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July 16, 2004

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Public Record

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, DC 20423

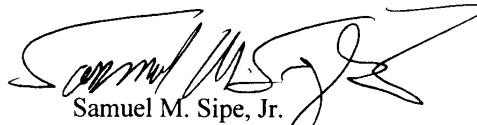
Re: STB Ex Parte No. 646 – Rail Rate Challenges in Small Cases

Dear Secretary Williams:

Pursuant to the Notice of Public Hearing in the above-captioned proceeding served by the Board on June 29, 2004, attached are the original and ten copies of the written statements of the speakers on behalf of the Association of American Railroads at the public hearing to be held on July 21, 2004. In accordance with the Board's requirements, also included are three electronic copies of the AAR's submission submitted on compact discs in Microsoft Word format. Please note that the AAR's submission also contains a certificate of service designating service on the participants at the July 21 hearing.

Please acknowledge filing and receipt on the enclosed copy of this letter.

Sincerely yours,


Samuel M. Sipe, Jr.
Counsel for the Association
of American Railroads

WASHINGTON

PHOENIX

LOS ANGELES

LONDON

BRUSSELS

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 646

RAIL RATE CHALLENGES IN SMALL CASES

**WRITTEN STATEMENTS OF
ASSOCIATION OF AMERICAN RAILROADS**



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Dated: July 16, 2004

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 646

RAIL RATE CHALLENGES IN SMALL CASES

**STATEMENT OF LOUIS P. WARCHOT
SR. VICE PRESIDENT – LAW AND GENERAL COUNSEL
ASSOCIATION OF AMERICAN RAILROADS**

JULY 16, 2004

On behalf of the members of the Association of American Railroads (“AAR”), we are pleased to have the opportunity to appear before the Board in response to the Surface Transportation Board’s (“STB”) notice of public hearing served on June 29, 2004 in the above-captioned proceeding. For 70 years, AAR has represented the interests of major North American freight railroads and has regularly participated in rulemaking proceedings before the Board and its predecessor relating to rail rate regulation.

As it has previously stated in this proceeding, AAR supports the STB’s efforts to simplify and expedite resolution of small rail rate cases. However, as the witnesses on behalf of the railroads who follow me will explain, the AAR is also deeply concerned that approaches which the Board may follow to simplify and expedite small cases not have a counterproductive effect on the ability of the railroads to earn adequate revenues, meet their capital requirements, address the capacity challenges they are facing and provide the services that the shipping public and the national economy require.

To present the AAR's position, following my comments, the Board will hear from:

- Mr. Hamberger, President and CEO of the AAR, who will describe the basis for the railroads' position with respect to small cases that eligibility should be limited to truly small shippers and that any criteria used to assess the reasonableness of rates for those truly small shippers should allow railroads the opportunity to earn adequate revenues overall. In his presentation, Mr. Hamberger will also be referring to and incorporating the statement of railroad chief financial officers (including all of the Class I railroad CFOs) regarding possible regulatory approaches to small cases and the impact that such approaches may have on the ability of the railroads to attract capital to meet future investment needs.
- Mr. Parsons, Chairman and CEO of the Wheeling and Lake Erie Railway Company, who will provide the perspective of a smaller regional railroad on these issues, sharing the concerns presented by other participants on this panel from the point of view of a railroad that may be even more impacted by proposed rules than the Class I railroads because of the disproportionately higher number of smaller shippers served by and smaller shipments carried over smaller railroads.
- Mr. Rockey, Vice President – Policy & Economics of the AAR, will describe the amount of rail industry traffic and revenues that will be subject to proposed criteria for eligibility as well as for various substantive standards.
- Mr. Rennie, Managing Director of Mercer Management Consulting, who will explain how regulatory approaches encompassing the traffic and revenues described by Mr.

Rockey will impact on the rail industry's ability to attract capital and meet its long-term capital funding needs.

I. AAR Continues to Support Mandatory, Non-Binding Mediation

AAR filed written testimony in this proceeding on April 16, 2003 and testified at the STB's hearing on this matter on April 22, 2003 to present its views regarding rail rate challenges in small cases subject to the STB's jurisdiction. AAR's principal recommendation at that time was for the Board to adopt a program of mandatory, non-binding mediation for small case rate disputes. AAR continues to believe that such a program is the best mechanism to deal with small case rate disputes for several reasons. First, mediation is a logical extension of the Staggers Act's preference for negotiated private sector resolution of commercial disputes. It allows carriers and their customers to attempt to resolve their differences with the assistance of a third party neutral whose involvement can be as extensive as the parties desire. Mediation is much less likely to disrupt commercial relationships than litigation and will be less expensive than rate litigation. The Board has expressed its support for mandatory, non-binding mediation in a related context. Last year, the STB adopted mandatory mediation for cases brought under the Constrained Market Pricing ("CMP") Guidelines.¹

AAR's proposal for mandatory, non-binding mediation would be simple to implement and would be subject to relatively few constraints. Given the statutory scheme, mandatory mediation would be available only in those situations where shippers have made a prime facie showing that there is no effective competition for the common carrier transportation at issue. AAR also recommends that the parties either agree to mediation procedures or follow the

¹ STB Ex Parte No. 638, *Procedures to Expedite Resolution of Rail Rate Challenges to Be Considered under the Stand-Alone Cost Methodology* (served Apr. 3, 2003).

American Arbitration Association's Commercial Mediation Rules ("CMR"). In selecting qualified mediators, AAR proposes that either the parties agree to a mediator or request the STB to appoint a disinterested mediator who is not an STB employee. The mediator would base his/her assessment of the parties' respective positions on considerations of reasonableness that are drawn from ICCTA. The mediation itself would remain confidential and would have no precedential effect in any STB or other proceeding that might follow.

II. AAR Supports Procedural Reforms to Expedite Small Rate Cases

AAR believes that if the STB adopts mandatory, non-binding mediation of small case rate disputes, there would be very few additional matters that would require formal resolution. Nonetheless, AAR supports procedural reforms to make those few remaining small rate cases as efficient and inexpensive as possible. AAR is prepared to offer concrete suggestions for improving small rate case procedures if the Board notices a proposed rulemaking on that matter.

III. AAR Opposes the Joint Shippers' Proposed Standard of Eligibility, Which Does Not Comport With the Statutory Standard for Small Case Eligibility

Following the STB's April 2003 hearing, a group of seventeen shipper interests submitted joint comments on July 11, 2003, proposing a bright-line standard that would extend eligibility to use the simplified small rate case guidelines to any shipper with an annual freight bill of \$4.8 million or less on the movement of a single commodity between a particular origin-destination pair. AAR's witness Craig Rockey explains in his testimony that this is such a high threshold it accounts for the vast majority of rail traffic and would expose a substantial amount of railroad revenue to challenge. Other AAR witnesses will describe the devastating impact of that result.

ICCTA limits the application of simplified small rate case guidelines to “those cases in which a full stand-alone cost presentation is too costly, given the value of the case.” 49 U.S.C. §10701(d)(3). However, the shippers’ proposal would encompass cases in which the amount in dispute should otherwise justify a full SAC case. The STB has previously recognized that simplified small rate case guidelines “will necessarily be cruder than [CMP].”² The shippers’ attempt to expand the use of these simplified guidelines would, as a practical matter, eliminate the use of CMP in most non-unit train coal rate cases.

AAR is not opposed to the notion of adopting a bright-line test for eligibility in small rate cases. However, as the AAR suggested in its June 23, 2003 letter to the Board, the AAR believes that the Board should formulate such a test to identify a class of truly small cases, measured by shipper size and annual freight bill, that are presumptively eligible for small rate case treatment. In cases that do not meet the test for presumptive small case treatment, eligibility could still be made on a case-by-case basis using the STB’s existing rules as a starting point. Such an approach would address shippers’ concern that the eligibility test alone discourages truly small shippers from pursuing rate cases.

With respect to substantive criteria, the AAR continues to encourage the Board to establish standards which are consistent with the principles of the Staggers Act that allow railroads the opportunity to earn adequate revenues and to differentially price their services. The AAR, as in its earlier comments to the Board on this issue, takes no position as to whether different standards may be called for. Depending upon how they are applied, the current guidelines, though clearly “cruder” than CMP, might be appropriate in those cases involving truly small shippers.

² *Rate Guidelines- Non-Coal Proceedings*, STB Ex Parte No. 347 (Sub-No. 2), 1 S.T.B. 1004, 1008 (1996).

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 646

RAIL RATE CHALLENGES IN SMALL CASES

**STATEMENT OF EDWARD R. HAMBERGER
PRESIDENT AND CHIEF EXECUTIVE OFFICER
ASSOCIATION OF AMERICAN RAILROADS**

JULY 16, 2004

On behalf of the members of the Association of American Railroads, I appreciate the opportunity to appear before the Board to express the rail industry's views regarding the processing of rail rate challenges that are not suitable for handling through a full stand-alone cost case. AAR members account for the vast majority of freight rail mileage, employees and revenue in the United States, and they have a vital interest in the processing of rate reasonableness complaints brought before the Board.

Overview

Like all businesses, AAR's members strongly desire to avoid the costs and risks associated with litigation, including the costs and risks of rate litigation before the Board. We are largely successful in avoiding litigation because in the overwhelming majority of instances where rates are potentially subject to challenge, the rates established by AAR's members are patently reasonable. When a rate is challenged and the dispute is not appropriate for resolution under full SAC procedures, AAR members want the dispute to be resolved as efficiently and as

inexpensively as possible while at the same time remaining consistent with the regulatory principles set forth in the Staggers Act. It is those principles which afford the railroads the right to differentially price their services and therefore, the opportunity to earn adequate revenues. Of course, only if railroads can earn an adequate return will they be able to make the investment necessary to continue to provide customers with the world's best rail freight service. Therefore, we are committed to working with the Board to identify improvements that will allow for the expedited resolution of small rate cases.

The most expedited way to resolve a disagreement over rates is to settle the disagreement before it ripens into a full-fledged dispute. To that end, AAR has previously recommended that the Board adopt mandatory, non-binding mediation as a pre-condition to the filing of a small rate case. We continue to believe that mediation has merit. It will not succeed in all cases, but there is a strong basis in the deregulatory thrust of the statutory scheme for encouraging the parties to reach negotiated settlements before they commit to the expense and uncertainty of litigation, even expedited litigation.

I should say at the outset that while AAR advocates mediation of small rate case disputes and will support improvements in the processing of such cases, the industry is very concerned about the efforts of some shippers to adopt virtually open-ended standards of eligibility for small rate case treatment.

Market-Based Achievements Must Not Be Undermined By Expanded Rate Regulation

For almost a quarter of a century now, the rail industry's commercial affairs have been conducted in an environment in which market forces have been paramount and regulatory intervention has been disfavored. That is not a historical accident. The promotion of market forces and restraint on regulation was the Congressional policy that came into being with the

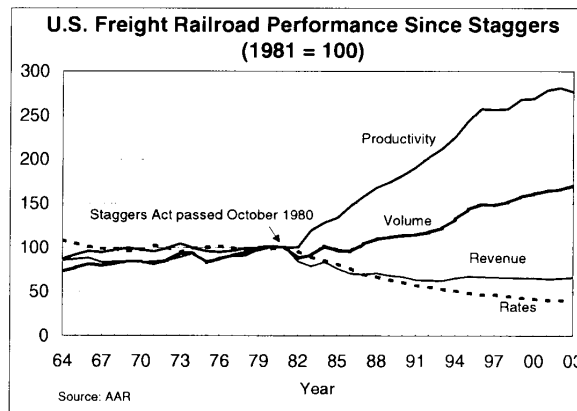
Staggers Act and it has proven to be a wise policy. Thanks to that policy, the achievements of the rail industry in the deregulatory post-Staggers environment – and the benefits those achievements have conferred upon rail shippers and the public at large – have been substantial. Consider the following:

- Rail intercity freight market share (measured in ton-miles as opposed to revenue) has been trending upward over the past 15 years, after decades of steady decline prior to Staggers.
- Prior to Staggers, railroads lacked capital to maintain properly their tracks. More than 47,000 route-miles had to be operated at reduced speeds because of dangerous track conditions, and deferred maintenance was in the billions of dollars. Since Staggers, Class I railroads alone have spent well over \$320 billion on infrastructure and equipment, and rail infrastructure investments per mile of road have risen sharply in inflation-adjusted terms.
- Based on revenue ton-miles per constant dollar operating expense, a measure that incorporates all cost components that contribute to rail operations, rail productivity has risen 177 percent since Staggers, compared to only about 15 percent in the comparable pre-Staggers time period.
- Nearly all of these productivity gains have been passed through to rail customers, including smaller shippers, in the form of sharply lower rates. Rates, as measured by revenue per ton-mile, have declined 60 percent in inflation-adjusted terms from 1981 to 2003, saving shippers and, ultimately, the consuming public, \$10 billion or more per year¹.

¹ See Scott Dennis, "Changes in railroad rates since the Staggers Act," in *Transportation Research Part E* (March 2001, pp. 55-69); Surface Transportation Board, Office of Economics, Environmental Analysis, and Administration, *Rail Rates Continue Multi-Year Decline* (December 2000); Carl D. Martland, "Productivity and Prices in the U.S. Rail Industry: Experience From 1965 to 1995 and Prospects for the Future," in *Journal of the Transportation Research Forum* (Volume 38, Number 1, pp. 64-75); Christopher C. Barnekov and A.N. Kleit, "The Efficiency Effects of Railroad Deregulation in the United States," in *International Journal of Transport Economics* (Vol. XVII, No. 1, February 1990, pp. 21-36); and Clifford Winston, et. al., *The Economic Effects of Surface Freight Deregulation*, (Brookings Institution, 1990, 69 pages).

- The Board itself has observed the trend of declining rail rates. In a December 2000 report the Board found that “inflation-adjusted rail rates have fallen 45.3 percent” from 1984 to 1999. The Board also observed that “all types of rail customers, and not just those with competitive transportation alternatives, must have received some portion of the rate reductions we have measured here.”²
- The rail accident rate has fallen 65 percent since Staggers, and the employee injury rate is down 76 percent.

The achievements realized by the industry since Staggers are portrayed graphically in the chart at right, which shows railroad productivity and volume increasing, while inflation-adjusted rates and total revenue have declined.



Perhaps the single most

important factor contributing to the improved state of the industry in the post-Staggers era has been the freedom accorded to railroads to engage in differential pricing. Congress made differential pricing legally possible by enacting a statute providing for rail pricing freedom. The ICC gave important impetus to differential pricing when it identified differential pricing as a key underpinning of Constrained Market Pricing. The Board has properly adhered to this principle. Railroads have worked to implement differential pricing in an effort to achieve adequate revenues. I should emphasize that in the vast majority of cases, the demand for rail service is highly elastic. Most rail rates are constrained by vigorous competition from trucks and/or other rail carriers. All rail shippers benefit from the industry’s pricing flexibility that enables it to

² Surface Transportation Board, *Rail Rates Continue Multi-Year Decline*, December 2000.

retain competitive traffic while recovering a greater portion of fixed and common costs from those who are willing to pay more for rail service.

While the financial condition of the rail industry has improved markedly since Staggers, railroads are still not earning satisfactory returns. Industry revenues are not adequate as you, the Surface Transportation Board, define them. And they certainly are not adequate in the eyes of the investment community, which scrutinizes our performance and attaches considerable significance to the effect of the Board's regulatory initiatives on that performance. Measured by total return to shareholders, the most recent Fortune 500 (dated April 5, 2004) ranks the railroad industry 33rd out of 46 industries in 2003, 34th out of 45 industries in the five years from 1998-2003, and 33rd out of 37 industries in the 10 years from 1993-2003. The investment community is sure to look with disfavor at regulatory changes that threaten to reduce rail earnings even more vis-à-vis other industries with whom railroads compete for capital.

The issue of railroad financial viability is particularly critical in the current environment. We have all heard expressions of concern that the demand for rail service may exceed available capacity over the near term as the economy recovers and expands. If railroads are to maintain their current systems, let alone augment them to bear a greater portion of the surface transportation burden, we must find the capital to replace existing infrastructure. While an expanded agenda of rate regulation would be a bad idea at any time, it would be especially pernicious today, when the resulting revenue drain would thwart the railroads' ability to make investments to meet surging transportation demand. The Board's revisiting of small rate case guidelines should not be the occasion for expanded government intervention in rail markets or a departure from the Staggers Act goal of allowing the railroads the opportunity to earn adequate revenues.

**The Shippers' Eligibility Proposal Would Threaten
To Exacerbate the Existing Railroad Revenue Shortfall**

In July 2003, a consortium of shipper organizations advanced a proposal whereby eligibility for small rate case treatment would be extended to the shipper of any commodity moving between an origin and destination that generated annual freight revenues of less than \$4.8 million. This proposal is seriously overreaching, as it would make a substantial majority of non-exempt rail traffic subject to challenge under a rate standard that "will necessarily be cruder than CMP."³ In his submission in this proceeding, AAR's Vice President of Policy and Economics, Craig Rockey, has quantified the potential adverse revenue impact on our industry of adopting a broad standard of eligibility. The Board would be defaulting on its responsibility to foster the financial health of the rail industry if it were to adopt anything remotely like this standard of eligibility.

As an attachment to this statement, I am submitting to the Board a joint statement of railroad Chief Financial Officers (including the CFOs of all of the Class I Railroads). That statement explains that capital investment is the lifeblood of the railroad industry, which is one of the most capital intensive industries in our economy. For railroads to have access to capital over the long term, their earnings must be sufficient to cover their cost of capital, but industry return on investment has continued to fall short of the cost of capital. The shortfall is particularly troubling in the current environment where increased demand for rail services calls for higher levels of capital investment.

³ In Ex Parte No. 347 (Sub-No. 2) the Board stated that "[t]he ICC expressed confidence that reliance on a cruder method would not significantly affect a carrier's overall ability to earn adequate revenues, because only a very small portion of rail traffic could be subjected to rate reasonableness review using such simplified procedures." 1 S.T.B. at 1008-09.

The shippers' eligibility proposal – as well as proposals regarding substantive criteria which would adversely affect the rail industry's opportunity to earn adequate revenues – would significantly exacerbate the industry's earnings challenge. The shippers would not be pushing for small rate case eligibility unless they believed that eligibility for small rate case treatment could translate into rate reductions. Revenue losses resulting from expanded rate regulation would have a serious adverse effect on railroads' ability to make necessary investments. Indeed, there could well be a chilling effect on industry investment resulting from the threat of increased rate litigation at the very time that the public interest calls for increased investment.

The majority of those who would be eligible to bring simplified rate challenges under the shippers' eligibility proposal are large shippers under any rational definition of the term. They include companies whose capitalization and annual revenues far exceed those of the largest railroads. They include sophisticated entities that have substantial bargaining leverage vis-à-vis railroads as a result of their ability to bundle freight from multiple origins and destinations, their access to other transportation modes, and other factors. In short, many of these entities do not need the special treatment inherent in access to simplified, expedited rate reasonableness determinations that may be appropriate for truly small shippers. The Board should reject efforts to expand the class of small rate cases or to impose substantive criteria which do not reflect sound railroad economics and the competitive marketplace in which railroads operate.

Conclusion

AAR looks forward to cooperating with the Board and other parties to this proceeding to develop procedures that will expedite rate cases for truly small shippers.

ATTACHMENT

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 646

RAIL RATE CHALLENGES IN SMALL CASES

STATEMENT OF RAILROAD CHIEF FINANCIAL OFFICERS

Thomas N. Hund
Executive Vice President & Chief Financial Officer
Burlington Northern & Santa Fe Railway Company

Claude Mongeau
Executive Vice President & Chief Financial Officer
Canadian National Railway Company

Michael T. Waites
Executive Vice President & Chief Financial Officer
Canadian Pacific Railway Company

Oscar Munoz
Executive Vice President & Chief Financial Officer
CSX Corporation

Ronald G. Russ
Executive Vice President & Chief Financial Officer
Kansas City Southern Railway Company

Henry C. Wolf
Vice Chairman & Chief Financial Officer
Norfolk Southern Railway Company

Robert M. Knight, Jr.
Executive Vice President & Chief Financial Officer
Union Pacific Corporation

Michael D. Mokodean
Vice President & Chief Financial Officer
Wheeling & Lake Erie Railway Company

July 16, 2004

Statement of Railroad Chief Financial Officers
In Ex Parte No. 646 On Small Rate Cases

We appreciate this opportunity to share our views with the Surface Transportation Board (STB) on the handling of small rate case matters. In particular, we urge the STB not to embrace any change in the regulation of such matters that would have the effect of reducing the revenue necessary for the industry to secure the capital to fund its infrastructure and capacity needs. Unfortunately, as the date of the hearing conflicts with the need to prepare for earnings announcements and Board of Directors meetings, we cannot testify in person but instead submit these written comments for the STB's consideration.

Others appearing before the STB in this hearing will discuss how the regulatory reforms that climaxed with the Staggers Rail Act of 1980 (Staggers Act) have delivered on their promise of profound public benefits. In the nearly quarter century since the passage of the Staggers Act, rates have fallen for shippers across markets, overall safety has improved, costs have been reduced and productivity enhanced, and rail traffic has grown. These results were made possible in large part because of the focus of the STB, and its predecessor, the Interstate Commerce Commission, on allowing rail rates to be set in the marketplace and on allowing railroads the opportunity (though not a guarantee) to earn adequate revenues.

Today our capital investment is directed to ensuring that the benefits of the Staggers Act are continued. We must all focus on the importance of capital investment to the rail network and to rail customers, the challenge that railroads

face in trying to recover the cost of that investment, and the effect that reduced revenue would have on the ability of railroads to continue the level of investment necessary to respond to customer service needs.

The Railroad Industry is a Highly Capital-Intensive Industry.

To understand how important capital is to the rail network, one need only look at the level of capital investment in the industry. In 2003, Class I railroads had a net investment of \$93.7 billion, compared to total operating revenue of \$36.6 billion. Just over the past five years, Class I capital expenditures have totaled nearly \$30 billion, equal to 14-18 percent of the annual revenue of individual railroads. This dwarfs the capital spending of most other industries also considered capital intensive, including many who use rail transportation extensively.

Railroad investment needs are substantial for a number of reasons. First of all, freight rail is a transportation mode whose infrastructure is overwhelmingly owned and paid for by the private sector. Consequently, the vast majority of needed capital must come from the private sector. In addition, rail assets are expensive. For example, new AC traction locomotives cost more than \$2 million apiece. A typical mile of new mainline can cost up to \$2 million to buy and install. Moreover, railroad assets are subjected to heavy wear-and-tear and must be replaced on an ongoing basis, as railroads haul 42 percent of the ton-miles of intercity freight in the United States even though they receive less than 10 percent of intercity freight revenue.

In addition to their enormous capital spending, railroads expend \$11-\$13 billion per year to repair and maintain their infrastructure and equipment. After depreciation, freight railroads typically spend \$15 billion or more — equal, on average, to approximately 45 percent of their operating revenue — to provide the high quality assets they need to operate safely and efficiently.

While investment in the rail industry is expensive, failure to invest in those assets is also expensive to railroads and their customers. It is expensive in terms of insurance, loss and damage claims and personal injury. If slow orders on track increase, for example, system velocity can slow and require more locomotives and crews to handle the traffic while customers see an increase in cycle time and a decrease in car utilization. Therefore, it is imperative that the industry has the capital for needed investments.

Indeed, as we move forward, the high quality of the infrastructure must be maintained and necessary investments made to meet the capacity and service challenges that lie ahead. According to U.S. Department of Transportation forecasts, rail tonnage will increase well over 50 percent between now and 2020. Beyond serious capacity issues related to this level of growth, rail customers will continue to insist that railroads invest heavily in service-enhancing infrastructure. And with highways becoming increasingly congested and demands to reduce emissions, conserve fuel, and promote transportation safety on the rise, pressure on railroads to provide relief will only increase.

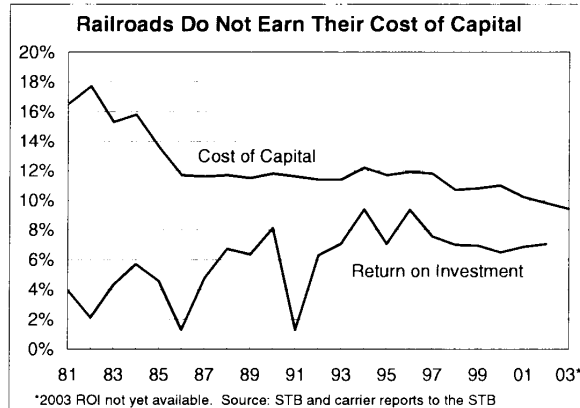
The Rail Industry's Returns Fall Short of its Cost of Capital

In order for any business to survive, that business must earn its cost of capital over the long term. Return on capital is a measure of performance that equity investors, commercial banks and the credit agencies monitor and review. Where a business systematically fails to earn its cost of capital and is unable to demonstrate that it will be able to earn its cost of capital, that capital will be redeployed to other business opportunities where investors believe a business will earn or exceed its cost of capital. That means that for all businesses, including railroads, the Return on Investment ("ROI") should at least be equal to the cost to acquire the capital that they have invested. So far, this has not been the case. The STB's revenue adequacy determination since 1981 demonstrates that the railroads are revenue

inadequate based on the fact that they are not earning their cost of capital. [See chart]. In some years, one or two rail carriers might match or modestly exceed the cost of capital, but over time not one railroad has consistently

returned earnings matching or exceeding the cost of capital.

This is not just a theoretical point. If ROI exceeds the cost of capital, capital spending can expand, railroads' physical plant becomes stronger and



their equipment more reliable, service becomes faster and more reliable, and the industry can sustain itself. Conversely, if ROI falls short of cost of capital, capital spending is lower, the physical plant deteriorates, service is slower and less reliable, and railroads are forced to disinvest in their networks.

We understand that some have criticized the STB's revenue adequacy determination as misleading. We disagree with that viewpoint. The STB's own calculations of Return on Investment are the same as, or closely approximate, the Return on Capital numbers calculated by equity analysts and the financial rating agencies for individual railroad companies. We find ourselves dealing with frequent criticisms by financial analysts that railroad returns do not support and cannot justify continued capital expenditures consuming such a large percentage of industry revenue.

The net result of the railroads consistently not earning their cost of capital is that the capital available over time to invest in replacement of existing assets, let alone new assets, will become increasingly more expensive or will not be available. Underinvestment can only lead to diminished and inferior rail service.

**The STB Must Avoid Changes in Rate Regulation That Deprive
Railroads of the Revenue Necessary to Serve Rail Shippers.**

Revenue is the engine that drives capital investment. Without revenue, both the capability and the willingness to invest funds into assets disappear. In the past, most rail investment has come from the cash remaining after paying employees, fuel bills, supplies, taxes and all the other costs of running a railroad. Our investors have been willing to let us make those investments because they

anticipated railroads could deliver more revenues and higher earnings. However, access to future capital will be at serious risk if the prospect for revenues and earnings is reduced.

In this connection, the Association of American Railroads has estimated that adopting the eligibility test that the shippers have proposed for small rate case procedures could affect railroad revenue by as much as \$2.9 billion. This compares to total net income of only \$2.7 billion in 2003. As there would be no cost savings associated with this loss of revenue, already inadequate earnings would be depleted further. Nor is there any reason to expect an increase in volume associated with such rate reductions to compensate for any revenue loss.

Thus, if we lose revenues, we cannot recoup them. We will need to cut costs, and service will be affected. In the 1980s and 1990s, railroads' reduced costs through productivity improvements that were largely passed through to customers in the form of lower rates. Not incidentally, many of those productivity gains were the product of capital investments such as locomotive power, longer sidings for bigger trains, state-of-the-art classification yards, and computer systems. This scenario allowed railroads to increase investment while sharing productivity with customers. Future productivity gains will be harder to find. Also, pervasive competition with trucks and other modes further dampens the industry's ability to recoup lost revenues. Thus, if revenues are further curtailed, investment will be reduced and service will be negatively affected.

Rather than curtailing revenues, government regulators and legislators should seek to ensure a stable regulatory environment in which railroads can safely and efficiently meet rail customer needs. We urge the STB not to take any action with respect to small rail rate matters that would have a negative impact on the ability of the rail industry to invest in important infrastructure and capacity. Such a result would only serve to erode the service that the industry is able to provide, an outcome that is completely at odds with the customer interests that the STB is attempting to address in this proceeding. We appreciate your consideration of our views.

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 646

RAIL RATE CHALLENGES IN SMALL CASES

**STATEMENT OF LARRY R. PARSONS
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
THE WHEELING & LAKE ERIE RAILWAY COMPANY**

JULY 16, 2004

My name is Larry R. Parsons and I am Chairman and CEO of the Wheeling and Lake Erie Railway Company. I appreciate the opportunity to appear before you today and to present the views of a smaller railroad on the question of how small rate cases should be handled by the Surface Transportation Board (STB).

The Wheeling and Lake Erie Railway Company is a regional railroad operating in the states of Ohio, West Virginia, Pennsylvania and Maryland. We employ approximately 375 people, operate over 900 miles of track and have annual gross revenues of approximately \$50 million from about 150 customers. I am pleased to say that we ship a wide variety of products and commodities serving a large customer base. We move coal from Harrison Mining, iron ore from the Great Lakes region, steel from six different mills, aggregates from four quarries, and chemicals, forest products and grain generating approximately 130,000 carloads annually.

The Board has heard from the Association of American Railroads' (AAR) witnesses at this hearing explaining the potentially devastating impacts that STB action could have on the

financial condition of the railroad industry if the Board: (1) promulgates regulations which are not based upon sound railroad economics allowing railroads the opportunity to earn adequate revenues; and (2) encompasses in any proposed regulations a sweepingly broad expanse of railroad traffic and revenues that is more than necessary to address the concerns of shippers in need of any perceived regulatory relief.

The Wheeling and Lake Erie Railway Company, as a non-Class I railroad, shares in and supports the statements made by the AAR witnesses in this proceeding. In fact, the adverse effect of Board regulations in this instance will potentially have a greater adverse effect on smaller railroads due to the fact that, as Mr. Rennie noted in his testimony in this proceeding, smaller railroads tend to have proportionately more small shippers than Class I railroads. I would like to take a moment to talk about the operating and financial environment of the smaller railroads.

Short line and regional railroads are a vital component of our nation's freight transportation system. These non-Class I railroads operate nearly 42,000 miles in 49 states, employ nearly 20,000 workers, and earn \$2.8 billion in annual revenue – 8 percent of the U.S. freight rail industry's total. Typically, short line railroads perform a gathering and distributing function, linking innumerable smaller rural shippers and communities to high-volume Class I lines. As the AASHTO Freight-Rail Bottom Line Report said, "short lines often provide the first and last service miles in the door-to-door collection and distribution of railcars" and as I mentioned earlier, the typical shipper and volume of shipment is smaller on a Class II and III railroad than on a Class I railroad.

There are over 500 short line and regional railroads operating today and over 81 percent of the total mileage operated by those railroads came into existence only since 1980 when the

Staggers Act and ICC decisions allowed the Class I carriers to spin-off those miles to short line and regional railroads whose lower costs and closer ties to their customers and communities enabled them to provide operations that Class I carriers could not. No one should forget that a major impetus behind the Staggers Act initiatives was the desire to preserve service for small shippers and small communities that would otherwise lose rail service. The Wheeling itself was created under these circumstances in 1990 initially as a spin-off of trackage from the Norfolk Southern Railway.

Today, smaller railroads serve over 11,500 individual customers. Approximately 25 percent of the total carloads handled by the Class I railroads originate or terminate on a short line or regional railroad; and again, that traffic typically comes from smaller shippers or communities.

Now, even though smaller railroads may typically have a lower cost structure than Class I railroads, they face the same concerns regarding the need to meet competitive alternatives in the marketplace and the need to attract the revenues necessary for infrastructure investment. Because of the intense competition they face, railroads of all sizes must constantly struggle to maintain (much less increase) their share of the freight market and earn enough to cover the costs of their operations. For the Wheeling, a substantial portion of our business is competitive with short-haul trucks and we constantly have to be mindful of that in our rate and service offerings.

While most smaller railroads are profitable, they, along with the rest of the rail industry, are well short of earning their cost of capital. Also, as is the case with the Class I railroads, the smaller railroads re-invest heavily back into their plant and equipment. Approximately \$884 million a year – about 30 percent of gross revenues – is invested by the smaller railroads in their plant and equipment.

I have to mention here also that the smaller railroads' investment needs are more urgent because of the generally more deteriorated condition of their systems. Remember that many of the smaller railroads were formed from lines spun-off by Class I railroads which had been subject to long periods of deferred maintenance. Also, the smaller railroads in many instances need to upgrade their lines to handle the 286,000-pound rail car to ensure that their shippers can utilize these cars in the national rail network; and the effort to obtain federal funding for the infrastructure upgrades necessary for smaller railroads to handle 286,000-pound cars remains a high priority on the smaller railroads' legislative agenda. I must also add that the Wheeling has just been awarded a \$25 million RRIF loan from the FRA to be used for rail infrastructure improvements and we are now in the process of finishing the legal documentation. The loan is for 25 years, and if we are to repay that loan and invest in other infrastructure improvements, we must have the opportunity to earn the necessary revenues.

The ability of any railroad, whether it be a Class I railroad or a smaller railroad like the Wheeling, to remain a competitive and viable transportation option depends, in large part, on the freedom to operate in the marketplace without undue regulatory restraints. There have been a wide range of statements made prior to this proceeding by various parties regarding the scope of any proposed rules and the criteria by which the cases should be decided. I have heard proposals that suggest that any shipper other than a unit train coal shipper should have the opportunity to bring cases under small case, or non-stand-alone cost, procedures. Let me tell you here that the Wheeling – and probably most other smaller railroads – have few unit train coal shipments on our lines. As such, all of the Wheeling's traffic would be potentially subject to small rate case procedures. I have also seen the proposal previously advanced by the National Industrial Transportation League (NITL) that shipments between an origin/destination pair with annual

revenues of less than \$4.8 million should be subject to small rate procedures. Even though much of the Wheeling's traffic is interlined with Class I railroads and only a part of those revenues would be accruing to the Wheeling, nonetheless every single carload of the Wheeling's traffic subject to regulation would still fall under this test. (Again, the Wheeling's total annual revenues are only approximately \$50 million.)

This brings me to another serious concern that the Wheeling has with proposals based upon the size of the shipment at issue. It does not take into account the relative bargaining positions that the shipper and railroad may have in rate negotiations. A smaller railroad quite often has very little bargaining power with a large shipper – which may have facilities on other rail lines or ships significant volumes from other locations – even where the large shipper has only a “small movement” between the origin/destination pair at issue. Any eligibility criteria that the Board may consider must take into account the leverage that a shipper may have over a rail carrier.

Moreover, any proposed rules should not be extended beyond truly small shippers. Any other shipper will have the leverage to protect itself in rate negotiations. For the Board to do otherwise would result in the extension of regulation beyond what is necessary to protect those shippers which are actually in need of the Board's regulatory “safety net.”

Lastly, the Board has properly recognized that there is a need to ensure that there be a rate review process that is efficient and economical for those shippers where the value of the case does not support a full SAC proceeding. Having said that, I do not believe that this means that the Board should promulgate regulations which are inconsistent with the principles of the Staggers Act and which would not allow the railroads – whether they be large or small – the ability to earn adequate revenues, attract capital and meet the service demands of their

customers. The progress that the large and small railroads have made over the last 20 years to rehabilitate and maintain a rail network to meet shippers' needs should not – and does not need to – be compromised by reregulating the railroads in this context.

In summary, I believe that proposals which depart from the principles of the Staggers Act and adversely affect the railroads' ability to earn adequate revenues – no matter how well intentioned – is essentially a step toward reregulation and unnecessary to address any concerns that the Board may have regarding small rate cases.

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 646

RAIL RATE CHALLENGES IN SMALL CASES

**STATEMENT OF CRAIG F. ROCKEY
VICE PRESIDENT – POLICY AND ECONOMICS
ASSOCIATION OF AMERICAN RAILROADS**

JULY 16, 2004

My name is Craig F. Rockey and I am Vice President of Policy and Economics at the Association of American Railroads (AAR), the trade association of major North American railroads, with a headquarters office located at 50 F Street, N.W., Washington, D.C. 20001. I am appearing on behalf of AAR member railroads, which employ 92 percent of all freight railroad workers and which generate 94 percent of all rail freight revenues in the United States.

I. INTRODUCTION

This forum provides the opportunity for interested parties to present views on the handling of small cases brought before the Surface Transportation Board (STB) involving a challenge to the reasonableness of railroad freight rates. The AAR and its member railroads have devoted significant time and resources over recent months to evaluating

the considerations and options concerning the eligibility and standards for rate reasonableness determinations for small cases and are grateful for the opportunity to share their thoughts on this matter.¹

An adequate evaluation of the options must, of necessity, encompass a knowledge of railroad operations, an appreciation for the economics driving the rail industry, and the marketplace realities that railroads confront. Moreover, a recognition of the wide spectrum of commodities that railroads are called upon to carry and services they are called upon to provide, the variant levels of demand for railroad service of different rail customers, and the resulting broad differentiation in movement costs, revenues, and margins are critical to a full appreciation of the complexity and potential gravity of the small shipper rate reasonableness issue.

II. SHIPPER PROPOSAL

Within this proceeding, a group of shipper interests has sponsored a proposal which defines what traffic should be designated as small case/small shipper traffic and, therefore, subject to special rate reasonableness standards. The proposal, made in July 11, 2003 comments submitted to the STB in this proceeding, calls for according “small shipper” status to shipments in which individual commodities transported between specific origin-destination pairs generate \$4.8 million per year or less in rail revenue.

The following is a brief examination of how all-encompassing such a proposal would be

¹ This issue is important not only to large railroads, but also to Class II and III rail carriers. In fact, information available on the revenue levels of the 545 local and regional railroads, the number of customer facilities they serve, the commodities they handle, and other statistics indicate that their shipper base is likely to consist of a relatively higher level of “small” shippers. Clearly that is the case in the context of the shipper proposal discussed later in this statement, whereby approximately 75 percent of the local and regional railroads have *total* system-wide revenues of less than \$5 million per year. Furthermore, the vast majority of the remaining 134 carriers are believed to exclusively serve customers which would be classified as “small” under the shipper proposal.

in actual application — and how devastating such a regulatory model could be under certain scenarios if adopted without consideration of the practical ramifications.

A. Shipments Identified as “Small” Shipper Traffic

Using 2002 Waybill Sample data,² Table 1 summarizes by major two-digit Standard Transportation Commodity Code the number of origin-destination (O-D) pairs and the related carloads, tons, and revenues that would be determined to be “small” under the shipper proposal.

Table 1
Traffic Identified as “Small” by Shipper Proposal

	Number of O-D Combos	Cars	Tons	Revenue
01 Farm Products	2,439	573,048	57,303,343	\$1,214,576,580
10 Metallic Ores	127	82,218	7,410,456	85,358,863
11 Coal	1,362	1,647,774	173,538,819	1,751,366,397
14 Nonmetallic Minerals	302	117,942	11,410,354	179,712,381
20 Food and Kindred Products	1,665	229,750	21,437,963	639,136,011
24 Lumber & Wood Products	0	0	0	0
26 Pulp, Paper, & Allied Products	65	4,960	404,560	18,361,520
28 Chemicals	10,704	1,090,807	100,158,207	3,958,887,348
29 Petroleum and Coal Products	2,013	250,987	20,035,527	635,503,227
32 Stone, Clay, & Glass Products	810	136,266	12,860,389	447,592,540
33 Primary Metal Products	0	0	0	0
37 Transportation Equipment	167	20,704	555,612	28,512,382
All Other	348	39,670	3,125,772	171,014,541
Total	20,002	4,194,126	408,241,002	\$9,130,021,790

The analysis underlying Table 1 was performed on non-exempt (regulated) rail traffic — the traffic which is not exempt from rate regulation by virtue of a revenue-to-variable cost (RVC) ratio above 180 or a commodity, car type, or type of service which has not been specifically exempted from economic regulation by the STB.³ Contract

² Specifically, the STB’s 2002 Costed Waybill Sample file, with URCS-costed movements and multiple-car and unit train adjustments, was used for this analysis.

³ Freight railroads were partially deregulated in 1980; however, economic regulation continues to apply directly or indirectly to 36 percent of rail tonnage and traffic which generates 29 percent of rail revenue.

traffic, which is also not subject to economic regulation, is included in the analysis because, for purposes of economic regulation, it automatically assumes the characteristics of regulated traffic once the contract expires.⁴ Even if the traffic continues to be transported under the provisions of a privately negotiated, arms-length price and service contract, the price and service provisions will likely have been influenced by the outcomes available to that rail customer in the regulatory arena.

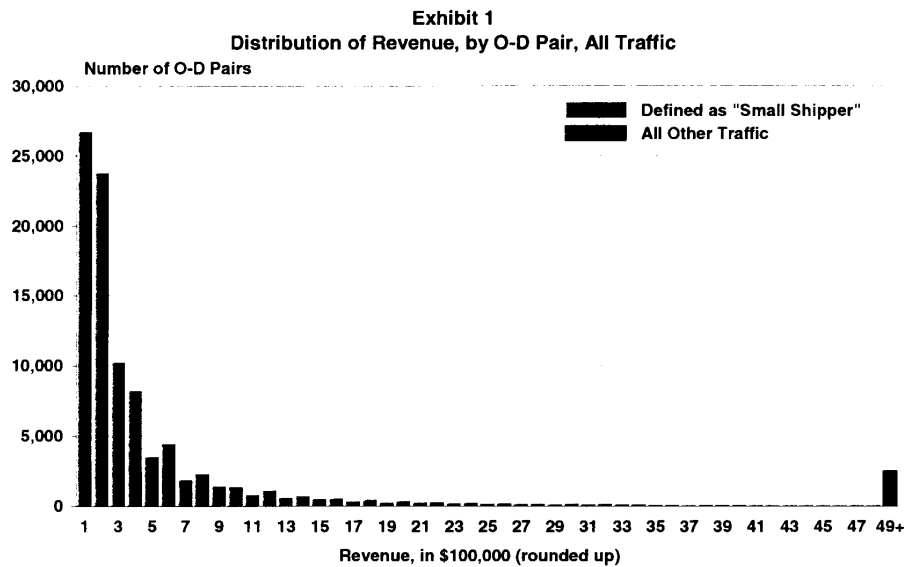
O-D pairs are defined as unique Freight Station Accounting Codes⁵ between which an individual commodity was moved.⁶ Out of the total of 20,383 O-D pairs between which non-exempted, individual commodities flow, fully 98 percent (20,002 pairings) generate rail revenues of not more than \$4.8 million annually — thus qualifying as “small shipper” treatment under the shipper proposal. Only 2 percent of all rail routes where non-exempted traffic moves would not be classified as small case/small shipper routes. Moreover, the \$9.130 billion in revenue that would be attributable to small shippers under the proposal is more than 68 percent of all revenue from regulated traffic. Obviously, such a virtually unlimited definition has little relevance to truly small shippers and is wholly inappropriate for use in the context of this proceeding.

⁴ From the Waybill Sample data fields alone, it is not possible to identify traffic which is transported under contracted terms.

⁵ Freight Station Accounting Codes are unique numbers assigned by carriers to every station they operate that originates billing.

⁶ A commodity description level was not specified in the shipper proposal. For purposes of this analysis, seven-digit STCCs were used.

The absurdity of the shipper proposal is perhaps best illustrated in Exhibit 1. In this graph, all rail traffic (not just regulated traffic) is arrayed in the roughly 96,000 O-D/commodity pairs and grouped by the rail revenue produced by the pairs (in \$100,000 increments). For instance, the first bar includes the almost 27,000 O-D/commodity pairs



each of which generate annual rail revenues of from \$0 through \$100,000. The second bar comprises close to 24,000 O-D/commodity pairs which yearly generate rail freight revenue from \$100,001 to \$200,000 each. And so on.

With so heavy a representation of traffic in the smaller annual revenue categories, over 50 percent of the 96,000 O-D/commodity combinations throughout the entire railroad traffic base are accounted for by merely the first two bars (i.e., traffic for which rail customers pay \$200,000 or less per year). In fact, with all rail traffic slotted into the 49 bars shown in Exhibit 1, only the traffic in the final, 49th bar is not considered “small”

under the terms of the shipper proposal. The shipper proposal thus conveys the title of “small” to over 97 percent of the O-D/commodity pairs and 60 percent of all freight rail industry revenues.

B. Potential Impact of Alternative Rate Reasonableness Proposals

If, however, this proposal were adopted and the shippers’ proposed \$4.8 million threshold became the determinant of what is “small,” a second and equally important criterion would then be applied — the standard on which reasonableness would be determined. While the shipper proposal did not include a suggested measure for reasonableness, Table 2 reveals the relative levels of revenue loss that would accompany various reasonableness thresholds applying specific RVC⁷ relationships which have at times been advocated. These thresholds include: (1) 180 RVC, (2) Average RVC>180, (3) RSAM, and (4) the so-called efficiency-adjusted RSAM.

Table 2
Possible Revenue Losses Under Shipper Proposal

Commodity Group	Revenue Lost Using 180% RVC Cutoff	Revenue Lost Using 'Average RVC>180'	Revenue Lost Using RSAM with Efficiency Adjustment	Revenue Lost Using RSAM w/o Efficiency Adjustment
01 Farm Products	\$300,014,269	\$121,090,751	\$135,770,754	\$40,756,406
10 Metallic Ores	21,426,445	9,929,182	11,757,287	3,545,875
11 Coal	568,214,566	388,981,858	394,866,588	210,973,300
14 Nonmetallic Minerals	\$39,218,677	\$15,478,668	\$15,782,910	\$3,710,410
20 Food and Kindred Products	151,299,793	63,204,822	73,729,890	20,187,608
24 Lumber & Wood Products	0	0	0	0
26 Pulp, Paper, & Allied Products	\$5,729,644	\$2,985,895	\$2,785,324	\$1,088,632
28 Chemicals	1,423,241,638	863,163,295	901,804,248	415,063,038
29 Petroleum and Coal Products	182,513,243	90,200,915	97,222,489	35,095,150
32 Stone, Clay, & Glass Products	\$93,417,223	\$32,708,440	\$39,815,052	\$8,050,883
33 Primary Metal Products	0	0	0	0
37 Transportation Equipment	12,260,490	8,460,355	8,830,874	5,252,409
All Other	82,973,377	63,582,299	65,900,124	49,891,772
Total	\$2,880,309,364	\$1,659,786,479	\$1,748,265,540	\$793,615,483

⁷ The masking of actual shipment revenues on contract traffic by railroads submitting the Waybill Sample data is one factor which prevents a precise accounting of RVC ratios, but it is believed that this level of imprecision does not materially impact the general findings of this analysis.

The lowest standard — the 180 RVC standard, which would cap rates at a 180 RVC — would produce the largest revenue drain at \$2.9 billion per year.

Under the Average RVC>180 standard, which is one of the three threshold measures of the STB's Ex Parte No. 347 (Sub-No. 2) rate reasonableness procedures, small shipper rates would be limited to the average RVC of all traffic above 180 percent. The traffic subsumed by this criterion was identified by applying four-year Average RVC>180 values (1999-2002) to the Waybill Sample shipments. Individual carrier values were used for local movements and the U.S. rail industry average value was applied to interline shipments involving two or more railroads.⁸ The resulting revenue loss would be \$1.7 billion.

Finally, two versions of the Revenue Shortfall Allocation Method (RSAM)⁹ — another of the three measures which make up the Ex Parte No. 347 (Sub-No. 2) reasonableness criteria — were analyzed using individual carrier average 1999-2002 RSAMs applied against single-line movements and the national average RSAM for interline movements, as was the case with the RVC>180 analysis. Under the so-called efficiency-adjusted RSAM, \$1.7 billion could be removed from industry coffers. The (unadjusted) RSAM could translate into a revenue loss of \$0.8 billion.

These results are clear and potentially catastrophic. Any of these thresholds, if adopted as rate reasonableness tests and applied to the traffic designated as "small" as per

⁸ The application procedures described above for the RVC>180, and the RSAM analyses described in a following section, were modified somewhat to accommodate the absence of some data for one railroad. In the May 17, 2004 decision in Ex Parte No. 347 (Sub-No. 2), in which the STB released 2002 RVC>180 and RSAM values, Grand Trunk Corporation's (GTC) figures for 1999-2001 were excluded and only 2002 data were included. Therefore, 2002 RVC>180 and RSAM values were applied against local movements over GTC railroads instead of average 1999-2002 values. For interline movements, the national figures used were built up from the four-year averages of all Class I carriers except GTC, for which the single 2002 figure was used.

⁹ RSAM is an estimate of the average markup over variable costs that a carrier must charge on all of its demand inelastic traffic (that traffic which is less price sensitive) to achieve revenue adequacy.

the shipper proposal, could result in the elimination of from 6 to 20 percent of all regulated traffic revenues. This revenue loss would inflict irreparable harm on freight rail finances, offsetting up to the entirety of Class I income.

III. CONCLUSION

Both the criteria for classification of traffic as “small case” or “small shipper” and the reasonableness standard by which that traffic is to be held are critical determinations which can have dramatic and lasting impacts on the sustainability of the freight railroad industry. The information presented above provides an indication of the unintended financial damage that could result from untoward regulatory actions. Specifically, the shipper proposal for defining a “small” shipment — i.e., O-D pairs that generate no more than \$4.8 million for a particular commodity — is extraordinarily and unjustifiably broad. If adopted, it could inflict substantial financial damage on the rail industry and make it impossible for carriers to invest enough in their systems to meet our nation’s current and future freight transportation needs.

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**STB EX PARTE NO. 646,
RAIL RATE CHALLENGES IN SMALL CASES**

**STATEMENT
OF
WILLIAM J. RENNICKE
MANAGING DIRECTOR
MERCER MANAGEMENT CONSULTING, INC.**

July 16, 2004

Statement of William J. Rennie, Managing Director, Mercer Management Consulting, Inc.

I. Introduction and Qualifications

I am William J. Rennie, a Managing Director with Mercer Management Consulting, Inc. (Mercer). I have more than 30 years of experience consulting to the transportation industry, to the users of transportation, and to suppliers of goods, services, and capital to the transportation industry on a wide range of management, regulatory, economic, litigation, and asset management issues. I specialize in transportation strategic planning, marketing, economics, and operations, and have particular expertise in restructuring and transactions to improve financial and operating performance of transport operators around the world. I am a licensed representative of Mercer Securities, a division of MMC Securities Corp., which is a U.S. registered broker/dealer and a member of NASD/SIPC.

I have previously provided expert testimony on the state of the North American rail industry on several occasions before the Interstate Commerce Commission, the United States Congress, and the Canadian Parliament.

My purpose in preparing this statement is (1) to provide the Surface Transportation Board (STB) with Mercer's perspective on key rail industry financial and performance measures, including the current financial position of the Class I railroads and their level of productivity and performance; (2) to identify the issues and challenges facing the industry, in particular its significant long-term capital funding needs; and (3) to explain how the risk of increasing the regulatory exposure of significant portions of railroad revenue would adversely affect the financial condition of the industry and its ability to meet the challenges it faces.

My testimony is based on experience working with many of the largest North American railroads, their suppliers, and their customers, as well as with many of the providers of capital to the industry. It covers some of the same subjects I discussed in testimony on March 31, 2004, before the House Subcommittee on Railroads in its hearing on the Status of the Surface Transportation Board and Railroad Economic Regulation.

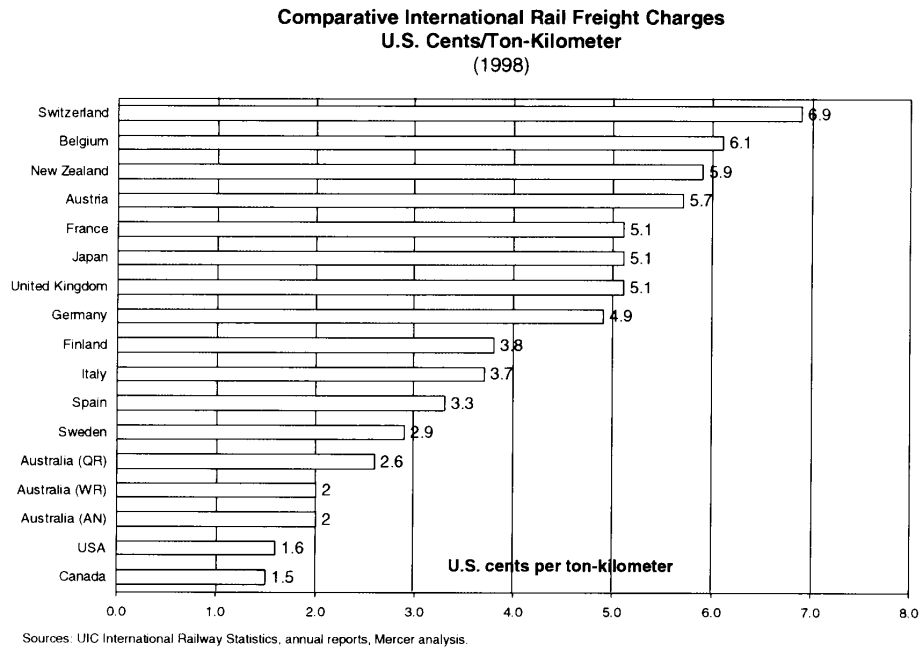
II. Traffic growth is now taxing the capacity of equipment, track, and other infrastructure in the U.S. railroad network.

The performance of the North American railroad freight network is the envy of other railroads worldwide. Since the late 1980s, Mercer has been one of the primary advisors to railroads, national governments, regulators, and financial institutions in Europe, Asia, Australia, and Latin America which have restructured or, in some cases, privatized their rail networks. Across the board, none of these countries, either before or after

restructuring, boasted a rail system that could provide the same level of performance, flexibility, and service as the U.S. railroads at as low costs to shippers and to the overall economy. Few countries can fund freight service fully without some type of government subsidy, and in no region is the private investment in rail infrastructure and equipment as high as in the U.S. The principles of Ramsey pricing and the progressive regulatory structure which have been adopted in the U.S. have produced results that are the target for most other nations.

Overall, North American rail freight rates remain the lowest in the world (Figure 1). The U.S. railroads' ability to move increasing volumes of goods and materials at lower and lower prices is an important factor in keeping the U.S. economy competitive in world markets. In fact, average rate levels in the U.S. have declined steadily over the years. However, it is clear and expected under the principles of Ramsey pricing that some commodities, regions, traffic flows, or customers, both large and small, may pay rates that are either higher or lower than the average. Analysis of rate patterns completed by Mercer in the last five years showed no systematic pattern of bias in rate levels to any particular shipper, size or class of shippers, commodity, or region. When all characteristics of movements and service are considered, the rate patterns observed produce results that would be expected under Ramsey pricing.

Figure 1

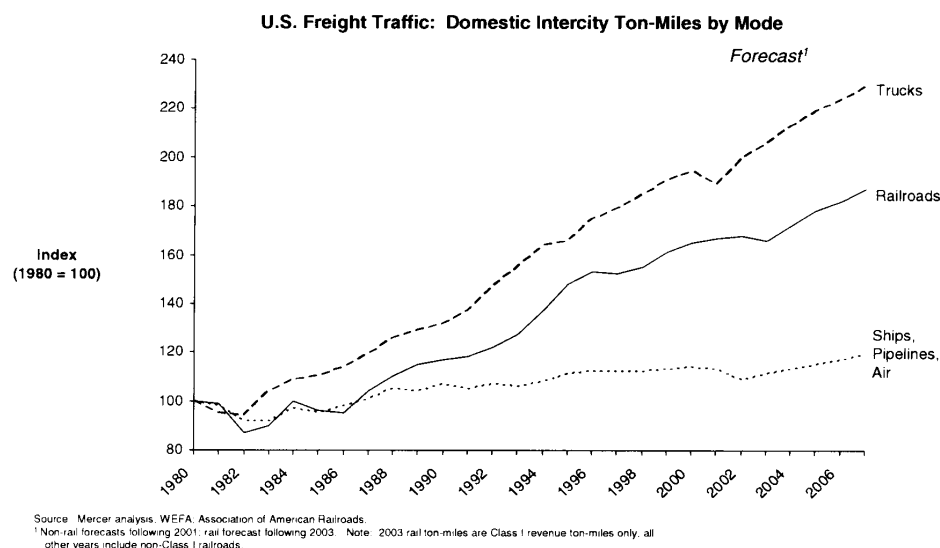


To stay competitive with motor carriers and with each other, railroads have had to reduce their rates across virtually all commodity categories. In every major commodity

category, Class I railroad average rates (in cents per ton-mile) declined substantially in real dollar terms from 1981 to 2002. Transportation equipment, which includes the finished automotive business, is by far the highest-rated commodity for railroads, earning an average of 11.87 cents per ton-mile in 2002. In 1981, however, this traffic was earning 17.42 cents per ton-mile (in 2002 dollars)—nearly 47 percent more per ton-mile than in 2002. In the case of coal—which is the core commodity for most railroads—the average rate declined by 63 percent, dropping from 4.09 cents per ton-mile in 1981 (in 2002 dollars) to only 1.53 cents per ton-mile in 2002.

Railroads in the United States today carry more tons and generate more ton-miles of service than at any point in their history. Since 1980, revenue ton-miles on the U.S. railroads (including non-Class I railroads) have grown by nearly 170 percent (Figure 2). This growth has approached the point where it is now taxing the ability of the railroads' existing asset base to handle it efficiently.

Figure 2



III. The availability of revenues affects investments in capacity.

Even as volume has grown, as a result of continuous rate reductions total railroad revenues in real dollars have been shrinking for several decades. Over the 1980 to 2003 period, total Class I operating revenue declined 34 percent in real dollars. At the same time, the U.S. economy as measured by GDP doubled. In contrast, the trucking sector – the railroads' main competitor – has seen its revenue rise (in real terms) by more than 70 percent. Even with the aggressive rate-cutting policies of the railroads, their market share of transportation revenues has continued to slip.

Consequently, by 2003, Class I railroads were carrying 69 percent more ton-miles than in 1980, but were receiving 34 percent less revenue in real dollars. In other words, the railroads were carrying more traffic but earning relatively less for that traffic than in 1980.

This trend is already having its effects in the financial markets to which the railroads are increasingly looking to fund capital improvements and capacity expansion. Long-term debt investors typically require a stable and fairly predictable revenue base in order to provide the necessary new capital to sustain and grow the network. Anything which increases the risk exposure or uncertainty of the railroads' revenue base is likely to dampen enthusiasm for funding additional investments to expand capacity.

Pricing flexibility is a key tool in profitably balancing customer demand, network capacity, and the need to attract new capital. Railroads are a fixed network business. Managers in a fixed network business seek to load the network to spread its fixed costs. They do this through differential pricing to attract additional customers until the network is fully loaded. The principles behind Ramsey pricing recognize that this strategy benefits both the business owner and the customers.

The possibility that new regulation may ultimately lead to rates being reduced even further for a significant class of shippers, at a time when rail capacity is already overtaxed, increases the exposure of significant portions of railroad revenue in the eyes of financial investors. Essentially, the railroads are being urged to build capacity to meet additional demand that is not justifiable on an economic basis to serve. This may lead to several unintended consequences, including creating additional, increasingly severe service problems during peak periods for railroad traffic and moving traffic to highways that, at key points, also are already at capacity, with the consequence of shifting the economic burden of constructing capacity to governments that may not have the financial wherewithal to do so.

IV. Productivity improvements during the past two and a half decades have allowed railroads to fund improvement of their equipment and networks so far. However, these productivity improvements are increasingly difficult to achieve. At the same time, the industry faces competitive requirements to improve service, many of which will require investment. The result is that railroads will have an increasingly difficult time meeting capital requirements from internal funds alone.

As discussed earlier, competitive pressures have forced railroads to cut rates in real terms. At the same time, railroads' unit costs have more than doubled in real terms since 1980. This has created a "rate-cost gap" that the railroads have been able to overcome only through aggressive productivity improvements (Figure 3).

The railroads been able to maintain the necessary financial performance to attract funds to the industry only by improving productivity over the years faster than the rates at which cost inflation has increased and revenue per ton-mile has declined. By continually

finding new ways to handle growing volumes with increasingly fewer locomotives, fewer freight cars, fewer miles of track, and fewer people, the railroads as a whole have been able to lower their average operating expenses per ton-mile to at least partially offset the decline in rates.

Figure 3

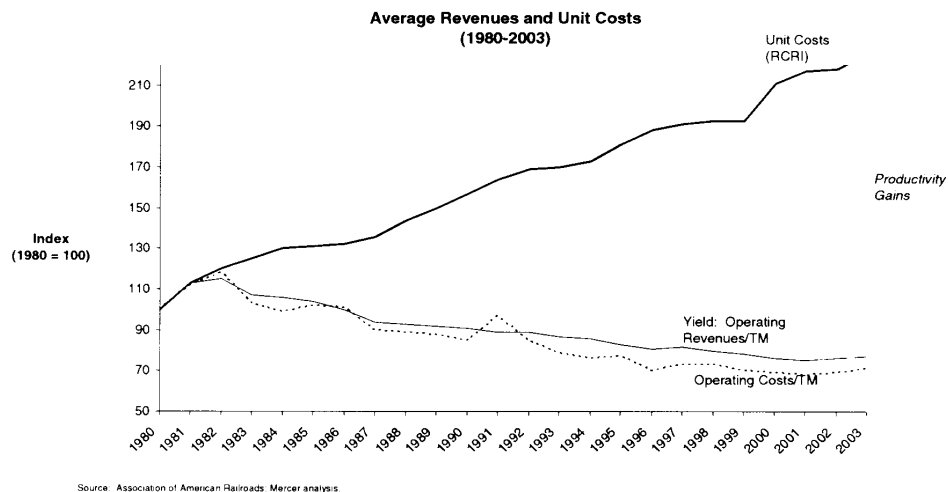


Figure 4 shows the absolute reductions in number of assets and employees for all Class I railroads. Between 1980 and 2003, through continual improvement efforts, the Class I railroads shed 26 percent of their locomotive fleets (more than 7,300 units), while the freight car fleet¹ shrank by some 23 percent (nearly 400,000 freight cars) and track was reduced by 38 percent (more than 101,000 miles). In the same period, the Class I railroads reduced their personnel by a total of 66 percent, or approximately 304,000 employees across the industry.

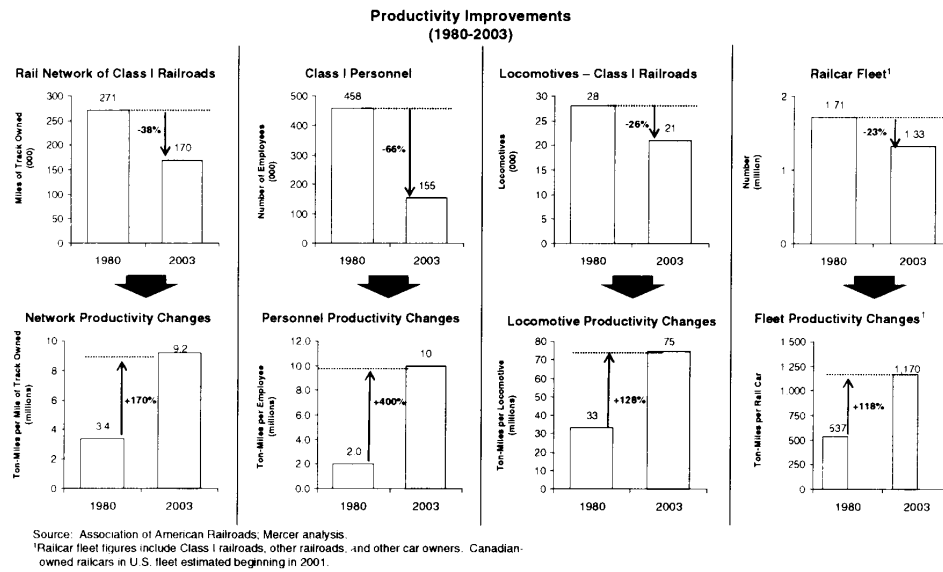
As a result of these actions, revenue ton-miles per locomotive (a measure of locomotive productivity) increased 128 percent from 1980 to 2003; ton-miles per freight car per day (a measure of freight car fleet productivity) improved by approximately 118 percent¹; and revenue ton-miles per mile of track owned (a measure of network productivity) increased by 170 percent.

The most dramatic improvement, however, is the increase of 380 percent in employee productivity from 1980 to 2003 (measured as revenue ton-miles per employee). Whereas

¹Freight car fleet figures include Class I railroads, other railroads, and other car owners (e.g., car leasing companies, shippers). Canadian-owned railcars in the U.S. fleet are estimated beginning in 2001.

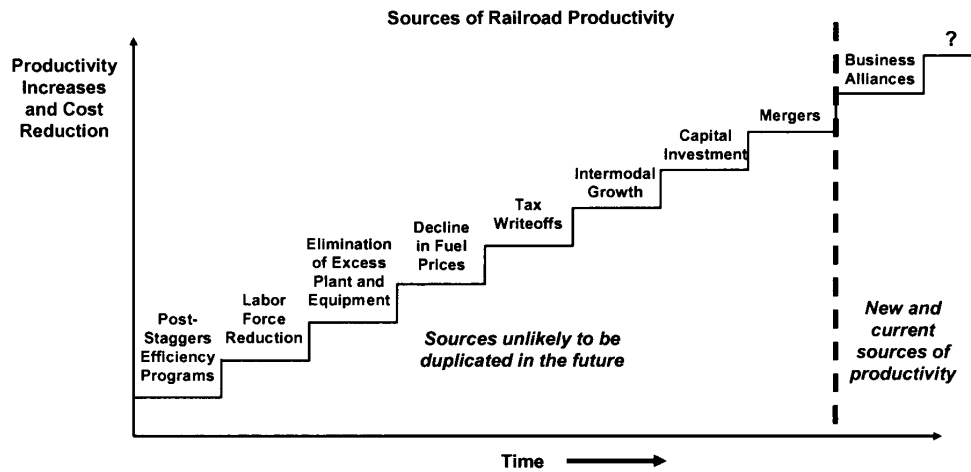
Class I railroads carried only 2.0 million ton-miles per employee in 1980, by 2003 that figure had quintupled to 10.0 million ton-miles per employee.

Figure 4



Now, however, the sources of productivity that fueled the positive financial performance of the railroads during the last several decades have for the most part been harvested. Rates of productivity improvement are slowing, and railroads are running out of traditional sources of productivity improvement (Figure 5).

Figure 5



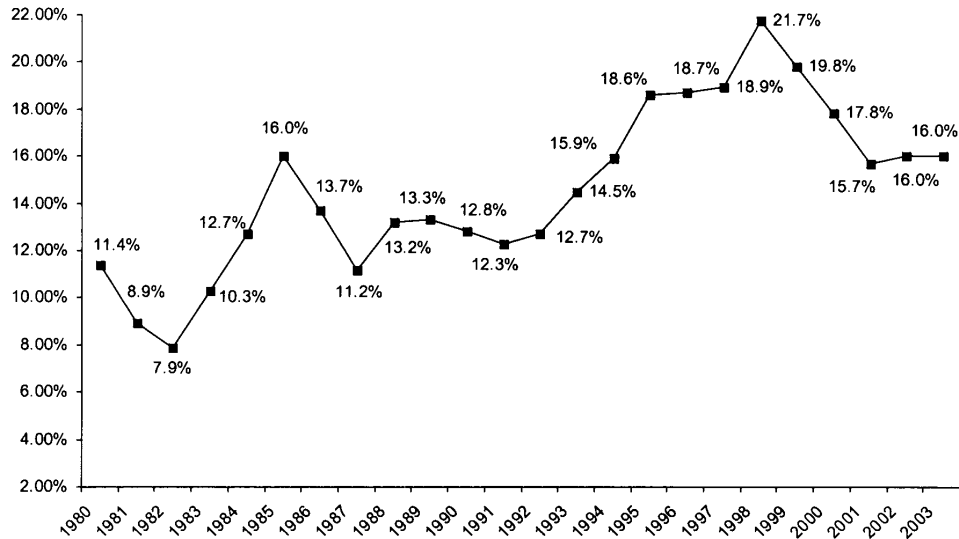
The railroads need strong operating performance to support the required annual capital expenditures just to keep the network at current capacity, as well as attract the new capital needed to add essential capacity for growth. Continuing competitive and market pressure to reduce rates, coupled with rising unit costs and increasing difficulty in achieving additional productivity improvements, call into question the railroads' ability to continue to generate internal funds at past levels.

Measured in terms of capital expenditures as a percentage of revenue, the railroad industry is the most capital-intensive industry in the nation. Railroads have invested heavily to improve their equipment, track, and other infrastructure. Class I rail capital expenditures² as a percentage of operating revenues have risen from 11.4 percent in 1980 to 16.0 percent in 2003 (Figure 6).

² Net of interest, investment, and construction in progress.

Figure 6

Class I Capital Expenditures as % of Operating Revenues



Source: Association of American Railroads.

The financial markets and investors understand the risk associated with the “rate-cost” gap and the ultimate financial impact if inflation, productivity, or revenue yields begin to move out of the historical patterns that have supported rail investment levels. Changes in the level of exposure of the revenue base to additional regulatory action would create a new level of uncertainty that undermines the current understanding of the delicate management of the “rate-cost” gap. If uncertainty grows with the revenue base, then having to rely almost exclusively on productivity changes to offset increases in inflation and declines in revenue yield can create significant challenges and further associated risks when traffic volumes increase and when certain external events, such as changes in Railroad Retirement rules, unexpectedly reduce the experienced workforce.

The current tight capacity situation on the North American network has increased awareness of the need to begin to add new capacity at a rate that will lead the anticipated traffic growth. The shipping community and the STB have expressed concern regarding railroad capacity constraints, and expect railroads to increase capital spending to expand capacity.

The financial community is gearing up to consider the funding of the programs needed to address the capacity shortfall and growth. In order for railroads to manage growth and stay financially viable, capacity additions must be financially supportable over the long term. Since it is improper and costly to build and equip solely for the peak, there will be

some continuing capacity constraints in the system, as there are in most other transportation networks around the world.

At the same time, railroads are also being challenged by customers to improve service performance. As one might expect, the pressure for improved service comes primarily from shippers of truck-competitive merchandise traffic, but it is also coming increasingly from shippers of bulk traffic as they seek to improve the utilization of their assets and to manage their inventory costs. Continued service improvements or even sustaining current levels of performance will require higher levels of capital investment.

Historically, railroads have had difficulty in maintaining past levels of capital spending from internal funds alone. With the rate of productivity improvement running up against practical realities, it will be even more difficult for the railroads to cover capital expenditures for capacity increases and service improvements demanded by shippers.

V. Increasing regulatory oversight over a significant portion of railroad traffic will complicate the railroads' ability to attract external capital to fund needed capacity improvements.

Some analysts are beginning to question the ability of the railroads to support additional capital spending even under current regulatory exposure. Few equity analysts discuss the state of the rail industry without comment on stand-alone (SAC) rate cases and the implications for rail revenue yields. In addition, in some cases major commercial banks in the U.S., as well as European banks that supply capital to the U.S. rail industry, are gearing up to revise and tighten their credit and risk review processes. The hangover from the financial losses suffered by many investors and lenders in the airline industry, and tightening supervision of investments by regulators and internal risk management and credit processes required by the Basel II Accords, will increase scrutiny of railroad investments in equipment, track, and other infrastructure.

The international Basel II Accords are establishing new procedures for evaluating the risk on railroad equipment (and in other cases, either directly or indirectly, on other railroad investments) and beginning to impact the ability of parties who are trying to finance rail equipment. The capital attributed to individual business units is insufficiently risk-sensitive at many banks today. Basel II represents a significant expansion of the risk sensitivity of capital regulation and is better aligned with best practice economic capital models. In August 2003, to ensure that leading U.S. banks comply with Basel II, the four U.S. bank and thrift regulators jointly issued two consultation documents on the implementation of the new Basel Capital Accord (Basel II).³

³ *Advance Notice of Proposed Rulemaking*, joint release from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, 4 August 2003.

Historically, during strong economic periods the valuation process for all types of transportation equipment relied heavily on appraisal and the trailing performance of the asset type. For the last 24 months, however, the high default and writedown rate for aviation assets has created a challenge for the whole range of parties that provide rail rolling stock and capital for other rail investments.

The tightening of credit and risk evaluation comes at a time when the rail equipment sector is trying to pull out of one of the most severe downturns in its history, and the users of rail equipment are scrambling to arrange capacity for areas where car shortages are undercutting customers' ability to ship and are driving business away from the railroads. Other asset areas that require external investment, such as terminals, are also being affected similarly.

Mercer Management Consulting and its sister companies in Mercer Inc. routinely evaluate and value asset investments on behalf of sponsors, investors, and lenders. In the last five years we have assisted with over 100 transportation-related transactions with a combined value in excess of \$30 billion. Uncertainty in the revenue stream that supports an asset, caused by factors such as overcapacity, unpredictable regulatory costs, or regulatory action that reduces revenues, are important drivers in the financial simulations that calculate the probability of default. Uncertainty increases the probability of default, which in turn increases required loan reserves and the cost of funds, and constrains their availability.

The increasing scrutiny of the level of risk for rail equipment and other railroad investments has already led in some cases to more complex and less successful funding. Regulatory actions that either directly or indirectly impede the railroads' ability to price their services, that add substantially to their administrative costs, or that introduce uncertainty into income projections would complicate the railroads' ability to fund capital improvements demanded by the STB and the shipping community. In particular, actions that depart from Ramsey pricing or subject large blocks of traffic – such as small shipments proffered by companies that in some cases have revenues that exceed those of the entire railroad industry – to an expanded regulatory process would adversely affect investment decisions.

The increased exposure of railroad revenue to regulatory proceedings and the attendant increase in the perception of risk will affect all classes of railroads. Indeed, it is likely that increasing the small shipper regulatory exposure may have a greater impact on the smaller carriers. Since 1984, Mercer has assisted with more than 75 projects involving shortlines and/or regional railroads. Our work has spanned topics from due diligence to bankruptcy and from assisting with marketing strategies to cost reduction and productivity assistance. The small railroads that Mercer has assisted have a much higher proportion of small customers and small shipments than the larger Class I's. One of the cornerstones of the shortline and regional renaissance of the last two decades has been the return of shippers that were overlooked by the larger prior owners. Small railroad service and marketing is more flexible and has met the needs of small shippers who built up existing traffic or in some cases returned to the use of railroads after shifting to other modes. Small railroads are often seen by the financial community as a much higher business risk and already have difficulty in raising funds, particularly for infrastructure

and capacity improvements (e.g., raising line capacity to the 286,000 pound industry standard).

Thus the increased uncertainty that would be introduced by the increase of regulatory exposure of significant portions of railroad will likely increase the cost of the funds needed to make capacity improvements. This will increase costs for all railroad users, and may be the difference in whether needed capacity expansions can be funded.

CERTIFICATE OF SERVICE

I hereby certify that on this 16th day of July 2004, I served a courtesy copy of the Written Statements of the Association of American Railroads by hand delivery or overnight mail to the following parties that filed a Notice of Intent to Participate in the Public Hearing in STB Ex Parte No. 646 scheduled for July 21, 2004:

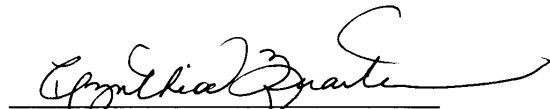
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