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Linking Logistics to Profitability

214906

Sandra J. Dearden, President

October 12, 2005

Surface Transportation Board
ATTN: STB Ex Parte 658
1925 K Street, NW
Washington, DC 20423-0001

RE: Docket Ex Parte 658
THE 25TH ANNIVERSARY OF THE STAGGERS RAIL
ACT OF 1980: A REVIEW AND LOOK AHEAD

Attached please find the testimony that I have prepared for presentation at the hearing scheduled to begin at 10:00 a.m. on Wednesday, October 19, 2005, at the Surface Transportation Board offices in Washington, DC., to provide a forum for the expression of views on the impact, effectiveness, and future of the Staggers Act.

We appreciate the opportunity to participate in this very important proceeding.

Sincerely,


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Enc.

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BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE 658

THE 25TH ANNIVERSARY OF THE STAGGERS RAIL ACT OF 1980:
A REVIEW AND LOOK AHEAD

VERIFIED STATEMENT
OF
SANDRA J. DEARDEN

My name is Sandra J. Dearden, President of HIGHROAD Consulting, Ltd., a transportation and logistics consulting firm with offices at 29 South LaSalle Street, Chicago, Illinois.

HIGHROAD is a full-service transportation and logistics consulting firm founded in 1996. We have consultants with senior management and middle management line experience in all modes of domestic and international transportation and logistics. However, it seems we have developed a niche because of our knowledge and experience in rail transportation; more than sixty percent of our revenues come from rail related projects. We have a diverse client base that includes shippers and railroads. Today, I am representing the views of some of my clients that are rail customers.

Prior to starting HIGHROAD, I spent 26 years in the railroad industry; my most recent position was General Manager - Marketing and Sales of a strategic business unit at Chicago & North Western Transportation Company.

In this verified statement, I will discuss the impact on businesses in the United States since the Staggers Rail Act was enacted, and I will offer some suggestions for changes to be considered, which will improve the Staggers Act and enhance the role of the Surface Transportation Board.

THE STAGGERS RAIL ACT HAS HELPED THE U. S. ECONOMY.

Rail customers and the railroad industry have realized benefits from the Staggers Rail Act, which gave the railroads the right to establish rate and service agreements with rail customers. Railroad marketing personnel, myself included, responded enthusiastically to the opportunity to work in partnership with customers to develop markets and on supply chain initiatives. High volume business with major customers was confirmed in multi-year contracts; some with terms as long as twenty years. Because of the long term contracts, rail customers initiated long range planning and committed capital to their transportation and supply chain infrastructures, feeling confident that they were assured certain rate and service levels. At the same time, the railroads also invested capital for equipment, track and yards, knowing the business would be there to cost-justify their investments. This was good for the railroads, the rail customers, and our economy.

Post-Staggers was a fun environment to work in for people in the rail industry. We were operating in a new entrepreneurial business environment, and we formed cross functional teams that applied *out-of-the-box* thinking to our planning processes. Examples of team initiatives included alternative route analyses and strategic allocation of assets. These initiatives, in addition to new labor agreements negotiated by the railroads, resulted in improved productivity and reduced costs, enhancing the railroads' ability to compete. The primary focus of railroad management personnel was on contribution growth and today, while there is significant room for improvement, the railroad industry is healthy and profitable.

THE IMPACT OF RAIL MERGERS/PRICING PRACTICES/SERVICE ISSUES.

I believe that many of the problems that we face today have developed because the rationalization of the rail industry has simply gone too far. The super sized railroads are so big and bureaucratic it seems they can not respond quickly to problems and opportunities. Railroad operations are sluggish, which contributes to

increased costs. This has also impacted on the rail customers' operating and supply chain costs, as customers have realized increased costs due to plant shutdowns, labor costs associated with service failures, or from emergency trucking required to keep plants open. Some rail customers have increased the size of their private railcar fleets, which increases their costs and adds more cars to the congested system.

One of our clients has 3,500 tank cars. Although his company's increased car costs associated with inefficient rail operations was documented and significant, two railroads declined his company's invoices to recover some of the costs on the basis there were no service commitments in the contracts. Shippers are not allowed to function on a level playing field – while they are required to pay demurrage when cars owned by the railroads are not unloaded and released on a timely basis, there are no measurements or processes in place that allows rail customers to collect when railroads do not handle their private cars with reasonable dispatch.

Currently, the STB has a new process to arbitrate disputes between shippers and carriers regarding service failures; however, the STB does not currently have the authority to mandate and enforce solutions. The term, "*reasonable dispatch*", needs to be defined and a process developed that is fair but not administratively burdensome, giving the customers recourse in those situations where abuse of the private equipment has been repetitive and significant.

Another problem that contributes to the cost increases incurred by shippers that move their products in private cars, is out-of-route movement of empty cars, which results in charges for *excess empty miles*. Mileages for some of the empty moves are more than 200% higher than those for the loaded moves, due to the railroad's choice of the return route for the empty car. These problems are compounded by a high incidence of railroad reporting errors – one example was an empty move from Chicago to Joliet, IL; mileage reported for that empty move by the

railroad was 444 miles. When challenged, the railroads have worked with us to address the problems, and we have succeeded in mitigating charges for excess empty miles by more than 80%. However, it has been our experience that we need to call attention to these moves, even though they often present opportunities for the railroads to improve efficiency of operations and to free up capacity. While this is not a problem to be addressed in the legislation discussed here, it is a symptom of an even bigger problem, i.e., the lessening of competition and that would present an incentive for railroads to improve the efficiency of operations.

Instead, the railroads' response to their high costs and capacity problems is to simply pass the problems through to the customers, increasing rates and accessorial fees, and in some cases, announcing new accessorial charges. Railroads submit that rail rates have declined substantially since the Staggers Rail Act was passed. However, I submit that this is somewhat misleading since rates established in contracts and tariffs for shipments in private cars, in most cases, are exclusive of mileage compensation. Therefore, comparisons of pre-Staggers versus post-Staggers rates and revenues do not present an accurate picture.

Currently, the railroads appear to be out of control with their pricing practices, demanding double digit increases in addition to double digit fuel surcharges and increased rates for accessorial charges. Further, they have been very aggressive, transitioning rates from contracts to tariffs - possibly with the motive to establish the ability to announce and implement increases on rates and charges on short notice.

The impact of railroad pricing policies and tactics on manufacturers in North America has been very significant and there is a saturation point. A chemical manufacturer, as an example, faces increased rates and fuel surcharges, not only on their finished products, but also on their inbound raw materials. Compiled, the fuel surcharges alone can increase costs by more than 30%. For a manufacturer with a

\$140 million rail spend, double digit fuel surcharges equate to big dollars – at 10%, he is paying \$14 million and at 16%, more than \$22 million annually. While we acknowledge the fact that fuel costs have increased, the data reported by the railroads in the R-1 reports support our position that fuel surcharges have become profit centers for the railroads. This causes one to question, what is fair and reasonable? We submit that these surcharges and accessorial charges should be subject to challenge and part of the rate reasonableness guidelines and processes.

Many of these rail customers have sales contracts with their customers, limiting their ability to pass all or some of the cost increases through to their customers. Further, because increases and charges are announced on short notice, the rail customers have no way to anticipate their rail rates and related transportation costs. Even if the manufacturers have the ability and decide to pass the increases through, it's like passing along a deadly virus because you know that in the end, some businesses will fail or they will look to other areas to reduce costs, such as workforce reductions. It seems to me, with the lessening of rail-to-rail competition, we have lost ground – that the rail customers are being forced back into the same business environment that existed prior to deregulation when they could not anticipate costs or have the ability to rely on rail service. This is a serious concern that could have a negative impact on the economy in the United States, as some manufacturers will stop investing in their supply chains, or they will shift more production and jobs to Mexico and offshore.

Another developing problem, that is not uncommon, is many rail customers have been caught unaware, and signed rail contracts that include contract rates that are higher than the published tariff rates. Prior to Staggers, it was established that the customer was entitled to the lowest applicable rate. However, because the contract rates are not under the jurisdiction of the STB, attorneys have advised that

the only recourse is a court proceeding and, to my knowledge, the subject has not been tested.

It has been our experience that the higher contract rates are not subject to any special commitments on the part of the railroads, such as service or car supply commitments, which leads us to believe that the mistakes occurred because of the inexperience of the people involved. We have been successful collecting overcharge claims but it is not a cakewalk. One railroad marketing representative acknowledged the contract rates were published in error, but offered no apology, and he defended his company's right to establish higher rates in contracts. Ultimately, an agreement was negotiated and the railroad paid, but only part of the claim. This is unconscionable - their contention that they should have the right to charge a customer who has committed volumes in a contract, rates that are higher than those published in open tariffs for the general public (with no volume commitments), defies logic and good business ethics. Granted, the contract rate is not under the jurisdiction of the STB; however, the tariff rates are. Therefore, it seems the STB should have the ability to enforce application of lower tariff rates when these mistakes occur. What we need are some common sense changes to the legislation defining the rules.

In numerous past proceedings before the STB and its predecessor agency, the Interstate Commerce Commission, the railroads have demonstrated that competition exists, pointing to the need to compete with other modes, and there have been instances when that was a valid argument. However, the landscape of the transportation industry has changed significantly in recent years, and what may have been valid in the past, does not necessarily apply today.

First of all, the United States Department of Transportation is forecasting that freight will double in the United States by the year 2020. The transportation infrastructure in the United States is already capacity challenged; there is a serious

shortage of drivers and the trucking industry is facing new hours of service regulations, which is limiting the motor carriers' ability to compete with the rail carriers.

Also, starting in the early 80's when the railroads started contracting with shippers, major rail customers committed the preponderance of their volumes to their respective *preferred rail carriers*. These contracts included rates for all of the customers' shipments to destinations that are rail served. In some cases, truck rates might have been lower than some of the rail rates in the contracts; however, because of the volumes committed, and the fact that the customer realizes a cost benefit from the total package, shipments still moved rail in those lanes even though the truck rates are lower. This underscores the need for rail-to-rail competition.

One example is the loss of rail-to-rail competition on shipments from Western Canada to destinations in the United States. Prior to the series of rail mergers, Canadian producers that are served by two railroads had numerous routing options to destinations beyond Chicago:

- CP - SOO - Chicago - connection
- CN - BNSF - Chicago - connection
- CN - CNW - Chicago - connection
- CN - MILW - Chicago - connection

Further, during peak seasons, some U.S. railroads connecting with the Canadian carriers assisted with equipment supply. Today, three competitors have been eliminated from the routes and the business is moving CP to Chicago, or CN direct to Chicago (or even to Memphis or the Gulf), and car supply and service is a major concern. We know that we cannot go back and reverse rail mergers, but we need to find a way to redefine and confirm the term, "*Competition*".

THE IMPACT OF TOTAL DEREGULATION OF SOME COMMODITIES AND SHIPMENT TYPES.

When the Staggers Rail Act was passed, some commodities and shipment types were totally deregulated and are no longer under the jurisdiction of the Surface

Transportation Board (STB). On the surface, coming out of a regulated environment, this seemed positive as railroads had new pricing freedom and they no longer were restricted, for example, by filing regulations. However, we are now realizing the pitfalls.

Because the STB has no jurisdiction, shippers of the deregulated shipments have no assurance they will continue to receive rail service or reasonable rates. What is key is the fact that the railroads have no common carrier obligation¹ to provide cars, service or rates for these shipments, and the STB's hands are tied because they cannot legally intervene.

For example, one of the deregulated business segments is boxcars. The railroads have been aggressive with their initiatives to divert consumer products to intermodal; the general service boxcar fleet has declined, and most railroads are not replacing those cars. While this makes sense for some products that are light density, such as boxes of cereal, some commodities shipped in boxcars, such as brick, are heavy and subject to damage with numerous transfers. Further, it takes four containers or trailers to handle the number of brick that is loaded in 50-foot boxcars. Earlier this year, an intermodal marketing company convinced our client to initiate some test shipments of brick via intermodal; the costs for the intermodal shipments were 80% higher than the boxcar rate. Therefore, intermodal is not practical for shipments of brick.

These rail customers should be afforded the same protection at the STB as other rail customers. They should have the right to access STB processes, and to challenge issues such as rate reasonableness and common carrier obligation.

¹ ICC Termination Act of 1995, §11101. Common carrier transportation, service and rates.

SOME RAILROADS ARE DIRECTING MARKETS

Of significance is the fact that some railroads are directing markets, in some cases totally freezing some customers out of markets. Let me share a story from my days at North Western. One of my counterparts at another railroad told me he planned to allow Customer A to have the business in Ohio, and Customer B to have the business in Georgia. I responded, "wait - time out! I don't want to talk about this. Don't you think it is wrong to decide where your customers can and cannot do business?" He said, "maybe, but if I can make more money in Ohio with Customer A, then I will do it."

One of the services HIGHROAD provides to its clients is rail benchmarking studies. Several times when developing and analyzing the data, we could only conclude that the railroad(s) were pricing to exclude some customers from the ability to compete in certain destination markets. For example, when performing a study in 2000, we could not find any records for shipments of grain from Montana and North Dakota to the southwestern feed market, even though we thought that would be a logical market for those grain producing origins.

Because of my railroad marketing background, I am sensitive to the fact that the marketing personnel are charged with representing their companies; they have budgets and are accountable for improving revenues and profits. However, at what point do they cross the line - when does that focus on contribution growth and excluding customers from markets become a violation of anti-trust laws? The reason we are here today is we have all been experiencing a learning curve during the past 25 years. I believe this hearing is a great opportunity to present issues and to seek solutions. Is this an issue that should be under the jurisdiction of the STB, should the rules be defined, or is this an issue to be addressed with the Department of Justice?

RULES ARE VAGUE; PUBLICATIONS ARE NOT MONITORED FOR LEGAL COMPLIANCE

There are numerous examples that could be cited; I will focus on only two.

Now that there are only seven Class I railroads, the railroads contend they do not plan to initiate any new mergers. However, they all seem to have selected "*partners*", and they are open about the fact they are operating under various "*marketing agreements*". In many cases, these agreements have not been presented for review by the STB, even though they often result in the elimination or reduction of rail-to-rail competition.

One example involves an agreement that was established in 1992, along with related and questionable changes that were published in the Open & Prepay Tariff. While the agreement and tariff changes were made 13 years ago, long before Canadian National (CN) acquired Wisconsin Central, Ltd., it serves as a significant example of what seemed to be a disregard for rules, and our need for an attentive STB.

The tariff changes were published concurrent with CN's reported agreement with Burlington Northern (BN), so CN could market direct to Chicago and to Minneapolis/St. Paul under the CN North American route. Again, it was not clear if the agreement between CN and BN was a "*haulage*" agreement, a trackage rights agreement, or a Voluntary Coordination Agreement ("VCA"), because the agreement was not reviewed or approved by the STB. Similar agreements established by other carriers have been given full review by the ICC or STB, allowing other carriers and shippers the opportunity to file statements in support of, or in opposition to the agreement.

This was not the case with the CN/BN agreement, so the only people who knew all of the facts and the decisions regarding any intention to use a legal method to use to initiate the agreement, are those who were directly involved at CN and BN.

Therefore, the questions outlined herein, while valid, are based solely on pieces of information received from the unique tariff amendments to the Open & Prepay Tariff.

Tariff ICC-OPSL-6000M, was first amended in Supplement 23, effective December 1, 1992, when Grand Trunk Western (GTW) added stations under the heading, "Haulage Stations." Stations listed were:

Chicago (31st St.), IL
Cicero, IL
Savannah, IL
LaCrosse, WI
St. Croix, MN
Northtown, MN
Coon Creek, MN
Superior, WI

Stations added were made subject to Note 5 of the tariff, which states these are for passing tracks only, no freight handled. All of the stations, except Northtown and Coon Creek, MN were previously listed in the tariff as stations served by BN. Even though we know the BN tracks pass through Northtown and Coon Creek, it seemed strange, to say the least, to have two new rail stations in Minnesota published in the tariff, and shown as served by GTW! Also, it was difficult to understand the reasoning behind listing stations such as LaCrosse, WI and Savannah, IL, if the intent of the haulage agreement was to cover shipments to Chicago and Minneapolis/St. Paul. Later, the tariff was further amended adding BN as a serving carrier at Northtown and Coon Creek, so perhaps someone realized that this appeared questionable.

When the CN/BN agreement was announced in October, 1992, shippers and carriers were led to believe that this was a haulage agreement, governing shipments in the Duluth to Chicago corridor. If this indeed was the case, why were the intermediate stations included in the amendment to the tariff, which was made effective subsequent to that announcement? Further, GTW was shown as the serving carrier for two destinations in Minnesota even though Minnesota was not part

of that railroad's service territory. Since the precedent has been established, is it possible that any railroad could partner with another carrier and apply this concept to extend its marketing reach to any and all stations served by its partner in the United States, without review by the STB?

Another recent example involves the methods used by some of the railroads to announce fuel surcharges and subsequent increases. While there is no protection for shippers of deregulated commodities and shipment types, railroads are still required to provide 20 days' statutory notice of rate increases to shippers of commodities and shipment types that remain under the jurisdiction of the STB.

When the fuel surcharge programs were first announced, it seemed that some of the railroads had carefully planned their publication process to comply with the requirement to provide statutory notice, while others seemed to have overlooked or disregarded the requirement to provide statutory notice. To my knowledge, the STB does not monitor tariff or other announced changes and, therefore, did not question the methods used to implement the surcharges and subsequent increases.

COST OF STAND ALONE RAILROADS
RATE PROCEEDINGS FOR SMALL SHIPPERS
RATE REASONABLENESS
REGULATORY COSTING

A typical rate case initiated by a unit train coal shipper to challenge rate reasonableness² includes the design and staffing of a stand-alone railroad³, with a railroad is technical in nature, it is time consuming and contributes to high costs for legal and consulting fees.

² Embraced by ICC Termination Act of 1995, §10701. Standards for rates, classifications, through routes, rules and practices. §10704. Authority and criteria: classifications, rules and practices prescribed by Board.

³ STB Ex Parte No 347 (Sub-No.3). General Procedures for Presenting Evidence in Stand-Alone Rate Cases.

fictitious organization and infrastructure (buildings, etc.), that operates in a dream world, a non-competitive environment. Development and costing of a stand-alone

Currently, there is in place a "simplified" process for rate cases for non-coal proceedings⁴. Typically, design and costing of a stand alone railroad is not relevant for non-coal proceedings because the traffic in question often moves from various origins to various destinations and, therefore, is not concentrated to one route. For a number of reasons, the non-coal process has not been used extensively and tested in the Court of Appeals. Even for a non-coal proceeding, legal fees associated with presenting a rate case are significant and in many cases not practicable when measured against the volumes and relief sought.

Both processes, including the use of costs for a stand alone railroad, need to be reviewed and changes need to be made. The objective should be to streamline and improve the integrity the processes, so the system is fair and it is not cost prohibitive.

The current processes are based on the respective parties presenting their positions on the reasonableness of the rates. Generally, rates that produce a revenue-to-variable cost ratio of 180% or lower are deemed reasonable. Once again, costs in coal proceedings are based on the cost of operating a fictitious stand-alone railroad, and are calculated using Uniform Rail Costing (URCS) costs.

The URCS cost model was developed in the early 80's by the railroads, under the umbrella of the AAR, to develop a method to discuss costs legally, without violating anti-trust laws - in other words, to use in rate proceedings. However, URCS costs are generally higher and do not reflect the respective railroads' actual operating costs. If the Board confirms that rate reasonableness based on costs has merit, there is another model that is available, that is also based on the railroads'

⁴ Ex Parte No. 347 (Sub-No.2). Rate Guidelines - Non Coal Proceedings.

financial data filed in their R-1 reports, and that model is considered to be more accurate.

Railroad marketing personnel will confirm that they do not use the URCS model because it does not reflect their company's actual operating costs; then consider the fact that URCS costs are used to determine the cost of a fictitious railroad, and the current process appears to be meaningless.

RECOMMENDATIONS

The role and staff at the STB need to be enhanced. Prior to Staggers, the ICC monitored publications for legal compliance, and they responded to shipper complaints and intervened when the rules were violated. We have not seen evidence that this is occurring today. I have confidence in the people at the STB. However, the rules need to be defined and the legislation amended, so that the Commissioners can apply and enforce the rules and laws that are needed. Further, the STB should resume proactive monitoring of publications and other changes to confirm their compliance with regulations. The STB does not have adequate staff for its current workload, much less the personnel that would be required to take on the responsibility of being a watch dog agency for our industry. I respectfully submit that the impact these issues have on businesses in the United States, and their ability to be competitive in a global economy, is adequate justification to give the STB the staff or staff support required to perform this very important role.

We need to restore the business environment that existed after the Staggers Rail Act was enacted, so rail customers can be confident when selecting carriers, and committing capital for new plants, the acquisition of additional rail equipment, and for their company's supply chain and rail infrastructure. In view of the size of the organizations, whether or not the railroads can restore the entrepreneurial spirit and a drive towards excellence is a question that cannot be addressed by these proceedings. However, relationships should not be abusive and the environment

should be less adversarial. While shippers and the rail carriers may continue to disagree on some issues, we should be able to work together on problems, opportunities, and solutions.

We need some common sense rules to fill the gaps that are present in the current legislation. These include, but should not be limited to:

- Restoring the protection of common carrier obligation and rate reasonableness for all commodities and shipment types.
- Confirming a rule that the shipper is entitled to the lowest applicable rate.
- Defining reasonable dispatch and developing measurements and a process, giving the STB the authority to address repetitive service failures. The process and policy should be based on an in-depth analysis, but should include reasons and the ability for the shippers to recover costs including those for emergency trucking, plant shut downs, and additional labor costs incurred as a result of the service failures.

The process for rate proceedings needs to be revised. Any railroad marketing officer will tell you that his/her company has transitioned to market based pricing. Yet, neither process for rate proceedings includes review of industry data to determine how the rates paid by complainant compare to those paid by other rail shippers competing in the same or similar markets. The process needs to be expanded to include consideration when rail customers are being disadvantaged by railroad pricing practices that direct markets and preclude the rail customers' ability to compete.

Further, the current process only includes review of rates. In view of the significant costs incurred for accessorial fees, with double digit fuel surcharges and increases for accessorial charges, the rate reasonableness guidelines should give the complaining shippers the right to introduce all of the rates and charges assessed by the defending railroads. The railroads' financial filings should include documentation of costs to support, for example, the fuel surcharges. The terms, "*competition*" and "*rate reasonableness*" need to be re-defined to conform with today's business environment.

CONCLUSION

The Staggers Rail Act has been good for the rail industry and for our economy. However, the landscape of the rail industry has changed significantly during the past 25 years, and rail customers have felt the impact of the loss of rail-to-rail competition, so rules need to be defined and confirmed, the legislation should be changed, and the role of the STB enhanced beyond its current administrative role, giving the STB the authority to monitor the industry, and to intervene when needed to protect the public interest.