



ASSOCIATION OF
AMERICAN RAILROADS

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October 12, 2005

Surface Transportation Board
Attn: STB Ex Parte No. 658
1925 K Street, N.W.
Washington, D.C. 20423-0001

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

Dear Sir/Madam:

Attached for filing in the above proceeding are the Comments of the Association
of American Railroads.

Very truly yours,

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 658

**THE 25th ANNIVERSARY OF THE STAGGERS ACT OF 1980:
A REVIEW AND LOOK AHEAD**

**COMMENTS OF
THE ASSOCIATION OF AMERICAN RAILROADS**

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October 12, 2005

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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**THE 25th ANNIVERSARY OF THE STAGGERS ACT OF 1980:
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The Association of American Railroads (AAR) submits these comments in response to the Surface Transportation Board's (STB) request for views on the impact, effectiveness, and future of the Staggers Rail Act of 1980. AAR members account for the vast majority of North American freight railroad mileage, employees, and revenue.

The more than 550 freight railroads operating in the United States today are a tremendous national asset, moving more freight, more efficiently, and at lower rates than any other freight rail system in the world. They account for more than 40 percent of our nation's intercity freight ton-miles — more than any other mode — and serve nearly every agricultural, industrial, wholesale, retail, and resource-based sector of our economy. They connect businesses with each other across the country and with markets overseas, while significantly enhancing our standard of living.

The global superiority of U.S. railroads is a direct result of a regulatory system, embodied in the Staggers Rail Act of 1980, that relies on market-based competition to establish nearly all rate and service standards. This limited regulation has allowed railroads to improve their financial performance from anemic levels prior to Staggers to

more moderate levels today, which in turn has allowed them to plow back literally hundreds of billions of dollars into improving the performance of their infrastructure and equipment — to the immense benefit of their customers and our nation at large.

We cannot be complacent, though. Looking ahead, our economic prosperity and our ability to compete successfully in the global marketplace will depend critically on the viability and effectiveness of our freight railroads. But to be viable and effective, especially in the face of projected huge increases in freight transportation demand over the next 20 years, railroads must be able to both maintain their *existing* infrastructure and equipment and build the substantial *new capacity* required to handle the additional traffic they will be called upon to haul.

Transportation policymakers have a critical role to play in this regard. Indeed, a primary obligation of policymakers at the STB and elsewhere is to take steps that assist — and, just as importantly, refrain from taking steps that hinder — railroads in earning enough to make the investments they need to sustain themselves and provide the current and future freight transportation capability our nation requires.

Thus, any policy — especially a swing in the regulatory environment back to heavy-handed government interference in rail operations — that endangers future revenue and capital cost recovery also threatens the sustainability of our nation's rail system and must be avoided. If counterproductive, artificial regulatory or legislative restraints restrict rail earnings, rail spending on infrastructure and equipment will shrink, the industry's physical plant will deteriorate, needed new capacity will not be added, and rail service will become slower, less responsive, and less reliable. Eventually, either the government will

have to make up the shortfall in rail earnings in the form of major subsidies to railroads, or rail management will have to, in the words of one analyst, begin "harvesting the business."

"Harvesting the business" of freight railroading is something best avoided. It can be avoided if policymakers refuse misguided calls, in whatever form, for a return to excessive government regulation of railroads.

The Rail Industry Before the Staggers Act

In 1887, Congress passed the Interstate Commerce Act, creating the Interstate Commerce Commission (ICC) and making railroads the first U.S. industry to become subject to comprehensive federal economic regulation. For the next 93 years, the federal government would control wide areas of railroad operations — and ultimately nearly destroy the industry.

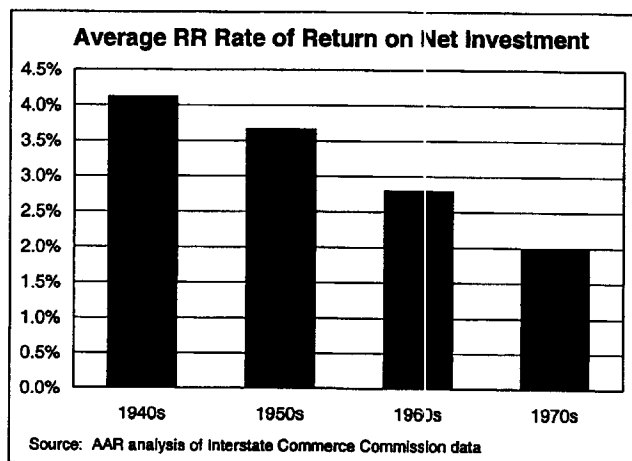
Indeed, by the 1970s, archaic regulations, in conjunction with intense competition from other modes and changing shipping patterns, had driven the rail industry to the brink of ruin. During the 1970s, virtually every major railroad in the Northeast, including the giant Penn Central and several major

Midwest railroads, filed for bankruptcy.

More than 20 percent of the nation's rail route mileage was accounted for by railroads operating under bankruptcy protection.

Between 1970 and 1979, the rail industry's rate of return on net

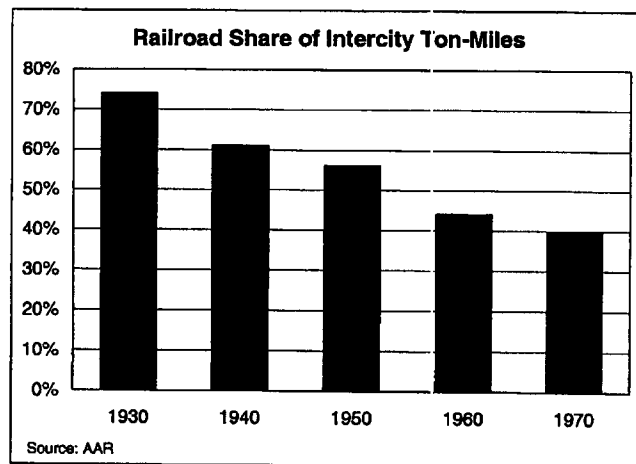
investment never exceeded 2.9 percent, and reached a low of 1.2 percent. The average rate



of return had been falling for decades: it was 4.1 percent in the 1940s, 3.7 percent in the 1950s, 2.8 percent in the 1960s, and 2.0 percent in the 1970s.

During this period, railroads lacked the capital to properly maintain their tracks. By 1976, more than 47,000 route-miles had to be operated at reduced speeds because of dangerous track conditions. The amount of deferred maintenance was in the billions of dollars and the term “standing derailment” — in which stationary railcars simply fell off poorly maintained track — entered the railroad lexicon.

By 1978, the rail share of inter-city freight had fallen to 35 percent, down from 75 percent in the 1920s. Despite record traffic levels in 1979, the rail industry’s rate of return on investment rose only to 2.9 percent.



Excessive and oppressive railroad regulation was largely to blame. As the U.S. Department of Transportation noted in 1978, “The current system of railroad regulation ... is a hodgepodge of inconsistent and often anachronistic regulations that no longer correspond to the economic condition of the railroads, the nature of intermodal competition, or the often-conflicting needs of shippers, consumers, and taxpayers.”¹

The status quo was untenable, leaving Congress with essentially two options: nationalization, at a continuing cost of untold billions of dollars, or deregulation and

¹ U.S. Department of Transportation, *A Prospectus for Change in the Freight Railroad Industry*, October 1978, p. 25.

greater reliance on the free market. Congress wisely chose deregulation and passed the Staggers Rail Act of 1980.

Major Provisions of the Staggers Act

Through the Staggers Act, Congress recognized that railroads faced intense competition from trucks and other modes for most freight traffic, but prevailing regulation prevented railroads from earning adequate revenues and competing effectively. Survival required a new regulatory structure that allowed railroads to establish their own routes, tailor their rates to market conditions, and differentiate rates on the basis of demand.

In passing Staggers, Congress intended that rail transportation service be determined principally by the marketplace — that is, by private actors making decisions about the use of privately-owned property — with rate regulation continuing only where effective competition was absent and as a remedy for anticompetitive railroad conduct. Consistent with these principles, the Staggers Act eliminated many of the most egregious regulations that prevented railroads from operating efficiently and competing effectively. For example, Staggers:

- Allowed railroads to price competing routes and services differently, to reflect the demand for each. Prior to Staggers, rates were set by rate bureaus, which recommended general rate increases that would apply across the board to all railroads and all commodities. Rates were equalized over all routes between a given origin/destination pair, without regard to differing costs. The Staggers Act discontinued rate equalization, phased out general rate increases, and gave railroads freedom to price according to market demand and to operate over routes they found to be most efficient.

- Allowed railroads to enter into confidential rate and service contracts with shippers. Such contracts were virtually unknown prior to Staggers because of regulatory restrictions on their use.
- Abolished collective ratemaking.
- Expanded the power of the ICC to exempt categories of traffic from regulation if the traffic was of limited scope or if regulation was not needed to protect shippers from an abuse of market power.
- Streamlined procedures for the abandonment and sale of rail lines. Prior to Staggers, the ICC required railroads to continue service on many rail lines for which revenues did not come close to matching operating costs.
- Directed that where the ICC retained jurisdiction over rail rates, it had to take into consideration the revenue adequacy of a railroad in determining whether or not a rate was "reasonable." (The concept of "revenue adequacy" is explored more fully later in this submission.)

One of the primary realizations embodied in the Staggers Act was something that had been essentially glossed over for decades prior to Staggers: if our nation is to have a viable, efficient, and capable freight transportation system, someone has to be willing to pay for it, and the market is far superior to the government in determining who should pay.

The Staggers Act did not completely deregulate railroads. In addition to retaining authority over a variety of non-rate areas, the ICC retained the authority to set maximum rates or take certain other actions if a railroad is found to have "market dominance" or to have engaged in anticompetitive behavior.

Railroad productivity gains made since Staggers represent the “easier” gains. In the words of one analyst, “All the obvious means of increasing productivity — the ‘low hanging fruit’ — have been already exploited.” Going forward, railroads will almost certainly continue to make incremental productivity gains, but it is unreasonable to expect rail productivity to grow in the future as swiftly as it has in the past.

- The overwhelming majority of railroad productivity gains have been passed along to rail customers in the form of lower rail rates. Average inflation-adjusted revenue per ton-mile, a useful surrogate for rail rates, fell 60 percent from 1981 to 2004, saving shippers and their customers billions of dollars every year.

In part because of differential pricing, not all rail shippers have shared equally in the profound post-Staggers rail rate reductions, but even the so-called “captive” shippers have generally shared in rail efficiencies. In a December 2000 report, the STB found that “inflation-adjusted rail rates have fallen 45.3 percent” from 1984 to 1999. The STB observed, “It is important to note 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 Studies by the U.S. Energy Information Administration, the U.S. General Accounting Office (now the Government Accountability Office), various academics, and others have confirmed the sharp drop in average freight railroad rates since Staggers.

Average rail rates cannot be expected to fall in perpetuity. The expected decline in future productivity growth will make it far more difficult for railroads to sustain rate reductions. In addition, railroads must earn sufficient revenue to make the massive investments in infrastructure and equipment they need to address current and future service and capacity challenges.

² Surface Transportation Board, Office of Economics, Environmental Analysis, and Administration, *Rail Rates Continue Multi-Year Decline*, December 2000.

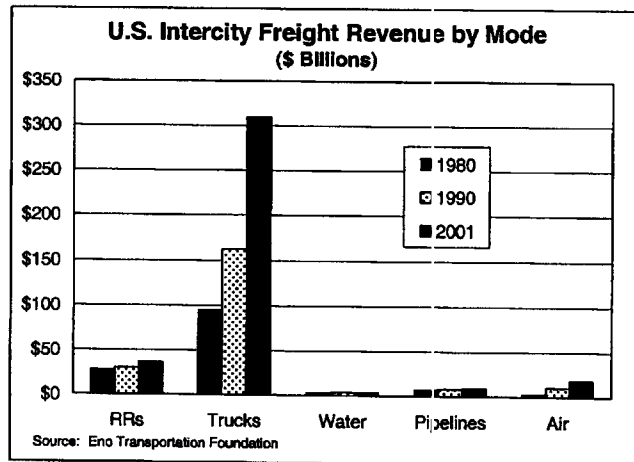
- Revenue ton-miles, a commonly-used indicator of freight transportation volume, have risen more than 80 percent since Staggers was passed — a rate more than double the comparable pre-Staggers traffic growth.
- After decades of steady decline, the rail intercity ton-mile market share bottomed out at 35 percent in 1978, but has trended slowly upward since then. It is currently around 42 percent.

This increase in rail ton-mile market share since Staggers is certainly welcome, but it is important to note that during this same time period the rail share of intercity freight revenue has continued a decades-long decline, falling from 21 percent in 1980 to 14 percent in 1990 to less than 10 percent in 2001, the most recent

year available. To put this in perspective, just the growth in truck revenue from 1990 to 2001 (\$147 billion) is more than four times total freight rail revenue in 2001 (\$37 billion).

Total intercity truck

revenue is now more than 8 times higher than total rail revenue. In 1980, truck revenue was only 3 times higher.



- Since 1980, Class I railroads have shed some 64,000 route-miles, slimming down to a national system of less than 100,000 miles. Instead of abandoning the typically low-density mileage — thereby leaving many customers and communities, mainly in rural areas, without rail service — the more favorable environment for freight railroading fostered by the Staggers Act has allowed Class I carriers to sell most of these miles to lower-cost short line entrepreneurs. Today, short lines operate

approximately 42,000 miles in 49 states, employ nearly 20,000 workers, and are critical components of our freight transportation system.

- Market-driven rail consolidations have eliminated numerous inefficient interlines, established more efficient route structures, and dramatically reduced railroad costs.

Most rail mergers since Staggers have been "end-to-end" (involving primarily non-overlapping railroads), increasing competition through the creation of more efficient, lower cost rail networks. These mergers have often eliminated the need to interchange traffic to a connecting railroad, extending the benefits of single-line service to more shippers, for more products, over longer distances.

Mergers of railroads with parallel lines have been less common, but can produce cost savings as great as or greater than those of end-to-end mergers. Consolidation of service onto one railroad line increases traffic density and allows the railroad to spread fixed costs over a larger traffic base, permitting more efficient use of labor and equipment.

In cases where proposed mergers would have reduced rail-to-rail competition for some shippers, the STB or the ICC before it either rejected the transactions outright or imposed conditions to address rail-to-rail competition. As a result of regulatory and commercial conditions placed on every major post-Staggers railroad merger, every shipper that had multiple railroads serving it prior to the merger still had multiple railroad service after the merger.³

Despite some serious (though temporary) merger implementation problems in the post-Staggers era, most rail shippers have realized significant benefits from both types of rail mergers because the mergers have produced

³ The extent of post-Staggers rail consolidation among major railroads is much lower than is often claimed. After accounting for changes in definition, operational integration of commonly-owned railroads that occurred prior to legal integration, and other factors, approximately 22 Class I railroads in 1980 were merged to form the seven Class I railroads operating today.

railroads that are better able to compete against each other and against other modes in the highly competitive transportation marketplace.

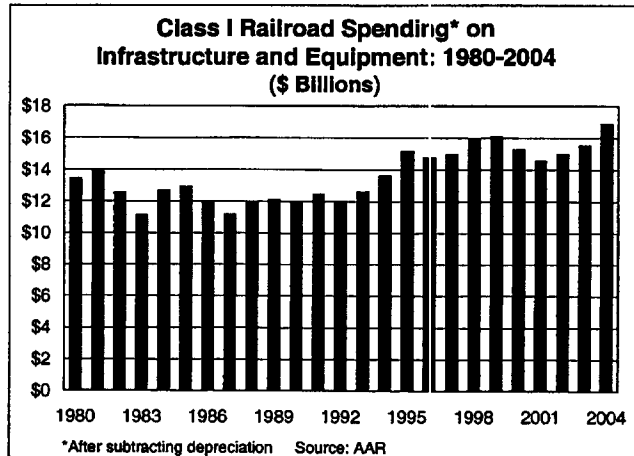
- From 1980-2004, Class I

railroads have been able to dedicate some \$340 billion toward maintenance expenses and capital investment — equivalent, on average, to 44 percent, of their operating revenue. Non-Class I railroads have spent billions of additional dollars.

To date, the vast majority of these funds have been directed toward maintaining the current rail network, rather than expanding it, and today U.S. freight rail infrastructure is in better overall condition than ever before.

Prior to Staggers, inadequate investment was a major factor contributing to railroads' poor financial health and unsatisfactory service. As Congress explained, "The simple fact of the matter is that the railroad industry is a capital-intensive industry which for decades has had inadequate earnings to maintain its plant and facilities at a level necessary to achieve improved services."⁴ Because railroads could not afford the massive investments they needed to maintain and modernize their systems, the result was often-crumbling infrastructure, substandard equipment, and poor service.

The investments made since the enactment of the Staggers Act have made railroads stronger and more effective competitors. The expansion and improvement of intermodal yards and terminals, track improvements, and raising the clearance of bridges to accommodate double-stack intermodal traffic have allowed the railroads to attract substantial traffic from trucks. Extensive investment in railroad infrastructure has permitted the

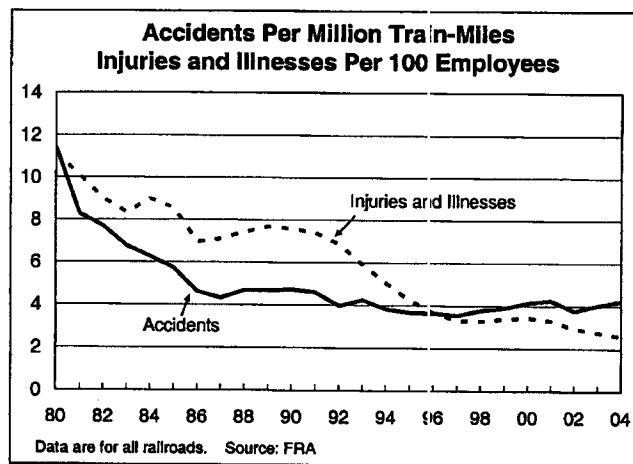


exploitation of Powder River Basin coal reserves. Operations have been improved through massive expenditures in information and dispatching systems. In these and countless other ways, railroads have used the investments made possible by Staggers to improve our nation's global competitiveness and enhance our standard of living. But as discussed below, railroads need to invest more in order to meet the growing freight demand from their customers today and what is expected for the future.

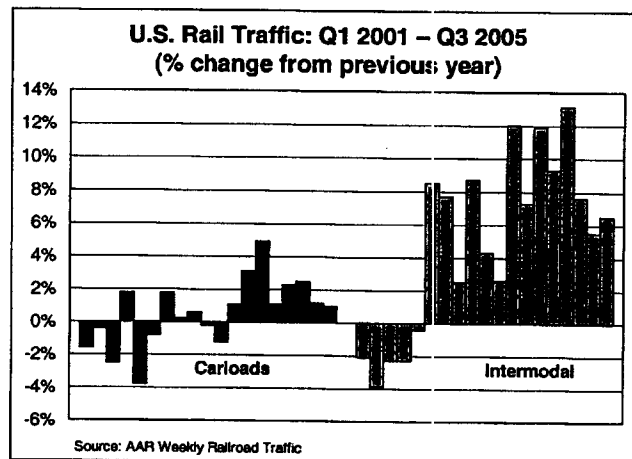
- The railroad accident rate has been reduced 63 percent since Staggers, while the employee casualty rate is down 77 percent.

Many factors have contributed to these impressive safety gains, but one such factor is certainly the massive investments in infrastructure and technology that were made possible

by Staggers. The rail safety experience post-Staggers is far different than the experience pre-Staggers, when most measures of rail safety were stagnant or worsening.



- Railroads have improved their financial performance considerably since Staggers, a topic that will be discussed in more detail below. Despite their financial



⁴ Staggers Rail Act of 1980, H.R. Rep. No. 96-1430, at 95 (1980) ("Staggers Act Report").

gains, though, railroads still do not earn enough to sustain their operations over the long term.

Most recently, solid growth in the overall economy, booming international trade, innovations in operating practices, and many other factors have led to record railroad traffic levels. Indeed, U.S. freight railroads today are hauling more freight than ever before. As of the third quarter of 2005, U.S. freight railroads have enjoyed positive carload traffic growth in eight straight quarters and positive intermodal traffic growth in 14 straight quarters.

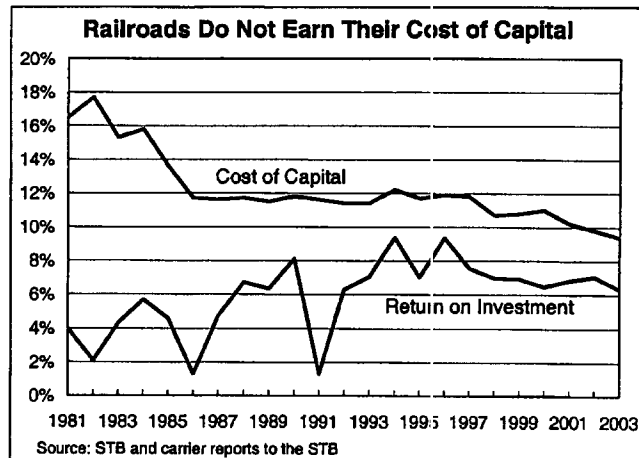
Intermodal traffic — which, by definition, is perhaps the most competitive rail traffic segment — has enjoyed particularly impressive growth. Some 39 of the top 50 highest-volume intermodal weeks in history for U.S. freight railroads occurred from September 2004 to September 2005. In 2003, for the first time ever, intermodal accounted for more revenue than coal, which for decades had been the single largest revenue generator for U.S. railroads.

All of the results discussed above — higher rail volumes, safer operations, increased investment, more productive operations, and improved rail profitability — were outcomes that Congress *meant* the Staggers Act to generate, and outcomes that are in the best interest of our nation.

Freight Railroad Profitability Since Staggers

As part of its Congressional mandate, each year the STB determines whether a railroad is “revenue adequate” — *i.e.*, it is earning enough to cover all costs of efficient operation, including a competitive return on invested capital — by calculating whether the railroad’s rate of return on net investment (ROI) equals or exceeds the rail industry’s

current cost of capital (COC). This standard is widely accepted, approved by the courts, and similar to that used by public utility regulators throughout the country. It is also consistent with the unassailable point that, in our free-market economy, firms and industries



must produce sufficient earnings over the long term or capital will not be attracted to them.

During the more than 25 years in which railroad revenue adequacy determinations have been made, railroads have significantly narrowed the COC vs. ROI gap, but they still do not earn their cost of capital. The average rate of return on net investment, which had been falling for decades, was 2.0 percent in the 1970s, rose to 4.4 percent in the 1980s, and was 6.9 percent from 1990 to 2003.

Rail customers certainly understand the importance of earning the cost of capital. A spokesman for a major Florida utility recently noted, "If we can't make an attractive investment for the shareholder, then we are going to have a very difficult time going in the marketplace and competing for dollars."⁵ The chairman of one of the world's largest chemical companies noted "Only profitable growth will give us an edge in the international competition for capital.... In all areas we want to earn our cost of capital — and a premium on it too."⁶ And the chairman of a major U.S. forest products company stated "[E]very

⁵ Spokesman for Florida Power & Light, quoted in *The Palm Beach Post*, January 16, 2005.

⁶ BASF Strategy and Value-based Management, *BASF Financial Report 2003*, p. 17.

business that's part of [our company] is going to be expected to earn cost of capital plus returns over a cycle."⁷

Railroads agree with this sentiment, which is echoed by firms in every sector of the economy. Without the ability to cover total costs and earn an adequate return, railroads — like electric utilities, chemical companies, or any other firm — would be unable to maintain (much less increase investment in) their networks and could not sustain themselves over the long term.

Some rail industry critics argue that since the freight rail industry has managed to survive over the past 25 years despite being "revenue inadequate" over that entire period, something must be wrong with the STB's revenue adequacy procedure, standard, and/or methodology. Alternatively, the argument is made that because railroads have been able to make new debt offerings, or issue new stock, or pay dividends to shareholders, or have seen improvements in certain financial measures, or have made positive public statements regarding their financial status, the revenue adequacy determination is meaningless or misleading. Some of those who subscribe to this view have called for the elimination of the annual revenue adequacy determinations or for an overhaul in the way revenue adequacy is calculated.

The argument that railroads have survived, therefore something must be wrong with the STB revenue adequacy determination, is mistaken for a number of basic reasons.

First, in a very real sense, the U.S. Class I freight railroad industry has *not* survived intact over the past 25 years. Since 1980, every Class I railroad has undergone significant route rationalization aimed at pruning unprofitable and marginal network segments.

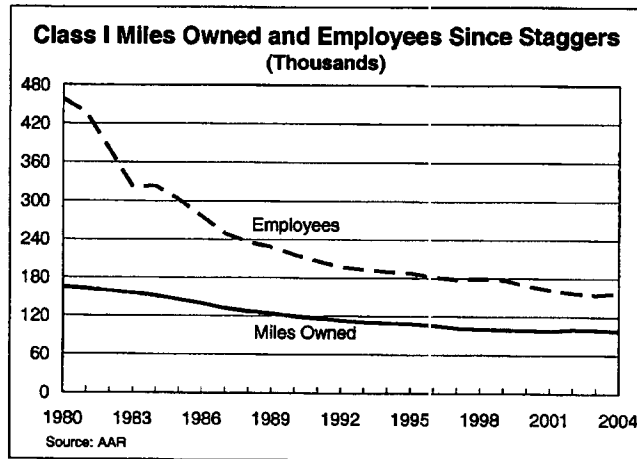
⁷ John Faraci, Chairman and CEO, International Paper, during the Q2 2004 International Paper Co. earnings conference call, July 26, 2004.

Likewise, efficiency gains have been a major rationale for the rail mergers that have occurred since Staggers. Rationalization has resulted in a reduction in total route miles owned by Class I carriers from more than 162,000 miles in 1981 to less than 98,000 miles today — a 40 percent decline.⁸

At the same time that Class I railroad mileage has fallen sharply, so too has rail employment. Class I rail employment of more than 436,000 in

1981 had been reduced to 157,000 by 2004 — a decline of 279,000, or 64 percent. Some of these rail jobs were picked up by non-Class I operators, but most were simply eliminated as railroads improved their productivity in the face of intense competitive constraints.⁹

The transfer of 64,000 route-miles and 279,000 employees out of Class I railroad service indicate that railroads have *not* been able to survive the test of time in their original form. Rather, railroads have had to undergo major and often wrenching adjustments to increase their productivity and maintain their competitiveness in the transportation marketplace. Indeed, the shrinkage of the U.S. rail system powerfully corroborates the fact that railroads have consistently been revenue inadequate. If rail properties consistently



⁸ As noted earlier, most of these miles were transferred to short-lines, so that rail service was retained.

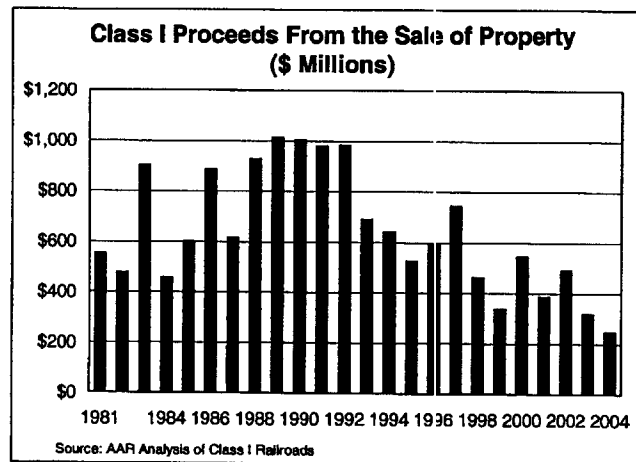
⁹ Over the past year, freight railroad employment has begun to rise again as railroads have added staff to handle increased traffic levels. It is noteworthy that the Class I employee rationalization took place simultaneously with dramatic railroad safety gains.

produced earnings above the cost of capital level, railroads would have been expanding — not contracting — over the years.

Second, railroads have survived in the face of continued revenue inadequacy because they have made the phenomenal productivity gains described earlier.

Third, railroads have used a number of what can be described as short-term means to achieve financial and operating improvements which have enabled them to attract capital and fund operations without being revenue adequate. For example, Class I railroads have often used non-operating income to fund rail operations. Asset sales, noted previously, are an example. From 1981 to 2004, Class I proceeds from the sale of property totaled \$15.4 billion, or \$20.7 billion in constant 2004 dollars. While some of these funds were needed to repay debt secured by the assets sold, a substantial portion of these funds helped support rail operations.

Likewise, the net of “other income” less “miscellaneous deductions” for Class I carriers totaled \$19.9 billion from 1980 through 2004, or \$28.6 billion in constant 2004 dollars. Funding rail operations from asset sales and the like cannot continue indefinitely. Indeed, funds from these sources have been trending steadily downward over the past 20 years, an indication that railroads’ ability to use these sources of funds has waned significantly.

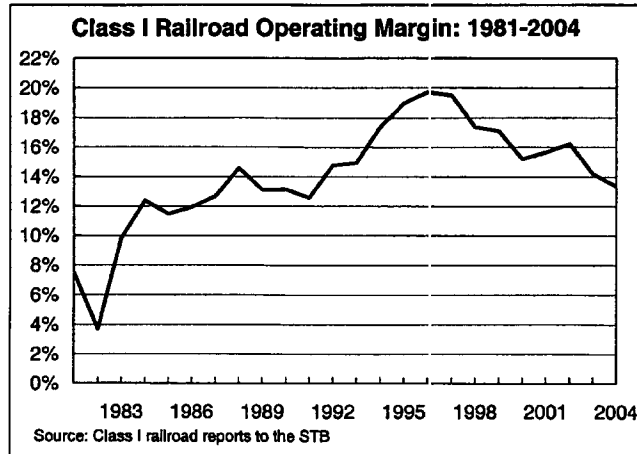


Fourth, one of the principal objectives of deregulation was to ensure that freight railroads would enjoy improved access to capital on competitive terms. As a practical matter, this has meant that rail carriers had to be provided with an opportunity (though not an assurance) to cover all of their costs, including a competitive return on capital. This *prospect* of profitability in a predictable, deregulated environment has attracted capital and investors to the rail industry. Over time, the improvement in railroad profitability has further increased investor confidence that railroads will be able to earn a competitive rate of return from rail investments over the long term. This virtuous circle has further improved investors' willingness to supply capital.

Fifth, even had it been possible to eliminate the corrosive effects of decades of pervasive regulation overnight, intense price and service competition from other transportation modes and within the rail industry itself would have ensured that the industry's progress toward revenue adequacy would be slow, as it has been. In short, it is not the cost of capital standard that is wrong, but the assumption that deregulation would quickly produce financially-sustainable carriers. We are not there yet. Achieving revenue adequacy has been, and continues to be, a long-term project for railroads.

Finally, whatever may be the minimum level of earnings, profitability, or solvency considered adequate by financial analysts to declare a railroad "healthy" for short-term investment purposes, the STB's responsibility as dictated by the Staggers Act is to determine whether a railroad's long-term profitability has reached the point at which regulatory actions can prudently be applied without adverse consequences for the rail network and the shipping public. Short-term improvements in profitability, short-term attainment of adequate revenue levels, accumulations of cash reserves, dividend pay-outs,

and other similar measures do not signal that the necessary level of long-term profitability on rail operations has been achieved. Only a return on investment equal to the cost of capital over a sustained period provides such a signal.

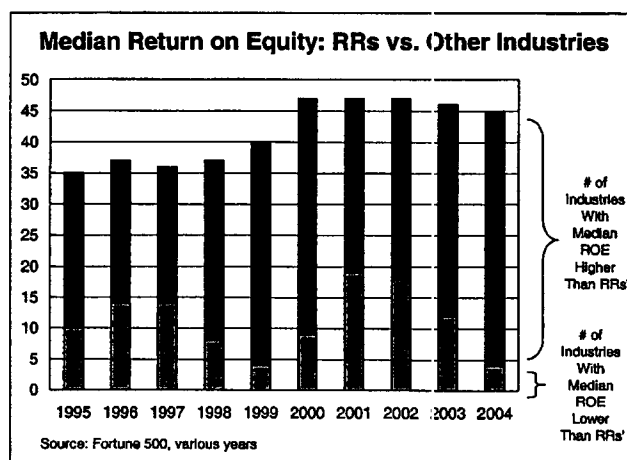


Even though return on investment compared with the cost of capital is the most pertinent indicator of rail profitability, other financial measures point to continued substandard rail profitability.

For example, the operating margin — operating revenue minus operating expense divided by operating revenue — is a relatively “clean” indicator of the profitability dynamics of the core railroad business. The railroads’ operating margin trended upward following railroad deregulation in 1980, but the last ten years have seen a reversal of this trend.

The April 4, 2005 issue of *Business Week* graded individual members of the S&P 500 based on various financial criteria, with “A” going to the top 20 percent of companies, “B” to the next 20 percent, and so on down to “F” for the bottom 20 percent. The four freight railroads that are part of the S&P 500 averaged a “C” for total three-year returns, between a “C” and a “D” for three-year profit growth, and between a “D” and an “F” for return on equity relative to the rest of the S&P 500.

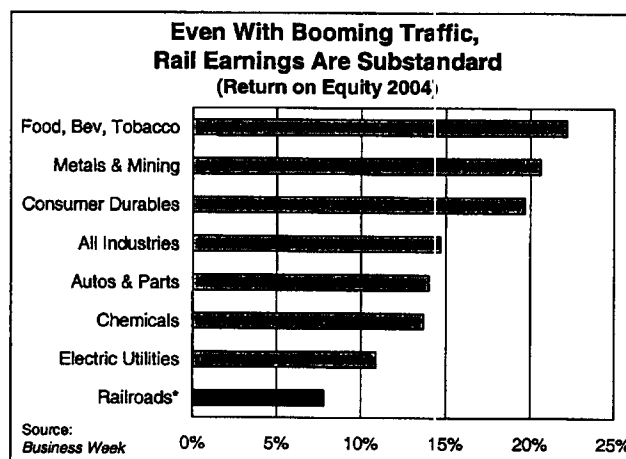
Return on equity (ROE) is commonly used as an indicator of short-term profitability. In each of the 20 years from 1985 to 2004, the median ROE for Class I railroads was less than the median for all Fortune 500 companies, and in 15 of the 20 years, the median railroad ROE was in the



lowest quartile among Fortune 500 industries. Similar analyses using data from the S&P 500 and Value Line yield similar results: railroads typically register returns substantially inferior to those of other industries.

Even in 2004, when railroads were hauling substantially elevated levels of traffic, rail industry earnings were substandard compared with other industries.

According to *Business Week* data, in 2004 the average ROE for the four largest U.S. railroads was 7.8 percent, well below the average for electric utilities (10.8 percent), metals and



mining (20.6 percent) and chemicals (13.7 percent), and well below the average for all industries (14.7 percent).

Over the past few quarters, some Class I railroads have achieved earnings that are substantially improved over what they have been in the past. Although these earnings are

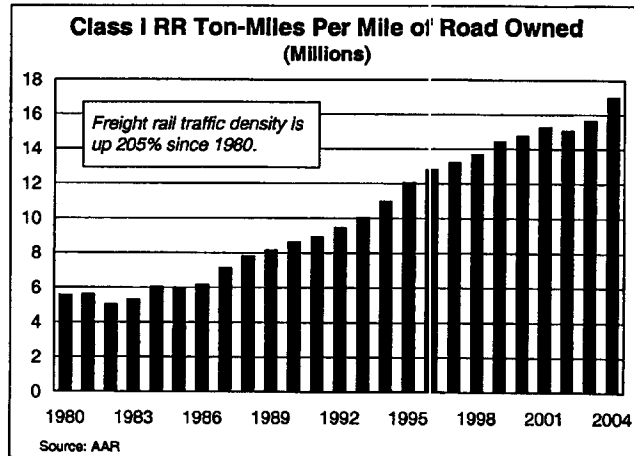
generally no more than (and in many cases less than) what many non-regulated companies and industries earn, they have been seized upon by some rail critics as proof that railroads are earning excessive profits that should be reigned in, or as proof that railroads are revenue adequate and therefore should be subject to heightened regulatory scrutiny.

This viewpoint — that increased railroad profitability to moderate levels justifies a reinstatement of onerous restrictions on rail earnings — is extraordinarily shortsighted. Revenue adequacy is a long-term concept. Earnings increases, or even a return on investment exceeding the cost of capital, for one or two years does not demonstrate sustained railroad revenue adequacy any more than a few good seasons for a baseball player by itself warrants election to the Hall of Fame. Prudent regulation of rail rates and earnings recognizes that improvements in rail profitability reflect the fact that deregulation is working. After all, long-term sustainability through higher earnings is precisely what Congress meant for railroads to achieve when it passed the Staggers Act.

Current and Future Rail Capacity and Service Issues

U.S. freight railroads today are hauling enormous amounts of freight, more than either they or their customers expected and enough to create capacity constraints and service issues at some points and on some rail corridors. Demand for freight transportation is projected to continue to rise sharply in the years ahead, putting additional pressure on railroads (and other freight transportation providers) to handle this growth. U.S. Department of Transportation forecasts, for example, call for a 55 percent increase in rail traffic by 2020 from 2000 levels.

This projected growth portends continued increases in traffic density. From 1980 through 2004, traffic density for Class I railroads — defined as revenue ton-miles per mile of road owned — rose 205 percent, including a 97 percent increase since 1990.



Obviously, not every rail line has had the same traffic density increase as every other line, but the trend illustrates why freight railroads in some areas already faced capacity limitations even before the sharp increases in traffic over recent periods.

In light of current capacity and service issues, some shippers and others have blamed railroads for rationalizing too much track, or for not having enough workers, or for in some other way not being prepared for the surge in traffic they've seen.

This kind of reaction is far too simplistic. In hindsight, railroads and shippers possibly could have done a better job at forecasting demand and preparing for the sharply higher traffic volumes. But to contend that railroads can afford, or that shippers would be willing to pay for, significant amounts of spare capacity — in terms of infrastructure, equipment, or labor — to have on hand 'just in case' is completely unrealistic. Broadly speaking, railroads try to build and staff for the traffic at hand or soon to be at hand. In other words, they do what most other companies do.

That said, U.S. freight railroads have been expending enormous resources toward improving their infrastructure and operations and alleviating the service and capacity issues they face. Railroads are devoting record amounts to capital spending, purchasing

hundreds of new locomotives and thousands of new freight cars, hiring and training thousands of new workers, revamping operating plans, improving communication with customers, adopting new technology, and taking many other steps to improve their operations.

It is unfortunate, though, that some are using existing capacity constraints as an excuse to promote an agenda calling for sharply greater regulatory involvement in rail operations. If the pre- and post-Staggers experience has taught us anything, it has demonstrated that Clifford Winston, a Brookings Institution transportation economist, was correct when he wrote, "The preponderance of scholarly evidence developed in transportation economics over the past several decades leaves no question that the government should greatly reduce its role in all aspects of transportation."¹⁰

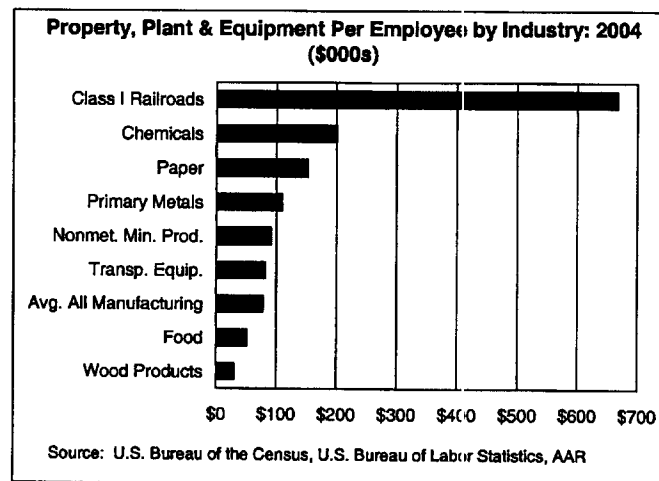
This point is especially important today. The asset reductions noted earlier indicate that, since Staggers, U.S. freight railroads have worked off a significant amount of excess capacity. Today, even though railroads will continue to critically assess their asset structures and prune or transfer to short lines segments that are not economical, the days of excess rail capacity are, on many critical corridors and locations, over. This means that as traffic grows, railroads will have to concentrate increasingly on replacing and building new capacity as well as maintaining existing capacity. But if a railroad is not revenue adequate over a sustained period, it will not be able to attract the capital necessary to maintain its existing network, and if a railroad is not collecting enough revenue to maintain its existing network, it certainly will not be able to invest the much larger sums in the replacement or expansion of infrastructure required by growing demand.

¹⁰ Clifford Winston, "You Can't Get There From Here: Government Failure in U.S. Transportation," *Brookings Review*, June 1999.

Investment needs are huge for freight railroads, who, by any of a variety of measures, are at or near the top among all U.S. industries in terms of capital intensity. Freight railroads spent an average of 17.0 percent of their revenue on capital investment from 1999 to 2003. The comparable number for U.S. manufacturing as a whole was just 3.4 percent. Similarly, in 2004 railroad net investment in plant and equipment per employee was \$667,000 — more than eight times the average for all U.S. manufacturing (\$78,000). Railroads also have significantly higher asset needs for each dollar of revenue produced than other industries. Based on *Fortune 500* data for 2004, the figure for railroads (\$2.91) is well over twice the average for industrial firms (\$1.34).

Capital Expenditures as a % of Revenue for Various U.S. Industries: Avg. 1999-2003	
Average all manufacturing	3.4%
Food manufacturing	2.6%
Transportation equip. mfg	2.7%
Machinery manufacturing	2.9%
Wood product mfg	2.9%
Petroleum & coal products mfg	3.1%
Fabricated metal product mfg	3.4%
Chemicals manufacturing	4.2%
Paper manufacturing	4.3%
Plastics & rubber products mfr.	4.5%
Computer & electr. product mfg	4.8%
Nonmetallic mineral product mfg	5.6%
Electric utilities	11.5%
Class I Railroads	17.0%

Source: U.S. Bureau of the Census, EEI, AAR



With minor exceptions, U.S. freight railroads are privately owned and operated. Compared to other transportation modes, they have received no appreciable government financial assistance for infrastructure construction and maintenance. Consequently, railroads have had to generate sufficient funds internally and from outside capital markets to finance their massive spending needs.

The Dangers of Reregulation

Self-interested advocacy groups from time to time propose amendments to the Staggers Act or changes to the regulatory regime it spawned that would fundamentally alter the landscape in which railroads operate, grievously harm our nation's transportation system, and deviate sharply from Congress's intent in passing Staggers.

Most importantly, reregulation would make it impossible for railroads to sustain themselves. Proponents of reregulation ignore the fact that rail investments in infrastructure and equipment, like most private investment decisions in our economy, are driven by expected returns. The hundreds of billions of dollars invested in U.S. freight railroads since Staggers would not have been provided if not for the investors' expectation that the *opportunity* for a return promised by Staggers would remain. This means that if changes were made in rail legislation or regulation that created uncertainty or lowered expected returns, less capital would be committed to the maintenance and expansion of our rail system, and the cost of the capital that was made available to railroads would be higher, which would not be good for rail customers in the long run.

In essence, reregulation would artificially restrain rail rates to below-market levels for a certain segment of rail customers, at the expense of other shippers, rail investors, rail employees, and the public at large. Rail earnings would necessarily fall, potentially by several billions of dollars per year. Railroads would again be unable to make the massive investments they need year after year to meet the current and future freight transportation requirements of our nation. Under reregulation, an era of capital starvation would return. Railroads would be forced to disinvest in their networks and reduce their service, an outcome completely at odds with our nation's current and future freight transportation requirements.

This point has been made repeatedly over many years by capital providers who understand that no law or regulation can force investors to provide resources to an industry whose returns are lower than the investors can obtain in other markets with comparable risk:

- In an October 1996 statement to the STB, a group of nine investment bankers and securities analysts wrote, "A move toward re-regulation that would cause a substantial reduction in rail revenues would sharply curtail the railroads' access to capital on reasonable terms, and would be a most unwise and short-sighted decision...If rail rates are more heavily regulated...the ultimate result will be that shippers and the public will suffer."
- In April 1998, Stephan C. Month of Credit Suisse First Boston, a global investment bank, testified to a U.S. House of Representatives Subcommittee that "the greater the limitations on the [rail] industry's ability to grow revenues and cut costs, the costlier Wall Street funding will become and...the more difficult it will be for the railroads to earn their cost of capital and remain economically viable."
- In September 1999, Anthony Hatch, a prominent independent Wall Street analyst, noted that "Capital flows to the areas of highest return. If ... new [rail] regulations change the rules of the game and ensure poor returns, then the Street will disinvest ... causing managements to begin to reallocate cash and begin "harvesting" the business. They will have no choice."
- In testimony to the U.S. Senate in May 2001, Morgan Stanley's James Valentine, another prominent analyst, cautioned that rail customers "need to be careful what they wish for, as their efforts to drive rates lower will likely only cause more capital to leave the industry and service to deteriorate."
- In a January 2004 research report, John Barnes of Deutsche Bank warned, "In the beginning, there would be short-term benefit [from reregulation] for

captive shippers through lower rates. However, instant gratification usually comes with a headache the next morning, and there would be no Advil strong enough for the long-term damage associated with railroad re-regulation...[O]ver the long-term, everyone would share in the hangover: shareholders, customers, railroads, the entire transportation system, the U.S. and global economies. In the worst case scenario, ... a repeat downward spiral of the railroad industry, similar to the 1970s, could occur, with multiple bankruptcies that could cripple the transportation system.”

At their most basic level, proponents of railroad reregulation believe that railroads charge too much and that the use of differential pricing by railroads is unfair. They fail to understand that a railroad must balance the desires of each customer to pay the lowest possible rate with the requirement that the overall network earn enough to pay for all the things needed to keep it functioning now and into the future. Simply put, no amount of rhetoric about “competition” can change the fact that if a railroad cannot cover its costs, it cannot maintain or expand its infrastructure and provide the services upon which its customers and our nation depend. Self-serving pleas to reregulate railroads must be considered within this context.

Indeed, when one looks behind the actions that proponents of reregulation are urging upon Congress and the STB to “balance” shippers’ needs with the railroads’ needs, it is clear that “balancing” is a euphemism for “subsidizing” and that the needs of the railroads and the general public are nowhere to be seen.

Proposed changes in the current railroad regulatory regime are based on a fundamental misrepresentation of what the Staggers Act was all about.

First, nothing in the Staggers Act is meant to imply that the only competitive force that matters is rail-to-rail competition, that service to a shipper by a single railroad is

equivalent to monopoly power, and that all rail shippers therefore have a right to service by more than one railroad. Rather, Staggers was premised on the understanding that the market — not regulatory or legislative fiat — would determine which markets have sufficient demand to sustain multiple railroads and which do not. Staggers encourages the creation of additional competition through private investment and initiative, but it does not seek to artificially manufacture additional competition through governmental intervention.

Second, Staggers did not bestow on railroads a special public service obligation, verging on the governmental, to subsidize other businesses, compensate for regional disadvantages or characteristics, or serve as the instrument for advancing other local or national objectives at the railroads' own expense. Thus, Congress did not intend to force railroads to provide service that does not pay its way.

Third, Staggers was not meant to force a railroad to price one shipper's movements at the same rate as another shipper's movements, or to cap rates at some percentage of variable costs. Instead, Staggers explicitly recognized differential pricing as essential for railroads. Only by pricing in accordance with the varying demands for rail service (with reasonable regulatory protections against unreasonable rates) can railroads efficiently recover all of their costs, serve the largest number of rail customers, and maintain the viability of the nation's rail system. Differential pricing benefits all shippers, because lower prices to some shippers generate revenue which otherwise would have to be raised from those with the strongest demand for rail transportation.

Of course, shippers are not always thrilled with the prices they are able to negotiate with the railroads. Virtually every purchaser of goods or services, including railroads, would like to get a better deal than what they have from their suppliers. But there is no

question that, since Staggers, the vast majority of railroad rates are market-based and driven by competition — just as Staggers intended.

Fourth, Staggers was not meant to be a vehicle through which one railroad could be ordered to make its facilities available for use by another railroad. Under current regulation, unless a railroad is found to have engaged in anticompetitive conduct, it is allowed to determine for itself how to utilize its assets. The experience prior to Staggers, when regulators again and again deemed their judgment superior to that of rail management in the allocation of rail assets — with dismal results — certainly should not be repeated.

Fifth, Staggers was not intended to prevent railroads from engaging in practices that improve efficiency, or from offering incentives to shippers that make efficiency improvements themselves. Thus, for example, railroads typically offer shippers incentives (in the form of lower rates) to move their product in larger shipments. The lower rates, which reflect railroads' cost savings, result in more efficient movements and increased competitiveness in the marketplace. Under this system, the market — not railroads — decides whether investments in facilities designed to handle more efficient shipments are appropriate.

Sixth, nothing in the Staggers Act supports efforts to cast aside the fundamental tenet of the economics of competition that says that where competition exists, there should be no regulatory intervention. Because the vast majority of rail freight movements are subject to a wide array of competitive forces — including geographic competition, product competition, competition from trucks and barges, countervailing power, plant siting and long-term contracts, and technological or structural changes — the vast majority of rail

movements should likewise be free of governmental oversight. Reregulatory proposals by some rail critics would unjustifiably subject huge swaths of rail traffic to governmental oversight.

Finally, Congress, through Staggers, has provided (and the ICC and STB have implemented) effective remedies to protect shippers from abuse of market power or anti-competitive behavior. But Staggers was not designed to allow those unhappy with either the rates they are charged or STB decisions in rate cases to simply abandon the use of sound economic principles as a basis for rate decisions or to ignore the fundamental principle that railroads need to earn sustainable revenues.

Remedies for unreasonably high rail rates are available if it can be shown that the railroad does not face effective competition for the issue traffic. Upon finding a rate unreasonably high — as it has done on numerous occasions — the STB is authorized to award reparations and/or to prescribe maximum reasonable rates for the future. Consistent with the market-based differential pricing principles set forth in the Staggers Act, Constrained Market Pricing (CMP) is the standard for determining the maximum rate level for market-dominant traffic. The CMP standard most commonly used is the “stand-alone cost” (SAC) test, which applies the principles of demand-based differential pricing to cap rail rates at the level that would be charged by a hypothetical “stand-alone railroad” providing head-to-head rail competition for the traffic at issue.

In late 1996, the STB adopted “simplified guidelines” regarding maximum rate standards to be used in cases where the amount at stake does not justify the expense of using the SAC approach. To date, no cases have been decided under these simplified

guidelines. Railroads recognize the desirability of a less complex, less expensive process to accommodate complaints of truly small shippers.

The fact remains, though, that absent governmental subsidies, shippers must be willing to pay for the rail service they say they need.

Conclusion

Current capacity issues notwithstanding, U.S. freight railroads do a remarkable job in meeting the needs of an extremely diverse set of shippers. Railroads move tens of thousands of railcars to and from thousands of origins and destinations every day. The vast majority of these shipments arrive on time, in good condition, with acceptable levels of service, and at rates that shippers elsewhere in the world would love to have. As the World Bank's railways adviser noted, "Because of a market based approach involving minimal government intervention, today's U.S. freight railroads add up to a network that, comparing the total cost to shippers and taxpayers, gives the world's most cost effective rail freight service."¹¹ Today, the North American rail system is the envy of the world.

These are marks of success, and they are due in large measure to the deregulatory reforms of the Staggers Act. The flexibility Staggers provided has enabled railroads to rationalize and upgrade their systems, reinvest in productive rail infrastructure, generate higher levels of service, dramatically increase productivity, and improve safety — while, at the same time, sharply lowering rates for shippers. Railroads will continue to face daunting challenges well into the future, but their progress to date has been substantial.

For this reason, the rail industry believes that the current regulatory regime — under which competition and market forces are the determining factors in setting rail rates

¹¹ Louis S. Thompson, "US rails: A world apart," *Journal of Commerce*, July 29, 1998.

and service standards in most cases, with maximum rate and other protections available to rail customers who truly need them — is, by and large, an appropriate one. It strikes a reasoned balance between providing railroads the freedom to compete effectively in the marketplace and providing shippers the means necessary to combat actual abuse of railroad market power and anti-competitive railroad behavior.

It may well be that particular elements of the current regime can be improved, and the rail industry has worked hard to identify areas where improvement might be made. Agreements and ongoing discussions with shipper groups and other transportation providers, and the willingness of the railroad industry to re-examine critical regulatory techniques and procedures, bear witness to this point.

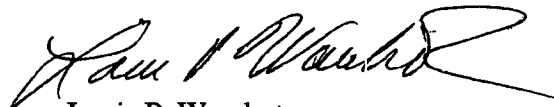
That legislators and regulators not take action that will reverse the progress that railroads have made is particularly important today, when increasing demand for transportation is impacting all aspects of our nation's transportation system, not just railroads. Trucks face severe network capacity constraints of their own. In addition, drivers are perennially in short supply, fuel costs are astronomical, and the issue of funding increased highway capacity remains hopelessly tangled. Our ports are increasingly pressed for funds to accommodate an explosion in international cargo. And our inland waterway system suffers from infrastructure funding issues, uncertain barge supply, and weather-related disturbances.

Despite these problems — or perhaps more accurately, because of them — it is clear that transportation capacity will have to increase as the economy expands. The railroads can contribute to meeting these increased capacity needs primarily through

private capital, but only if the regulatory structure gives the railroads an incentive to make the necessary investments.

Railroads are genuinely willing to engage in private sector and regulatory initiatives concerned with rate, service, safety, and other areas of rail operations to identify particular elements of the current system that might be improved. That said, going forward, railroads need the continued flexibility that deregulation has offered in order to efficiently handle the rapidly expanding transportation needs of our domestic economy and sustain our nation's international competitiveness.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Louis P. Warchot", with a stylized flourish extending from the end.

Louis P. Warchot
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