

STEPTOE & JOHNSON ^{LLP}

ATTORNEYS AT LAW

Samuel J. Sipe Jr.
202.429.6486
ssipe@steptoe.com

214 904
830 Connecticut Avenue, NW
Washington, DC 20036-1795
Tel 202.429.3000
Fax 202.429.3902
steptoe.com

October 12, 2005

By Hand

Honorable Vernon Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Room 715
Washington, D.C. 20423

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Office of Proceedings

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Re: STB Ex Parte No. 658, The 25th Anniversary of the Staggers Rail Act of 1980:
A Review and Look Ahead

Dear Secretary Williams:

Enclosed for filing in the captioned proceeding on behalf of BNSF Railway Company, please find the original and ten copies of the Statement of John P. Lanigan. Also enclosed are three compact disks containing electronic copies of Mr. Lanigan's Statement in Microsoft Word format.

Please contact me at 202 429-6486 if you have any questions regarding this filing.

Sincerely yours,

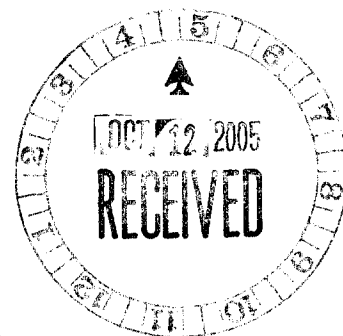
A handwritten signature in black ink, appearing to read 'Samuel M. Sipe, Jr.' with a large, sweeping flourish at the end.

Samuel M. Sipe, Jr.
Counsel for BNSF Railway Company

cc: John P. Lanigan
Richard E. Weicher, Esq.

Hearing Before the Surface Transportation Board

October 19, 2005



Ex Parte No. 658

The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead

Statement of
John P. Lanigan

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My name is John P. Lanigan. I am Executive Vice President and Chief Marketing Officer of BNSF Railway Company. I appreciate this opportunity to appear before the Surface Transportation Board to recognize the achievements that have been realized under the Staggers Rail Act of 1980 and to address the challenges that face the rail industry and our customers in the years ahead.

As a marketing officer, I am acutely aware that the goal of my company and the rail industry is to meet the transportation needs of our customers so that they can compete effectively in their markets. Increasingly these are global markets, and although BNSF's rail assets are located in North America, I do not think anyone would dispute that our rail network promotes the working of global markets in providing the land bridge for international container traffic and export grain, among other commodities. Similarly, I do not think anyone would deny that the quantity and quality of service that we are currently able to provide could not have been achieved without the deregulatory initiatives of the Staggers Act.

In my testimony, I will describe some of the accomplishments that BNSF and its predecessors have been able to realize under Staggers. Although the broad contours of this successful legislative experiment are generally understood, the details are not familiar to all and warrant emphasis here. The achievements fall generally in the areas of rail network rationalization, increased productivity, market based pricing and the promotion of competition.

My testimony will also address the challenges that lie ahead for BNSF, for our industry and for our customers. The overall challenge is to transform improved financial performance into sustained revenue adequacy that allows us to invest with confidence in increased capacity. Increased capacity should lead to improved rail service that will promote the growth of our customers' businesses. My message is basically upbeat: The railroads are poised to shoulder an increased share of the transportation burden if they can consistently realize the returns that justify new investments. But I must also sound a cautionary note. We continue to hear calls for reregulation from some quarters. The effect of answering those calls would be to deprive the rail industry of the funds it needs to invest in new capacity. If we want the rail industry to become more vibrant, we must continue to embrace the policies introduced with the Staggers Act and give railroads the freedom to operate in the marketplace without artificial constraints.

I. The Role of the Staggers Act in Achieving Rail Network Rationalization

A. Financial Vulnerability and Over-Capacity At The Time Of Staggers

Prior to the enactment of the Staggers Rail Act of 1980,¹ pervasive economic regulation of the railroad industry denied railroads the flexibility to compete effectively in surface transportation markets. In 1947, the railroads had handled two thirds of the total intercity freight

¹ Public Law 96-448, 94 Stat. 1932

ton miles, but by 1979 their share had dropped to only one-third.² While intercity freight tonnage *doubled* between 1947 and 1977, railroad tonnage *decreased* by 9 percent. Moreover, the railroad industry's share of surface freight revenues decreased from 70% to 30% and the railroad industry rate of return lagged behind other modes and industries. In 1978, the trucking industry had a rate of return of 18%, manufacturing 16%, and public utilities (gas and electric) 11%, while the rail industry rate of return was only 1%.³

The increased competition from other modes of transportation (often government subsidized), coupled with a regulatory system that denied railroads the rate flexibility needed to meet that competition, resulted in a precarious financial situation for the industry. Between 1970 and 1980, nearly a dozen major railroads went bankrupt.⁴ Congress recognized that these were "symptoms of a system that is not working well" and pointed to the need for a "comprehensive approach for changing the economic environment in which railroads must do business."⁵ The Senate likewise recognized that "railroads cannot function without constant large infusions of capital" and that "[t]he ability to get capital depends on profitability."⁶ The railroads' historical response to inadequate financial returns had been to defer maintenance and delay capital expenditures for roadway and equipment. As a result by 1979 there were slow orders on 47,200

² S. Rep. No. 96-470, at 4 (1979).

³ Hearing on H.R. 4570 Before the Subcomm. On Transportation and Commerce, 96th Cong. 127 (1979) (testimony of William Dempsey).

⁴ 126 Cong. Rec. 17788 (1980).

⁵ 126 Cong. Rec. 17788 (1980).

⁶ S. Rep. No. 96-470, at 3 (1979).

miles of track, leading to deterioration of the quality of service and the resulting loss of business.⁷

Part of the problem was that rail expansion during the early years of the twentieth century had been "too extensive" resulting in "excess capacity and extensive duplication of competitive lines, both rural and urban."⁸ Unfortunately, the pre-Staggers regulatory scheme inhibited carriers from taking steps to restructure their systems by disposing of redundant and light density lines. Consequently, "America enter[ed] the 1980's with a rail system weakened by nearly \$4 billion in deferred maintenance. [Locomotive] [p]ower shortages and railbed deterioration touch[ed] every region of the country, and even on their main lines, few railroads c[ould] maintain the operation speed they were accustomed to just three decades [earlier]."⁹

Most observers recognized that the regulatory system that had developed over the past century was in large part responsible for the failing financial condition of the railroad industry. The combination of pervasive rate regulation and stringent abandonment standards hindered railroad management from responding to market signals. Congress recognized that unless the regulatory structure was dramatically changed to give railroads the freedom to compete in the marketplace, the country would be faced with more railroad bankruptcies and/or heavy federal subsidies, including the possible nationalization of the railroads.¹⁰

⁷ *Id.*

⁸ *Id.* at 5.

⁹ 126 Cong. Rec. 7273 (1980).

¹⁰ 126 Cong. Rec. 17786 (1980).

B. Staggers Encouraged Rail Network Rationalization And The Elimination Of Excess Capacity

In addition to providing railroads with new pricing freedoms, discussed below, the Staggers Act revised the regulatory scheme to permit railroads to more quickly and easily abandon unprofitable or light density lines. The Staggers Act also encouraged the ICC to exempt from cumbersome regulatory proceedings transactions that were of limited scope and where protection against market abuse was not needed. This significantly reduced the time and expense associated with the abandonment process. In addition, the Act relaxed the requirements for showing that an abandonment was consistent with the public convenience and necessity. In calculating the full cost of a line, railroads were allowed to include the opportunity cost associated with the line by demonstrating that the maintenance and operating monies allocated to the line could be allocated more efficiently and profitably elsewhere.

While simplifying the abandonment process, the Act also sought to preserve rail service in rural areas by encouraging line sales to shortline railroads and the development of feeder lines. These measures benefited both the shippers and the railroads as they allowed the smaller railroads to provide tailored service to shippers on light density lines, while allowing the Class I railroads to reallocate their resources to their main lines. Additional provisions encouraged the use of abandoned lines for trails and other public uses to preserve right of way for future rail use. A more flexible attitude toward rationalization of railroad systems allowed railroads to reduce redundant lines in markets that could not support multiple Class I carriers. Prior to Staggers, "slow motion abandonment [allowing the line to deteriorate] ha[d] become the only option for a carrier to get out of a market."¹¹ Congress recognized that although railroads have a common

¹¹ 126 Cong. Rec. 17790 (1980).

carrier responsibility to serve all shippers, “that common carrier responsibility is not worth much if service is so poor that shippers cannot be served.” The Staggers Act therefore promoted the feeder line development program as a “constructive alternative to slow motion or actual abandonment.”¹²

Due to the greater flexibility enjoyed by railroads under the Staggers Act, the railroad industry successfully rationalized the overbuilt system, reducing the national rail network to 143,000 route miles as of 2003, down from approximately 175,000 route miles in 1980.¹³ Meanwhile, the feeder line development program has allowed the continuation of service to many rural areas through the creation of shortline carriers. A large percentage of the more than 500 shortline railroads that exist today were formed after, and as a result of, the Staggers Act.

The efficiency initiatives encouraged by the Staggers Act contributed significantly to the improved financial performance of the industry in the years since 1980. The average rate of return on net investment for U.S. Class I railroads has risen from an annual average of 2.0 percent in the 1970s to 4.4 percent in the 1980s and 7.0 percent in the 1990s.¹⁴ By 2000, according to the Department of Labor, railroad productivity gains were outpacing those of nearly every other U. S. industry. DOL reported that rail productivity had risen 171 percent in the post-Staggers period, compared to just 10 percent in the comparable pre-Staggers period.¹⁵

¹² *Id.*

¹³ See McHallberg, *Railroads in North America*, at 32 (2004), (Chart titled “Rail Miles Owned by Class I, II and III Railroads 1830 -2001”).

¹⁴ Statement of Edward R. Hamberger Before the Canada Transportation Act Review Panel, at 5 (Oct. 6, 2000).

¹⁵ *Id.* at 4.

C. Steps Taken By BNSF And Its Predecessors to Configure their Networks More Efficiently.

It is instructive to look at the specific network rationalization initiatives undertaken by BNSF and its predecessors. In 1976, BNSF's predecessor Burlington Northern and its subsidiaries had a network system of 24,950 route miles of which 14,520 miles were main line and 10,430 miles were branch lines.¹⁶ In other words, 42 percent of the route miles of the BN system consisted of low density branch lines. At the same time, coal traffic was increasing rapidly, wearing out BN track at a much faster rate than expected, thus increasing maintenance needs. The operating and maintenance costs of branch lines drained much needed capital from BN's core main lines and critical main line maintenance was deferred.

Prompted in part by the enactment of Staggers, BN aggressively began to rationalize its system. Between 1980 and 1985, BN abandoned nearly 1,900 miles of low density rail lines. In 1986 through 1987, BN abandoned another 440 miles, but its main focus during that period was the sale of lines to shortline railroads. In those years, BN transacted eight major line sales encompassing 2,749 miles of rail line. The most significant of these was the creation of Montana Rail Link in October 1987 which included more than 800 miles of former BN lines between Huntley, MT and Sandpoint, ID. That same year, BN spun off 655 miles to the Red River Valley & Western Railroad. In all, since 1980, BNSF and its predecessors have abandoned or spun off over 20,000 miles of low density rail lines.

Through these lines sales and abandonments BNSF reduced maintenance and operating costs and freed up money for increased maintenance and capacity improvements on its core main lines. By focusing on long-haul, high-density routes, BNSF was able to operate more efficiently.

¹⁶ *Burlington Northern, Inc. - Control and Merger - St. Louis-San Francisco Ry. Co.*, 360 I.C.C. 788, 1980 ICC LEXIS 104, *15.

The sale of lines to shortline carriers provided multiple benefits. BNSF benefited by being able to reallocate resources from branch lines to its main lines, while in many cases retaining the customers on the low density lines for the long-haul portion of movements over its core lines. Shippers benefited by receiving service from shortline carriers tailored to their specific needs, with improved long-haul service by BNSF and its predecessors over core traffic corridors.

BNSF has also taken steps in the post-Staggers era to rationalize its equipment ownership and utilization. In 1981, BN and ATSF owned combined locomotive fleets of 5,288 locomotives, and moved an average of 44.2 million ton-miles of freight per locomotive on an annual basis. In 2004, BNSF operated a slightly larger (by 2 percent) fleet of 5,377 more efficient locomotives which moved an average of 106.1 million ton-miles of freight per locomotive, an increase of 140 percent.¹⁷

BNSF has achieved substantial productivity gains in the use of rail cars in the post-Staggers era. Between 1981 and 2004, the number of tons per railcar transported by the BNSF fleet increased 215 percent. This dramatic improvement in railcar productivity has resulted from both investment and marketing initiatives, as well as more efficient rail operations. With respect to investment, BNSF replaced outdated equipment with new equipment with greater carrying capacity for grain and intermodal traffic.¹⁸ It also invested in the development of a prototype for a light weight, high capacity, articulated coal car known as a trough car to improve hauling capacity.¹⁹ In addition, BNSF encouraged the cooperation of shippers to achieve mutually beneficial changes in equipment utilization. This included giving incentives to coal shippers to

¹⁷ *Id.*

¹⁸ BNSF Annual Report, at 6 (1990A).

¹⁹ BNSF Annual Report, at 11 (1990A).

supply their own trainsets for dedicated unit coal trains, thereby ensuring the availability of equipment.

Between 2000 and the last quarter of 2005, BNSF has aggressively modernized and increased the capacity of its covered hopper fleet used to transport grain. The size of the active hopper fleet will grow to over 28,000 cars by the end of this year. All of the new hopper car fleet consists of high capacity cars with state of the art hatch covers. The combined effect of the growth in number of cars and growth in capacity of the cars means that the total carrying capacity of the fleet has increased by 12 percent.

BNSF also promotes better utilization of the grain car fleet through marketing innovations, such as the Certificate of Transportation (COT) program. The COT program offers future transportation capacity on specified movements of grain and related products to any shipper seeking guaranteed rail service. COT prices are established through competitive bidding, and the purchased certificates are negotiable. The auction mechanism allows the market place to efficiently allocate capacity to the corridors and commodities with the greatest demand.

While network rationalization entails downsizing on some portions of the network, the goal is to create the most productive network overall, which also involves making investments to streamline flows over high volume portions of the system. BNSF has made major investments in its premier transcontinental routes and in intermodal yards across the system to facilitate the growth in intermodal traffic. We have also continued to invest in our Powder River Basin lines and terminals to facilitate the continued growth of coal traffic.

D. The Role Of Mergers In Rationalizing The National Rail Network

Prior to the Staggers Act, regulatory procedures governing rail consolidations constituted another restraint on the ability of railroads to rationalize their networks. Railroad merger

procedures were cumbersome and many cases languished before the agency for years. In the Staggers Act, Congress signaled its intent that the ICC should develop regulations that would promote efficient consolidations, so long as competition, access to essential service, and other public interest goals were not compromised.²⁰ The ICC responded by promulgating new merger rules. It acknowledged that "[t]he basic standard is that 'we shall approve and authorize a transaction . . . when [we] find the transaction is consistent with the public interest.' Section 11343(c)."²¹

The Staggers Act also promoted infrastructure rationalization by limiting the scope of regulatory review of rail consolidation transactions that do not involve the merger or control of two or more Class I railroads. Whereas the prior regulations required the ICC to consider the same broad public interest standard in minor transactions as applied to the largest and most significant rail restructuring proposals, the Staggers Act expressly directed the ICC to approve any transaction not involving the merger or control of two or more Class I railroads unless "as a result of the transaction, there is likely to be substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States"²²

Congress further facilitated mergers by imposing statutory time requirements to ensure expeditious handling, and established even more expedited schedules for smaller transactions.²³

²⁰ See e.g., *Major Rail Consolidation Procedures*, 4 S.T.B. 570 (2000).

²¹ *Railroad Consolidation Procedures Expedited Processing*, 363 I.C.C. 767 (1980).

²² See *Former*, 49 U.S.C. 11344(d).

²³ The Conference Committee report stressed that the statutory deadlines for consolidation proceedings "are, of course, maximum time limits and the Committee believes that

Rail consolidations in the post-Staggers era have led to the creation of fewer, but stronger Class I carriers offering longer, more efficient single-line routes to our customers. In 1980, there were 36 Class I railroads. They had \$26 billion in freight revenue and handled 22 million carloads of freight. They had an operating ratio of 95 percent, meaning that they had 5 cents of every dollar leftover after deducting expenses from revenue. Capital expenditures totaled \$3.3 billion for the year. Return on net investment was 4.2 percent. Seventeen percent of the carriers had negative net income, or losses.²⁴

In 2004, there were seven Class I railroads. They had \$39 billion in freight revenue and handled 30 million carloads of freight. Their operating ratio averaged 86.7 percent, a significant improvement over 1980. Capital expenditures had more than doubled to \$7 billion. Return on net investment had grown to 6.65 percent.²⁵

In its own post-Staggers experience, BNSF benefited from significant mergers of predecessors in 1980 and 1995. The 1980 merger of Burlington Northern and the St. Louis and San Francisco Railway (Frisco) promoted increased efficiency through a 13 percent reduction in the number of employees, the closing of 660 miles of unprofitable branch lines, shop consolidations, inventory reductions, the mechanization of inspection and repair forces and the adoption of a fuel conservation program.²⁶

The 1995 merger of BN and ATSF resulted in a 32 percent improvement in operating income over 1994 and an operating ratio of 80.7 percent, down from 84.5 percent. Cost savings

many applications can and should be processed without taking the full amount of time allowed." H.R. Rep. No. 96-1430, at 120 (1980).

²⁴ Rose, Matt, Remarks at Department of Transportation Salon at 3 (2005).

²⁵ *Id.* at 4.

²⁶ BN Financial Information, at 4 (January 1982).

were achieved through elimination of 3,000 positions, disposition of about 4,000 miles of low-density track in 14 states, and the closing of unnecessary offices and facilities. Most important, the BN/ATSF merger enabled us to bring our customers the benefits of a more efficient route structure, a continued decline in rates and increased productivity.

In the three full years after the Burlington Northern/ATSF merger, BNSF spent an unprecedented \$7.1 billion on capital programs in an effort to realize the potential of the new network. At the same time, the company brought its debt/equity ratio down to 41.9 percent from 46 percent and by 1998 achieved an operating ratio of 75.9 percent.²⁷

E. The Emerging Need for Additional Rail Capacity

While a major emphasis over the past 25 years has been on the rationalization of excess capacity, the rail industry is now on the cusp of significant change. Excess capacity has largely been shed. The new networks forged in the post-Staggers era are in need of capacity enhancements to meet current and projected growth in demand for consistently reliable rail service.

In 2004, fueled by the expanding economy, growth in international trade, and bumper grain harvests, rail traffic reached all time highs, raising concerns as to whether the industry would be able to meet the surge. However, actions taken by the railroads to increase capacity or manage demand were successful in avoiding serious service disruptions. Those actions included the hiring and training of additional personnel, the purchase or lease of new equipment, changes in operations that would allow more efficient use of equipment (such as consolidating shipments,

²⁷ Kaufman, Lawrence H., *BNSF's Krebs: "It's grow or die"*, RailAge, June Highlights 1999, <http://www.railwayage.com/june99/growordie.html>..

increasing train size, etc.) and some rate increases to bring the supply of rail service into balance with demand.²⁸

As we look forward, there is reason to believe that the demand for rail service will increase, particularly in the intermodal segment where BNSF has been experiencing record volume. The railroads are more fuel efficient and environmentally friendly than trucks. Highway capacity is constrained in many areas and driver shortages for long-haul truck movements persist. The rail industry will not be able to meet the demands of additional traffic without substantial capital investment in new rail capacity.

II. The Role of the Staggers Act in Promoting Competition

Prior to the Staggers Act, railroads were hobbled in their ability to compete among themselves and with other modes by pervasive ICC rate regulation. Burdened by a regime of universal tariff filings with rates that did not reflect the demand for or value of service, railroads were unable to respond promptly to market signals. They lost out to truckers time and again in the competitive battle to transport high value consumer products.

A. The Post-Staggers Reliance on Market Forces

In many ways, the Staggers Act freed the railroads to function like ordinary businesses, subject to economic forces and possessing the flexibility to respond rationally to those forces. The Staggers Act granted railroads much greater freedom over pricing and other terms governing interactions with shippers. Railroads were permitted to set rates in the first instance, and those rates could only be challenged if revenues exceeded variable costs by a substantial margin.²⁹

²⁸ Cong. Budget Office, *Freight Rail Transportation: A Review of the 2004 Experience* 4 (2005).

²⁹ 49 U.S.C. §§ 10702, 10707.

Railroads were now free to enter into transportation contracts with shippers, with transportation under such contracts outside the scope of ICC jurisdiction.³⁰ The ICC was encouraged to exempt classes of transportation and commodities from regulation entirely if it determined that doing so was consistent with national transportation policy and that continued regulation was not necessary to protect shippers from market power abuse.³¹ In short, decision-making was largely turned over to market participants acting in response to market forces.

The Staggers Act's reliance on market forces rather than regulatory solutions has been critical to improvements in the financial health of railroads. The added flexibility to respond to market conditions, to charge prices that reflect the shipper's demand for the service and to negotiate suitable contractual arrangements driven by the commercial interests of the parties have allowed railroads to make progress toward revenue adequacy.

The pricing freedoms introduced by the Staggers Act were based on a recognition of the distinct cost structure of the rail industry and the differing demand for rail service in different markets and on the part of different shippers. The capital intensive nature of railroads and the existence of economies of density in the industry means that the high fixed costs of railroads are not recoverable when competition limits railroads' ability to charge rates significantly above marginal cost. Unless railroads have the pricing flexibility to recover their fixed (and unattributable) costs from those shippers whose level of demand justifies a significant mark-up over directly attributable costs, it is impossible for railroads to earn revenues adequate to maintain and enhance their networks.

³⁰ 49 U.S.C. § 10709.

³¹ 49 U.S.C. § 10502.

Since the enactment of Staggers, the ICC, and subsequently the STB, have repeatedly acknowledged the critical role that pricing flexibility plays in the financial health of the railroads. In formulating the *Coal Rate Guidelines*, the ICC explained that “the cost structure of the railroad industry necessitates differential pricing of rail services.”³² The ICC’s observation remains just as true today as it was twenty years ago. A regime that permits differential pricing in response to market demand benefits both shippers and railroads:

- Higher rates for shippers with demand characteristics that enable them to pay those rates, enable railroads to come closer to covering their full costs;
- Lower rates for shippers who have competitive options keep lower margin traffic on the rail network, thereby enabling all shippers to enjoy the reduced costs that result from economies of density and sharing costs across a broader group of shippers;
- Lower rates for shippers with competitive options also permit railroads to compete with those other modes of transportation, thereby benefiting shippers who use those other modes even if they do not actually ship by rail;
- Differential pricing in response to demand allocates the cost of rail service among shippers in an economically efficient manner; and
- Better financial health achieved through differential pricing increases the likelihood that railroads can attract capital to maintain and expand the rail network.

The pricing flexibility enjoyed by railroads post-Staggers is not simply a tool to promote revenue adequacy. It is more fundamentally a mechanism to allow freight transportation markets to work efficiently. As noted previously, there was serious concern last year that a surge in demand for rail transportation during the fall peak season would overwhelm the railroads, resulting in serious service disruptions. In an after-the-fact analysis of this situation, a report on the 2004 traffic surge prepared by the Congressional Budget Office concluded that the ability of

³² *Coal Rate Guidelines – Nationwide*, 1 I.C.C. 2d 520, 526 (1985).

railroads to price flexibly, and in that case to selectively raise rates, was a significant factor in moderating the economic impact of the feared crisis. Specifically, CBO found that “the freight market functioned well in the short run: price signals were sent and received, allowing the costs associated with an increase in demand to be accommodated without serious damage to the economy,”³³ and “without substantial government intervention.”³⁴ The CBO attributed the railroads’ ability to raise rates to adjust to changes in market conditions to a greater flexibility in rate-making than what railroads had under “the regulatory environment in which they once operated.”³⁵ The report concluded that “a temporary increase in demand that stretches rail capacity to its limits . . . does not imply a need for government intervention, [but] . . . simply indicate[s] a need for price increases to clear the market.”³⁶

The 2004 experience described by the CBO is a clear vindication of the congressional policy introduced in the Staggers Act “to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for rates for transportation by rail.”³⁷

B. The Board’s Role in Allowing Competition to Work Rather than Manufacturing Competition

The ascendancy of market forces in the post-Staggers era has entailed a concomitant de-emphasis of regulatory solutions to perceived problems. Shippers have complained about this, claiming that the competitive options available in the marketplace are not sufficient to constrain

³³ *Id.*

³⁴ *Id.* at 5.

³⁵ *Id.* at 13.

³⁶ *Id.* at 15.

³⁷ 49 U.S.C. § 10101(1).

rail prices to reasonable levels and that additional competition must be promoted by the regulator.

To their credit, the ICC and the Board have rejected calls to retreat from the Staggers Act's embrace of market forces. In particular, the agency has rejected demands from certain shipper interests that the Board force railroads to grant "competitive access" to their tracks and terminal facilities to other rail carriers and that the Board permit rate challenges that cover only a "bottleneck" segment of a through route. However, the shippers have not given up. As in prior years, legislation has been introduced in Congress that would reverse the Board's policy on these issues and manufacture supposedly competitive conditions rather than permitting market forces to operate without regulatory intrusion.³⁸

With respect to competitive access, the Board currently has authority to require a rail carrier to provide a through rate and route to a shipper that involves an interline move with another railroad,³⁹ to require a rail carrier to engage in "reciprocal switching" to enable a second carrier to serve an otherwise solely-served shipper,⁴⁰ and to provide access to its terminal facilities to a second carrier for the same purpose.⁴¹ The Board has been sensibly cautious in requiring any such access, however, recognizing that the Staggers Act intended to provide railroads with greater operational flexibility, including the right to make their own judgments

³⁸ H.R. 2057, *Railroad Competition Improvement and Reauthorization Act of 2005* (introduced May 3, 2005); S. 919, *Railroad Competition Act of 2005* (introduced April 27, 2005).

³⁹ 49 U.S.C. § 10705(a).

⁴⁰ 49 U.S.C. § 11102(c).

⁴¹ 49 U.S.C. § 11102(a).

about efficient routings. The Board does not grant any of these forms of access absent a showing that the incumbent carrier has engaged in anticompetitive conduct.⁴²

Such restraint makes sense for a number of reasons. First, it avoids introducing regulatory distortions (i.e., choices not driven by market forces) into the rail market that would not be present in an entirely unregulated market. In an unregulated market, the owner of an essential facility is typically not required to grant access to that facility to competitors. The Board's approach thus embraces the rules governing competition that ordinarily apply. Second, the Board's approach preserves the operational and cost efficiencies that exist when a rail carrier is able to maximize traffic density on a segment of its network and to transport that traffic using the least amount of resources. Third, the Board preserves the ability of rail carriers to engage in differential pricing when ownership of a uniquely situated facility gives them the opportunity to do so. This ability is crucial to the financial viability of the railroads.

With respect to bottlenecks, the Board has determined that shippers should not be permitted to force a carrier to quote a rate for only the bottleneck portion of a through movement and then challenge the rate for that segment, as opposed to the rate for an entire through movement.⁴³ Again, the Board's conclusion makes sense in the context of the Staggers Act goal of relying on market forces rather than regulation in the rail industry. If a railroad is capable of providing through service, either in a single-line movement or by quoting a through or proportional rate with another railroad, there is no basis for requiring the railroad to take the less

⁴² *Review of Rail Access and Competition Issues*, 3 S.T.B. 92, 97-98 (1998); 49 C.F.R. § 1144.2.

⁴³ *Central Power & Light Co. v. Southern Pac. Transp. Co.*, 1 S.T.B. 1059 (1996), *clarified*, 2 S.T.B. 235 (1997), *aff'd sub nom. MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir.), *cert. denied*, 528 U.S. 950 (1999).

economically rational and less efficient approach of providing service only over a shorter segment of the through route. Moreover, the ability of railroads to own and charge for transportation over segments where they can obtain higher rates is crucial to their ability to achieve revenue adequacy. If the Board's access and ratemaking authority were applied to eliminate opportunities for railroads to engage in differential pricing, the rail industry would likely revert to its woeful financial state of the pre-Staggers era.

There is no basis to assert that the Board's bottleneck rule gives railroads license to freely exploit shippers who require transportation across bottleneck segments. The through rate is fully subject to challenge and must be reasonable. Shippers who assert that they are entitled to something better than a reasonable rate, especially when the consequence is inefficient operations and financially distressed rail carriers, place their own short-term economic interest ahead of the broader public interest in a sound rail transportation system.

Calls for the Board to manufacture competition by overturning its competitive access and bottleneck rules seek to replace the market-based approach of Staggers -- and the differential pricing that permits railroads to survive -- with renewed regulation from a bygone era. Chairman Nober correctly observed in congressional testimony last year that the goal of those who seek such changes is to have it both ways: they want market forces to govern where market forces are advantageous to them and they want strict regulation of rates where market forces produce an unfavorable result.⁴⁴ His response was also clearly correct: "Either you have regulation the whole way or you have market based the whole way. And if you have market based the whole way, they may not like what they get charged for the last few miles. I think that's just a

⁴⁴ *Status of Railroad Economic Regulation: Hearing Before the Subcomm. on Railroads of the H. Comm. on Transportation and Infrastructure*, 108th Cong. 14 (2004) (testimony of Roger Nober, Chairman, STB).

fundamental principle of how the railroads work.”⁴⁵ No other approach is viable because if railroads are deprived, by regulation, of the opportunity to earn adequate returns based on market forces, regulation will also be required to allow them to earn adequate revenues by some other means.

C. Railroads Will Invest to Promote Sustainable Competition

The true story of Staggers deregulation is that manufactured competition, propped up by regulation, is neither necessary nor socially desirable. Where markets present the opportunity for profitable rail-to-rail competition, railroads will invest in the facilities they need to compete. BNSF’s proposal to build a rail spur into the Bayport Loop near Houston to serve several industrial customers already served by another Class I railroad is just one example. Although the actual build-in, BNSF’s preferred approach, did not occur due to litigation delays, BNSF’s willingness and ability to invest in the new line was a sufficiently viable competitive alternative to lead to a trackage rights agreement that now provides BNSF access to the Loop. While the trackage rights approach was a less economically favorable outcome to BNSF and its customers, it did provide those customers with access to a second railroad.

Bayport is not an isolated example. Build outs by coal-fired generating plants (and the threat of build outs) are an ever present competitive force as well as an opportunity to pursue new markets. To cite just a few examples over the last decade, Sunflower Electric obtained a conditional exemption pending environmental review to construct and operate a spur that would give its Holcomb plant access to UP as well as BNSF. In 1999, Texas Utilities completed an 18 mile spur that connected its Big Brown plant to BNSF’s lines. And in the mid-1990s, Central &

⁴⁵ *Id.*

South West Corporation completed a 12-mile spur to its Public Service Company of Oklahoma Northeastern plant in Oologah, Oklahoma. These examples demonstrate that under the Staggers Act regime railroads and their shipper partners will pursue new competitive opportunities.

Building into Bayport made business sense to BNSF because we judged there was enough traffic there to be carried at profitable rates to support the operation of both BNSF and its competitor. In other situations, we might make the judgment that there is not sufficient traffic available to put our capital at risk. These decisions are properly dictated by the circumstances of particular markets.

III. The Board Should Promote Revenue Adequacy Even More Vigorously in Light of the Need for Investment in Additional Capacity

As I noted earlier, our industry has reached the point at which we will need to invest in more rail capacity to meet the demands of our customers. I believe that the industry has the will to make the investments. The question is whether we can realize the returns that justify the investments. The question is a vexing one. I read with interest Chairman Nober's testimony of March 31, 2004 before the House Committee on Transportation and Infrastructure to the effect that the railroads face a "conundrum" as regards capacity and investment:

The service railroads provide and the rates they charge customers are directly limited by the capacity and reliability of their network. To increase their business or to charge premium prices, railroads must improve services. But, they can only improve service if they increase their capital investments. Railroads cannot increase infrastructure spending because they are not earning their cost of capital. To earn their cost of capital and be revenue adequate, railroads must increase their revenues, which are limited due to the

condition of their networks. And thus the problem comes full circle.⁴⁶

I do not know whether Chairman Nober's views have changed in the year and a half that has elapsed since these remarks, or whether the problem seems as intractable as it did at the time. Perhaps the relatively successful experience of 2004 provides some cause for optimism for the industry as a whole.

At BNSF, we are optimistic. We have not yet achieved revenue adequacy, but we believe it is in sight, and we believe that we can justify investments in additional capacity. To achieve these goals, we must do three things:

- (1) Provide the best service we can with the resources that are available;
- (2) Increase our prices where the value of the service we provide and demand for those services justify such increase; and
- (3) Preserve the market-based impetus of Staggers and defeat calls for reregulation.

I would like to elaborate somewhat on the third point, because it is the one that most directly implicates the Board, both in its exercise of its regulatory responsibilities and in its interactions with Congress on these issues. First, the Board must stand firm in its refusal to change its existing policies in response to calls for enhanced, i.e., manufactured, competition. Second, the Board must be careful not to impair BNSF's prospects of achieving revenue adequacy through rate regulation.

When I speak of rate regulation, I refer in particular to coal rate cases, several of which involving BNSF are still pending before the Board. Because of the huge amounts at stake in

⁴⁶ Testimony of Roger Nober Before the House Committee Transportation and Infrastructure Subcommittee on Railroads, Hearing on the Status of Railroad Economic Regulation, March 31, 2004, p. 13.

individual cases, there is a real danger here that an over-zealous or inappropriate application of maximum rate standards could impair our prospects of attaining revenue adequacy. Earlier this year, I offered testimony on behalf of BNSF in Ex Parte No. 657. BNSF supported what it understood to be the Board's inclination to reopen the *Coal Rate Guidelines* to make sure that they were being applied consistent with their original purposes and with the Board's obligation to take revenue adequacy into account in individual rate cases.

The Board's maximum rate authority should not be used to prevent BNSF from earning the revenues needed to maintain and expand the railroad network. That, of course, cannot happen with intermodal traffic, which is unregulated. As demand for our intermodal traffic has increased over the last year, the rates on that traffic have gone up, as they should have. The increased revenues support additional investments in our intermodal network. We need increased revenues in the regulated coal segment of our business as well, particularly since the coal business consumes so much of our capital. As coal demand increases, the need for additional capacity in our coal network is greater than ever. BNSF has historically reinvested large portions of its revenues in coal infrastructure, so any artificial limits on the revenues BNSF can earn will only reduce the investments we are able to make. The entire community of coal shippers that we serve would be adversely affected.

Coal shippers have been the beneficiaries of our capital infrastructure investments. From 1994 through 2004, BNSF invested \$2.4 billion in coal-related capacity. BNSF is investing another \$216 million this year alone in coal capacity. In 2004 and 2005, BNSF will have acquired 23 additional coal train sets and 117 AC locomotives for our coal shippers. A triple-track expansion of the Joint Line in the PRB between Walker and Shawnee will be completed by

the end of this year. In addition, we have expended millions of dollars on PRB line maintenance over the last several months due to the coal dust and flooding problems that arose last May.

The need for capital investments in coal-related capacity is growing at a fast pace. The Department of Energy's EIA estimates that western coal production will increase 350 million tons from 2002 to 2025. Eighty percent of that new coal production will come from the PRB. BNSF expects that this will result in 26 additional trainloads of PRB coal per day. Substantial new capital expenditures will be needed to meet this tremendous growth. BNSF estimates that it will need to spend between \$500 and \$800 million expanding track and terminal capacity to handle this increased coal traffic. BNSF will need to spend between \$1 billion and \$1.2 billion on additional AC locomotives and between \$1.2 and \$1.3 billion on additional aluminum trainsets.

The Board must protect the interests of all coal shippers in having a rail network capable of meeting this growing demand. BNSF therefore urges the Board to apply its rate reasonableness standards in a way that protects legitimate claims by shippers without becoming an obstacle to the necessary expansion of the rail network.

Conclusion

The Staggers Act has been a success story. It promoted market oriented behavior that resulted in more efficient and financially healthier railroads. Individual customers and the public generally have benefited from a stronger national rail network. Now, to meet growing demand for rail service, we must do more, both in terms of providing better quality service and in terms of expanding the capacity of the rail network. Achievement of these goals requires massive capital investments, and the investments will only be made if railroads realize adequate returns

on the investments they have already made. I urge the Board to pursue a policy that promotes such investments and to resist any calls to turn back the clock.