency and connectivity of the entire system instead of concentrating on specific modes.
- **The connectivity of the rail gathering network where efficient should be preserved and where necessary should be supported with public funding.**
A significant public investment in rail infrastructure must be made, in order to, upgrade existing track and bridges and enhance the efficient interchange between large and small railroads. Many short lines and Class I secondary lines are at risk because they are not able to competitively access the capital necessary to maintain and upgrade their systems to interchange efficiently with Class I trunk lines.
- **Limited economic access must be provided to small shippers and small railroads.**
The drive to consolidate within the rail industry has severely reduced small railroad routing options and small shipper recourse in the event of poor service. Two potential areas where economic accountability would increase capacity and efficiency include: (1) mandatory switching or routing options over least-cost/most efficient interchanges equipped to handle cars between railroads and (2) modification of the Bottleneck Decision to require railroads to quote commercially competitive rates for the most efficient interchanges and routings.

RSTAC believes that the public interest requires a shift in regulatory policy toward small shippers and small railroads. Recent events would suggest that we have moved too far away from traditional public sector demand for general transportation access in the name of economic efficiency.

Rail Regulation and the Advent of Staggers

Perceived inequities in the rail system are nothing new. Regulation was first introduced in 1887. But, in the past, regulation focused on balancing economic efficiency against other social goals such as regional development and small town rail access. With few exceptions, policy was oriented toward equal access even when that policy might reduce economic efficiency. Profits from the most efficient portions of the business (high volume, trunk line) were used to subsidize less efficient segments of the industry (passenger, low volume, and secondary lines). However, burdensome regulation prevented either raising

prices on the less efficient portions of the business or line abandonment. Much of the industry fell into economic hard times. Maintenance was deferred and there were widespread service failures. "Equal access" resulted in customers, large and small, "enjoying" equally poor service.

Staggers, launched as the solution for a 1970's capital-anemic rail industry, freed railroads to price their services competitively and initiate the consolidation process. Staggers offered railroads the opportunity to consolidate operations on to those lines that produced the best return while abandoning, or selling to small railroads, those lines that inefficiently utilized capital resources. This segmentation of operations allowed railroads to achieve profitability mainly through system rationalization, including cost cutting measures such as labor reduction, line rationalization and closure of low volume interchanges and yards.

Several hundred small railroads were formed from the sale of light density lines. The transaction was mutually advantageous. Large railroads were able to divest themselves of excess capacity and reduce the work force by fifty percent. Entrepreneurs and their investors thought that they would now be able to create viable small businesses that, because of their lower cost-of-operation and marketing advantage, would supplement the large railroads. The covenant between the Class Is and small railroads was to work together to build increased business—the Class Is furnishing railcars and controlling rates and the small railroads furnishing a cheaper gathering operation and a local marketing presence.

The Results of Rail Consolidation

Twenty years have passed and the 63 Class I railroads of 1976 have consolidated until today only five large Class I trunk line systems remain. Two of the five have systems extending throughout the western U.S. and two will soon extend throughout the eastern U.S. Each of the five trunk line systems have experienced capacity constraints and will need ongoing additional capital investment just to maintain their current infrastructure, not to mention the additional capital needed to increase their carrying capacity to meet expected growth.

Conversely, the economic circumstances of the small railroads have not changed significantly since the late 1970s. Although there are now more than 525 small railroads, operating in excess of 25,000 miles of track in a disconnected gathering network, their capacity continues to be underutilized, in spite of, aggressive local marketing and somewhat lower average operating costs than those of Class Is. While Class Is have focused capital resources on increasing the carrying capacity of their trunk lines, many small railroads have been unable to generate returns sufficient to raise capital at competitive rates.

Class I investment in computerized switching, heavier weight rail, double and triple tracking, unit train economies-of-scale and inter-modal operation has significantly increased trunk line carrying capacity and transportation market share. However, this achievement has potentially condemned a significant portion of the short line capacity to obsolescence. The very technologies applied to achieve this success by Class Is have enhanced their capital acquisition capabilities and widened the technology gap. Now it is even less economic and efficient for the majority of the short lines to interchange with Class Is because, for example, short lines cannot afford to upgrade their per railcar standard weight from 263,000 lbs. gross weight on rail (GWOR) to 286,000 lbs. GWOR and eventually to 315,000 lbs. GWOR.

The designers of Staggers did not anticipate the rapidity of industry consolidation nor the resulting two-tiered rail infrastructure that was the natural outgrowth of deregulation. The need to purchase scarce capital at market price will lead to further consolidation *within* Class Is as they focus upon those business units that provide the best return on their cost of capital. Thus, Class Is can be expected to de-market marginally profitable lines of business, especially if those businesses requires new capital. Similarly, those short line railroads unable to competitively access capital at market rates will continue to fall further behind in maintenance and service standards and, eventually, go out of business.

Thus, a conflict has developed between the small railroads and their trunk line partners. As previously stated, the small railroads remain underutilized while the trunk lines have become crowded conveyor belts. And, as capacity constraints have developed, the trunk lines have sought ways to carry more traffic over their existing high-density corridors. The solutions have generally favored unit trains, converting to greater weight-on-rail and discouraging single-car traffic.

While we agree with the rational short-term economic basis for such decisions, accompanying these policies are costs to the general economy that include the potential to affect negatively the railroad gathering network and lose its infrastructure forever. Fully rationalizing the rail transportation system abrogates the original assumption that existed when the small railroads were created: Class Is are dependent upon interchange with those lines to move traffic. The irony is that, in spite of the considerable

reallocation of labor and other resources that resulted from the industry consolidation precipitated by Staggers, the economic health of another sector of the rail industry is again in doubt.

Today, the economics of consolidation have determined that single line service provides the best economic return. Yet small railroads are still dependent on a national rail system operated as an open network. Small railroads cannot survive without regular and efficient interchanges to and from Class I trunk lines. However, as Class Is attempt to enhance single-line, multiple-car traffic on trunk lines, they are pricing away small railroad access by incenting shippers to consolidate shipments at trunk line locations and abandon their short line locations, or exit the business.

In summary, the mutual interests of small and large railroads are diverging. The underlying economics of the two groups no longer will support what has been a successful partnership. As divergent interests have become obvious and the old covenant is discarded, small railroads and large railroads have found it difficult and often impossible to develop new relationships that allow small railroads to develop new business. Bargaining is difficult because of the great disparity of physical and economic size. Also, many small railroads are unable, for various operating and commercial reasons (some of which are justified and some not), to do business with more than one trunk line. The inexorable evolution of consolidation is revealing the dark side of the much-hailed miracle of industry resurrection: Externalities may be like matter, they cannot be created nor destroyed. Their cost has only been deferred.

The Allocation of Investment Capital

The reality of the market place will force this two-tiered rail system into further divergence because the next step, in the process of rail consolidation, is for the Class Is to concentrate their capital in areas that expand the capacity of their trunk lines. If we compare the rail infrastructure to the highway system, the most efficient arteries are the superhighways that carry the bulk of the traffic at the highest speeds. These same lines have first priority for available capital. The net result is that scarce capital will be allocated away from the gathering network (short lines and Class I secondary lines) as Class Is invest in the trunk lines. Large railroads now have high debt levels and increased maintenance/capacity requirements on their trunk lines. They will not have sufficient funds for much of their secondary network without diverting funds from trunk line projects. And, without an adequate trunk line system, both large and small shippers will ultimately suffer.

Thus, today's dilemma and policy challenge is that rail transportation infrastructure is developing into a two-tiered system composed of (1) a rail gathering network that is capital deficit and capacity surplus and (2) a trunk line network which is capital neutral and capacity constrained. Therefore, the public policy issue is whether it is in the public interest to preserve the rail gathering network and utilize its available capacity, or permit this network to fail thus losing its capacity and transferring the traffic and associated costs to other transportation modes and the general economy. Expressed differently, are we willing to assume the costs of consolidation externalities before we actually know what those costs are?

Without public sector participation, many small railroads will be unable to compete with Class Is for capital dollars. Short lines and businesses tributary to the trunk lines that have sufficient volume and/or transportation revenue to justify regular interchange should enjoy acceptable service, because they will attract sufficient capital for continued investment. However, lower density short lines or Class I secondary lines may be forced to discontinue operations, thereby forcing small rail shippers on those lines to relocate back to a Class I point or turn to other transport modes like water or truck. Class Is will continue this pattern of de-marketing those business segments that cannot afford the economic rent of rail service. This may be at the expense of small shippers located on those under-invested short lines.

The issue is that, in the current economic environment, small railroads that either cannot afford, or do not invest, the necessary capital to maintain a competitive infrastructure will eventually lose trunk line access. Class Is, as they strive to maximize returns for their stockholders, will continue to de-market those businesses and rail segments that cannot afford the economic rent of rail service and to extract the highest rent from their consolidated organizations. Capital will be allocated to those areas that provide the best returns—areas that result in a reduction in costs or an increase in revenues. Services and facilities, whether on Class Is or small railroads, that do not meet minimum investment hurdles will not be funded with private capital. The natural economic consequence of this evolution will be the reduction of the short line gathering network.

Capacity and Efficiency

The rail industry has often argued that they will not be able to raise the necessary capital to maintain and grow their systems if they are required to operate their businesses in an environment where selective monopolistic pricing is limited. However, it is unclear to us whether this argument has merit in a

capacity-constrained environment. Many argue that competition and accountability are the foundation for all really successful businesses. Arguably, it is the market place that keeps businesses continuously productive and efficient. But are railroads, as natural monopolies, fundamentally different? Theoretically, as natural monopolies, railroads must not compete with each other or they lose the profits from monopolistic pricing that they require in order to cover their fixed costs and to attract the capital necessary to maintain their infrastructure. We would suggest, however, that in a capacity-constrained environment this argument is fundamentally flawed.

In a capacity constrained environment, efficient allocation of resources should be the highest priority so that access to the capacity (utilization) can be maximized. However, the inefficiencies inherent to a monopoly tend to favor monopolistic pricing at the expense of maximizing the efficient allocation of resources. For example, there is evidence that certain intra-industry segments receive a higher allocation of investment capital and other resources than is justified by their revenue to variable cost ratios. Further complicating this scenario is the fact that, in the present consolidated environment, there are actually five basic monopolies functioning to maximize their individual advantages at the expense of the whole system. Thus, in this environment, it is not surprising that the "Bottleneck" issue becomes a cause celebre.

Our study of the "Bottleneck" issue has led us to conclude that it is far more complicated than its pundits try to argue. Not only are there bottlenecks at both origin and destination, but the economics can be vastly different depending upon the relative density of the bottleneck portion. On the one hand, some shippers continue to receive service precisely because the Bottleneck Decision allows their serving carrier to deny them bottleneck access and charge a rate that justifies that use of their infrastructure. On the other hand, there are countless examples where the Bottleneck Decision actually reduces efficiency because the most efficient routing, using another carrier, is denied to the shipper. In this case, in our opinion, the justification for monopolistic pricing is invalid because (a) exploiting the bottleneck forces a less efficient move, which reduces the overall efficiency of the entire system, and (b) the higher revenues generated because of the Bottleneck Decision are used to subsidize other traffic -- traffic that does not pay its full economic rent and that uses scarce capacity. In addition, the whole "Bottleneck" issue is not the zero-sum game that many have argued. Some railroads would be better off if the Bottleneck Decision was rescinded and overall efficiency of the entire system increased. Alternatively, many shippers would lose access to rail service.

Proposed regulatory changes

We agree with the railroad industry that many of the popular regulatory "solutions" proposed in the name of increasing competition will not solve this problem. The regulation of the past is no longer a solution for the future. However, the cries of "re-regulation" are disingenuous since, in spite of the rhetoric, railroads have never been deregulated.

RSTAC, therefore, recommends the following regulatory *modifications* that we think will restore a more equitable balance between the interests of efficiency, the need to maintain a viable short line gathering network, and the needs of small shippers.

- (1) Require routing alternatives for shippers and small railroads that emphasize service and efficiency.
- (2) Modification of the Bottleneck Decision.

Our nation's economic health depends on an efficient transportation network. Shippers and small railroads must be allowed to transit from origin to destination via the most efficient and economic routing, even if that means carriage on other than the originating or terminating railroad. We propose that shippers and small railroads should have, under certain defined circumstances, the right to shift traffic from their originating or terminating carrier at the earliest efficient interchange, *as long as it provides the most efficient routing to the desired destination*. In making this proposal, we recognize that new routing options may increase the price of a specific movement and that some level of surcharge might need to be imposed, and would be acceptable, if it resulted in greater efficiency and service.

Appropriation

Finally, we conclude that greater emphasis should be placed upon the long-term strategic transportation needs of this country when transportation appropriation bills are debated. Our growing economy depends upon an increasingly efficient and connective transportation system to transport and deliver the goods that it produces and consumes. Capacity is at a premium and infrastructure expansion is extremely expensive. Therefore, consideration should be given to allocate public transportation monies into a pool that would be used solely for projects that improve the nation's gathering and interchange infrastructure and increase the overall performance and connectivity of the system.

**Dissent by Edward Wytkind, Public Member
Railroad-Shipper Transportation Advisory Council
In Response to the RSTAC White Paper #2**

April 25, 1999

As the only voting Public Member serving on the Railroad-Shipper Transportation Advisory Council (RSTAC), I offer the following dissent and alternative opinion to the majority views embodied in White Paper #2 released today.

First, the paper attempts to gloss over the severe effects that deregulation of the railroad industry has had on railroad workers. When the paper cites the benefits and achievements of deregulation, it ignores that most of the "accomplishments" came at the expense of the almost 300,000 workers who have lost their jobs since the late 1970s or seen their collective bargaining rights weakened or destroyed.

Second, the post-deregulation trend by the Class I railroads toward discarding their smaller or lighter density lines in the form of short line sell-offs was a clear and well orchestrated plan to slash jobs, eliminate unionization and collective bargaining agreement rights and in most cases create a class of lower wage, non-union railroad employees. The paper acknowledges this fact, in part, by stating that the sale of light density lines that followed deregulation was "mutually advantageous" and allowed the industry to "reduce the work force by 50 percent." The so-called "covenant" between Class I and small carriers was accomplished on the backs of workers and therefore was not in the public interest. For workers, the sell-off of short lines was nothing less than the railroad industry's version of "double-breasting" -- a underhanded practice seen in other industries, including trucking and construction, whereby unionized jobs are transferred to lower wage, non-union operations. Describing these spin-off railroads as "lower cost operations," the paper again glosses over the fact that whatever productivity gains were made by short lines were largely accomplished by severely slashing workforce levels and investments in infrastructure, and wiping out the remaining employees' union representation.

Third, it is ironic that a paper that continues to defend deregulation, or "less government," offers as a solution more federal government involvement in the form of federal appropriations to support the smaller railroads. I certainly support the use of federal transportation dollars for all worthy public transportation infrastructure needs, but I find it interesting that almost 20 years ago the solutions to an ailing railroad industry centered around rolling back the role of the federal government and today elements of the industry now turn to that same federal government for more involvement, assistance and, yes, federal dollars.

Finally, the paper attempts to inject "public interest" considerations but fails to mention that the public interest includes the interests of employees who continue to suffer from two decades of severe job cuts, deferred investment in safety and infrastructure, and an unprecedented consolidation among their employers from dozens of major railroads to only a

handful. Worst of all, during a major part of that consolidation – beginning in 1983 – the Interstate Commerce Commission and now the Surface Transportation Board have literally destroyed the collective bargaining agreements of thousands of workers affected by transactions under the guise of operational “necessity.” Not only does this practice violate the basic rights of employees, but it also creates a difficult environment for employees and a management to work together to provide customers with efficient rail transportation service – a concern I know is shared by all RSTAC members. Congress must put a stop to this perverted use of the law and the regulatory process by the nation’s railroads, and I urge my colleagues on the RSTAC to support any proposals offered this year to accomplish this goal.

I am pleased to offer these dissenting views in an attempt to ensure that the Council’s majority views are balanced with a viewpoint encompassing interests other than those of small railroads and shippers.