

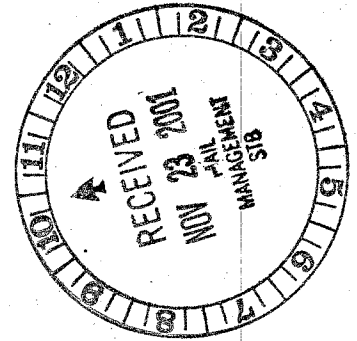
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Arbitration—Various Matters Relating to its Use
as an Effective Means of Resolving Disputes
that are Subject to the Board's Jurisdiction

Ex Parte No. 586

Initial Comments of the
United States Department of Transportation

I. INTRODUCTION

The process through which the Surface Transportation Board ("STB" or "Board") resolves rate disputes between railroads and shippers seeks to determine a competitive rate in instances in which there is no actual competition, taking into account the rail industry's fundamental need to engage in differential pricing. Despite their analytical validity, however, these procedures are time-consuming and very expensive. Consequently, they are used virtually exclusively by large shippers with substantial sums at stake. Small shippers, with limited traffic and much lower amounts at risk, cannot avail themselves of these procedures as a practical matter. The Board's continuing efforts to provide some realistic relief to these shippers has led it in this proceeding to seek comments on whether binding arbitration should be legislatively prescribed for resolving rate disputes brought by small shippers. Decision served September 20, 2001 ("Decision").

The United States Department of Transportation ("DOT" or "Department") applauds this attempt to address the concerns of these shippers. Arbitration may save time and money, and final offer arbitration gives the parties a strong incentive to offer reasonable proposals. In addition, it can be used as leverage during rate negotiations, thus avoiding the need for dispute resolution.

However, there are also risks associated with arbitration. It can be a long, expensive process if not appropriately structured. An arbitration award may also be arbitrary and without basis in fact or law. Furthermore, there are typically limited grounds for appeal, including corruption, fraud, or misconduct. In addition, the Department has specific concerns about applying an expedited process to rate disputes that are inherently complex.

However, if arbitration could be properly structured to preserve differential pricing, DOT believes it may provide a practical solution to small shippers without threatening the rail industry's financial viability. A pilot program might be the best way to test this approach.

II. BACKGROUND

The Problem

Pursuing rail rate cases before the STB entails a procedure that is expensive and time-consuming. Small shippers, with limited financial resources and small amounts at stake, have complained for years that this avenue is not realistically available to protect them from excessively high rates. This concern has also been voiced by Members of Congress, and the use of arbitration for small rail rate cases has been raised in Congressional hearings as a possibility. Indeed, legislation has been introduced that would apply binding arbitration to all railroad-shipper disputes otherwise within the Board's jurisdiction. S.1103.

The Board and its predecessor (the Interstate Commerce Commission) have previously tried to respond to this problem by exploring a cheaper and simpler procedure, but to date nothing has proven workable.¹ The STB generally favors private-sector dispute resolution, and it has encouraged (with this Department's support) increased use of such techniques as voluntary mediation and arbitration. However, current federal law precludes binding (mandatory) arbitration to resolve railroad rate disputes. Therefore, the Board now seeks to develop a public record through this proceeding that would assist Congress in considering whether binding arbitration should be legislatively prescribed for rail rate cases involving small shippers. The Board has requested comment and analytical data relating to the possible use of mandatory arbitration for small shippers, including: (1) how to properly identify the small rail shippers for whom arbitration of rate disputes should be required; (2) the types and amounts of traffic that would be embraced; and (3) the form that binding arbitration should take and the extent of the arbitrator's authority. Decision at 4.

Differential Pricing is Essential to Rail System Viability

The railroad industry has very high fixed costs before even one railcar is moved; thereafter average rail costs decrease as the volume of traffic increases. In such

^{1/} For example, the STB approved a simplified procedure for considering small rate cases in 1996; however, virtually no use has been made of it. Rate Guidelines – Non-Coal Proceedings 1 S.T.B. 1004 (1996). Some shippers have complained to the STB that even this procedure is too costly and complex to pursue.

circumstances revenues are maximized when carriers have the freedom to charge higher rates to those shippers with few economical alternatives to rail transportation, while charging comparatively lower rates to those who might otherwise use alternative transportation (differential pricing). In this way, shippers with other transportation alternatives may still find it cost-effective to use rail, thus making at least some contribution toward carrier fixed costs. This demand-based pricing approach unquestionably benefits even those shippers paying higher rates, since if the lower-rated traffic switched to other modes the rates of the shippers dependent upon rail would need to be higher still in order to raise the total amount of revenue needed to maintain the railroad infrastructure.

Before the Staggers Act of 1980, rail rates were generally required to be similar for similar shipments regardless of the competitive circumstances of the movements. As a result, railroads were unable to offer lower rates to retain or attract customers that benefited from intensifying truck and barge competition. As railroads lost traffic to this competition, they were forced to keep repeatedly applying to the ICC for higher rates on the remaining traffic. This became a vicious cycle -- greater inroads from truck and barge led to higher rail rates, which led to still more lost rail traffic. Eventually, this cycle contributed significantly to the bankruptcy of a number of major railroads. The Staggers Act ended the cycle by specifically recognizing the necessity for rail carriers to charge "differential" rates, which vary with the demand elasticity of the customer rather than with the cost of providing the service. Since 1980 differential pricing has been a major factor in the financial recovery of the railroad industry. To ensure continued economic viability, therefore, any mandatory arbitration program must require the arbitrators to take into account the carriers' need to charge differential rates.

Maximum Rate Regulation and Small Shippers

Even under differential pricing, railroads may not literally charge "what the traffic will bear," since statutory provisions limit maximum rates in order to protect shippers where competition is not effective to do so. 49 U.S.C. §§ 10101(6), 10701(d). The rate limit as determined in STB cases is known as "constrained market pricing," where a "hypothetical" railroad competitor is constructed and its costs, including a reasonable return on capital, are calculated. Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985). With limited exceptions, a railroad may not charge a rate above this constrained price. In effect, this approach, also known as "stand-alone cost," attempts to determine the total cost of providing service to the customer, allowing for the initial investment, depreciation, variable costs, and a reasonable return.

This approach works fairly well for major shippers with regular, large, shipments. For example, a number of coal shippers have secured lower rates and reparations in the millions of dollars for past overcharges. However, the legal and analytical costs involved in determining stand-alone cost are significant (as much as \$1 million or more), and the process is extremely time-consuming, making it impossible, as a practical matter, for small shippers to pursue. Moreover, the stand-alone cost model does not appear to work

acceptably for cases involving small shipments. Many shippers, both large and small, support efforts to find a cheaper and faster method for resolving rate disputes. Arbitration has been suggested as a possible solution.

The Board's Proposal

The STB in particular asks for comments on the advisability of using final offer or "baseball-style" arbitration as a way of resolving rate disputes involving small shippers. Under baseball-style arbitration, the shipper and the railroad would each submit material in support of their positions for consideration by one or more arbitrators, and the two parties would then tender their "final" offers of what the rate or rates should be. The arbitrators would have to select one of these without modification, which (subject only to very limited review) would then become the applicable rate(s). The STB seeks comment on the criteria that should be applied, if any; whether arbitration would ease or shift procedural burdens; and whether the arbitrators' decisions should be appealable, and if so, to whom and on what grounds.

The Board has also indicated that the small shippers to whom its proposal would apply should be identified according to their annual total rail traffic, not just the traffic covered by the rate at issue, and that a reasonable dividing line these shippers "might be in the 200- to 500- carload-per-year range." Decision at 5. The STB considers this range "low enough to exclude higher-volume rail customers who may be able to exert greater pricing leverage, but not so low that the resulting customer group would be too narrow to meet the procedural need that has been expressed." *Id.* at 4 (footnote omitted).

III. THE MOST APPROPRIATE APPROACH MAY BE A CAREFULLY STRUCTURED PILOT PROGRAM

The Department agrees that the current STB system for resolving complaints about rail rates is too expensive and time-consuming for small shippers and should be replaced. Alternatives, including arbitration, should be considered. However, although arbitration may be less expensive than a full-blown stand-alone cost analysis, discussions with shippers and railroads make clear that it is not particularly cheap. Most important, binding arbitration introduces a potential risk to the rail industry's financial stability because of the uncertainty about how this process would take into account the carriers' need to price differentially. A pilot program of binding arbitration, whether baseball-style or not, that contains precautionary elements designed to promote accessibility to small shippers and reduce financial threats to the industry may be appropriate. The program should run for a set period of time -- say, three to five years -- and the effects on shipper rates and industry revenues analyzed to determine whether to extend, modify, or end the use of mandatory arbitration.

The inaccessibility of the existing regulatory protections, the relatively small amounts of traffic and revenue involved, and their dependence on rail transportation all

combine to deny small shippers meaningful leverage in negotiating rates with railroads. If arbitration proved expensive and difficult, or tended to provide little rate relief, it would do little to resolve the concerns of small shippers. On the other hand, if mandatory arbitration proved simple, cheap, and effective at securing lower rates for a broad category of shippers, but at the expense of differential pricing, there might well be an overall negative financial impact on railroad investment. DOT suggests below several areas that may offer ways to reach the appropriate balance.²

Arbitrators' Criteria: Qualifications

Following the announcement of this proceeding, DOT personnel discussed with railroads and shippers the issues presented by binding arbitration. The Board noted that Canada has in place a system of binding final offer ("baseball-style") arbitration, and in our discussions we learned that there are no qualifications or specific prerequisites that apply to those who serve as arbitrators in Canada. Representatives of Canadian carriers and shippers both agreed that they would prefer to see relevant background or experience required for arbitrators.³ The Department considers it important to have a cadre of competent arbitrators for this complex and important function. We therefore recommend that the Board should impose standards on prospective arbitrators related to rail transportation experience, neutrality, and possibly other qualifications. The STB should also consider providing training on the economics of rail transportation to arbitration candidates.

Small Shipper Criteria

The Department agrees with the STB's goal to consider arbitration for small shippers whose traffic volume is "low enough to exclude higher-volume rail customers who may be able to exert greater pricing leverage, but not so low that the resulting customer group would be too narrow to meet the procedural need that has been expressed." Decision at 4. The Board has suggested that such shippers could be defined as those shipping between 200 and 500 carloads per year. *Id.* at 5. DOT does not at this time have an opinion on what the appropriate range or criterion should be, but, as

^{2/} The Department assumes that existing statutory provisions applicable to maximum rate regulation, such as revenue-variable cost ratios, the need to establish market dominance, and so forth, would remain in effect for small shippers. Similarly, certain traffic is exempt from the Board's regulatory jurisdiction, such as that moving under contract, or in boxcars or intermodal equipment. We likewise assume that this will remain outside the application of any arbitration proposal. These provisions should not present any meaningful impediment to rate relief, and they serve to focus the access to protection to those shippers who truly need it.

^{3/} The Department has had several discussions with railroads, shippers, and Canadian government officials concerning the final offer arbitration process that is used in Canada. The Attachment hereto contains a description of the Canadian process and its application, taken from a recent Canadian government review entitled *Vision and Balance Report of the Canada Transportation Act Review Panel*, June 2001. The document is available online at www.reviewcta-examenlrc.gc.ca

discussed below, believes strongly that the effects of different levels should be considered before a final decision is made: the larger the amount of traffic encompassed by binding arbitration, the greater the potential risk to rail industry revenues from decisions reducing rates. We have examined the Carload Waybill Sample ("Waybill") statistics to estimate the potential aggregate number of carloads that might be covered using the STB's suggested range. Since the Waybill does not identify shippers, however, it was not possible to estimate the number of carloads or shippers accurately. The Department believes that the Board should have accurate numbers of the total carloads and shippers involved at different traffic levels under consideration. Since only the railroads have this information, we recommend that the Board should obtain it from them.

Decisional Criteria: Differential Pricing

The most critical factor for any arbitration process is the requirement for it to acknowledge and take into account the railroad industry's need to engage in differential pricing. This was crucial to the success of the Staggers Act and it remains so today. Yet the concept is far easier to recognize than to actually put into effect. How does an arbitrator select between two rate proposals, both over the jurisdictional threshold, without recourse to a maximum rate standard? Absent such a standard, an arbitrator may find it difficult to rationalize a railroad's proposal that approaches stand-alone cost, as long as the shipper's proposal is above 180 percent of variable cost. However, the underlying premise of differential pricing requires that the carriers be permitted to set rates that approach but do not exceed the theoretical maximum.

The importance of this issue cannot be overstated. If the set of "small shippers" eligible for arbitration is eventually defined in an overly expansive manner, they could collectively account for a significant amount of overall railroad revenues. If these shippers are paying rates well above variable costs and arbitration lowers them to the jurisdictional minimum of 180 percent of variable cost, this would reduce rail revenue by several percentage points. The impact on income or cash flow available for reinvestment in these circumstances would be much larger and could either discourage additional railroad investment or actually cause railroads to reduce service.⁴ Obviously, the possibility of such an outcome would have to be analyzed and guarded against in any arbitration proposal.

^{4/} A revenue loss of only a few percent may seem unimportant to overall railroad finances, but any rate reductions will lead directly to income losses. In 1999, net railway operating income was 12.1 percent of total revenue. A 2 percent decrease in total revenue due to rate reductions, with no corresponding change in carloads handled, would roughly translate to a 16 percent decrease in net railway operating income -- clearly a significant impact. While the revenues represented by "small" shippers -- however defined -- may not be great, any expansion of shipper eligibility makes concerns about decreases in rail revenues that much more critical.

The need for a standard that arbitrators can apply in rate cases is clear. Unfortunately, at this time, the Department is not aware of an appropriate methodology that reconciles the need for a relatively fast and simple procedure with the complexities of the differential pricing system. We hope that this proceeding will shed some light on the problem.

Appeal of Arbitration Decisions

Arbitration decisions are typically appealable only on very narrow grounds, such as fraud or bias. This limitation is imposed in the interests of finality, and avoidance of prolonged litigation. See 9 U.S.C. § 10. It is clear that if appeal on broader grounds is available, it will be pursued, with consequent added time and expense. DOT believes that this would undercut the reasons for using arbitration in the first place. It is true that the unsuccessful party in any arbitration will question whether the standards were properly applied. However, the need to offer small shippers some meaningful avenue of relief counsels against broad-based appeal. This makes it even more important that any arbitration program include precautionary elements, such as those noted above, to guard against any untoward impact on rail carriers. With this caveat, therefore, the Department supports adoption of the traditional narrow standards applicable to appeals from arbitration.

IV. CONCLUSION

The Department looks forward to the comments of other parties regarding this difficult issue. At this time, DOT is prepared to offer the following recommendations:

First, to ensure a corps of competent arbitrators, there should be qualifications related to rail transportation experience, neutrality, and other relevant criteria. The Board might also consider proposing a training requirement related to the economics of rail transportation.

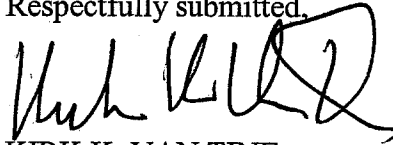
Second, the "small shippers" to whom arbitration would be available would have to be carefully defined. To calculate the potential collective impact of arbitration on the rail industry requires information about the overall revenues and carloads derived from small shippers, however defined. Neither we nor the STB now has the data to make this determination, and we therefore recommend that the Board obtain it from the carriers.

Third, the criteria under which arbitrators would resolve questions about the appropriate level of differential pricing must be clearly set forth.

Fourth, appeals from arbitration decisions should be limited to traditional narrow grounds.

Finally, any arbitration process should initially be limited to a pilot program that would be evaluated to determine its effectiveness and impact on shippers and the industry prior to any final decision about permanent adoption of this alternative.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kirk K. Van Tine", written over a horizontal line.

KIRK K. VAN TINE
General Counsel

November 23, 2001

ATTACHMENT

While DOT understands that conditions in Canada differ from those in the U.S. in a number of ways, it is interesting to note that the final offer arbitration process in Canada has primarily been used in larger cases, since there is still considerable cost in preparing and pursuing a claim. Also, the rate selected by the arbitrator can only be in effect for one year. We note as well that both railroads and shippers credit the Canadian arbitration program with increasing shipper leverage, promoting successful resolution of disagreements without resort to the process, and facilitating settlement after initiation but before completion of the arbitration process. Finally, it appears that the vast majority of Canadian cases pursued to resolution under this system were "won" by the shipper.

Discussions with Canadian groups also raised the question of how cost-effective mandatory arbitration would actually be for small shippers. As noted, to fairly resolve a case, a considerable amount of information would still be required. The shipper would, presumably, have to submit data (and/or contest the railroads' claims) regarding the cost of providing service, alternatives available to the shipper, and other data. (There is no equivalent to a "market dominance" threshold requirement in Canada.) While the cost and time required may be less than for the current STB process, it is not clear that this process would be economical enough to attract many small shippers. Rate cases brought before the Board using the current process involve very large shippers, with many thousands of carloads per year over many years. A substantial reduction in time and cost would be required to make the process an attractive option for truly small shippers. See note 1, *supra*.

The following is an extract from the Vision and Balance Report of the Canada Transportation Act Review Panel, published in June of 2001 (at 35):

The Canadian Final Offer Arbitration (FOA) is available to shippers as a means of resolving disputes with carriers over rates or conditions of service. The process involves an independent arbitrator reviewing the final offers of the shipper and the carrier and deciding in favour of one or the other. The parties to an FOA can, and often do, keep the details of the arbitration confidential.

Twenty-three FOAs have been initiated since 1988 when the provision first came into force – most of them since 1996. The Panel heard that more than half the matters submitted for arbitration were settled by the parties before the end of the arbitration hearing, suggesting that the availability of FOA is an incentive to reaching a negotiated settlement.

Although some shippers see FOA as an effective dispute resolution mechanism, the extended time and expense involved in what amounts to a complex legal procedure have been criticized. The FOA process was amended recently as part of reform of the grain handling and transportation system; now a quicker FOA process is available for disputes involving freight charges of less than \$750,000. Both shipper and carrier must file final offers simultaneously, instead of the shipper filing before the carrier. There is not yet enough experience with the new regime to know whether perceived faults have been corrected.

The mainline railways suggest that the FOA process gives shippers, having already negotiated rates in good faith, a further chance to reduce rates at no risk. They want to see FOA replaced by standard commercial arbitration.