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Charles N. Marshall
Attorney-at-Law
1040 West Schuylkill Road
Pottstown, Pa. 19465

Telephone 610-323-8631
Fax 610-326-3195

July 13, 2006

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
Attn: Ex Parte No. 575
1925 K Street, N.W.
Washington, D.C. 20423

Re: STB Ex Parte No. 575, Review of Rail Access and Competition Issues --
Renewed Petition of the Western Coal Traffic League

Dear Secretary Williams:

Attached for filing in the above proceeding is a copy of my oral testimony to be presented at the hearing on July 27, 2006.

To the extent that the Board will have panels of witnesses at the hearing, it is requested that I be included on any panel that may have the witnesses from the Association of American Railroads and the American Short Line and Regional Railroad Association.

Respectfully submitted,



Attachment

BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 575

REVIEW OF RAIL ACCESS AND COMPETITION ISSUES—
RENEWED PETITION OF THE WESTERN COAL TRAFFIC LEAGUE

Statement of
Charles N. Marshall

July 27, 2006

My name is Charles N. Marshall, 1040 West Schuylkill Road, Pottstown, Pa. 19465. I am appearing in behalf of Genesee & Wyoming Inc. (G&W) and Farmrail System, Inc. (Farmrail).

Since June 1 of this year, I have been Sr. Vice President of Industry Relations of Farmrail. Farmrail operates two Class III railroads in western Oklahoma, totaling 347 route miles. I am the former President & Chief Operating Officer (and subsequently Vice Chairman) of G&W, a firm from which I retired on April 30, 2006. G&W operates 41 Class III railroads throughout the country, totaling 2757 route miles. I have 45 years' experience with Class I and short line railroads in the areas of marketing, operations, engineering, and regulatory matters, and I have advised rail shippers as a consultant.

The short of my testimony here today is that the Surface Transportation Board should not interfere with paper barriers. No good could come of such a regulatory effort, and the negative consequences could be substantial.

What are paper barriers? Generally speaking, they are contractual terms agreed at the time a new short line is formed that provide an incentive for traffic

involving the short line to continue to move in connection with the Class I railroad that formerly operated the short line track. (Many short lines, including many short lines created by Class I's, do not have such agreements). There are numerous forms of such agreements, but typically they require some sort of payment from the short line to the Class I if traffic is routed on a competing Class I. Sometimes, these provisions require a payment of "X" dollars for every car that uses the competing route. Sometimes they require payments if the volume of shipments on the creating Class I falls below a specified number. And sometimes they require the short line to pay rent that is otherwise waived if shipments start to be made over the competing route.

Looking at this from the Class I standpoint, the paper barrier has the effect of assuring a revenue flow from the new short line with reasonable continuity. That revenue flow is a thing of value, and it affects the price that the short line pays to acquire or lease the line. One way to think of paper barrier agreements is as "requirements contracts" that are common in everyday affairs. In effect, the short line is committing all of its business to the Class I in return for a specified economic package. It is instructive that a recent paper by the American Trucking Associations shows that rail market share for merchandise traffic is minuscule, implying that there is not even a scent of monopoly power justifying regulation of short line railroad relationships.¹

From the short line's perspective, the barrier also is a thing that has been accepted after arm's length bargaining. The short line can pay more and buy out

¹ Statement of Timothy Lynch before the Subcommittee on Highways, Transit & Pipelines of the Committee on Transportation & Infrastructure, U.S. House of Representatives, June 15, 2006.

the barrier (as has happened in many cases) or pay less for the line and accept the barrier. The barrier is accepted where the acquiring short line judges that the cost of buying it out is not justified by the opportunity presented.

From the shipper's perspective, the paper barrier simply continues the commercial opportunities that were available before the short line was formed. A shipper originally on Red Railroad retains precisely the same routing opportunities following a short line lease or sale by Red Railroad as the shipper had beforehand. (There is a different situation involving "new" traffic, traffic that is not moving at the time the short line is formed. We shall return to "new" traffic in a moment).

But first let's look at "old" traffic, the existing flows of business on the Class I branch at the time the short line is formed. The simple reality is that a paper barrier prevents a transfer of rents from the rail industry to the shipper of "old" traffic. The papers of the petitioners in this proceeding make it clear that their objective is lower freight rates—an easy objective to understand.

However lower freight rates for the shipper mean less revenue for the railroads. Is that good for the shippers? Or the railroads? Or is it sound public policy? "No," as to all three. Remember that short lines are formed when large railroads determine that some part of their operation is not economically satisfactory and that the local attention brought to bear by a short line is likely to improve things. Remember, too, that abandonment is often an alternative.

To understand how removal of paper barriers would transfer money to shippers, it is helpful to review some basic railroad economics. Usually, railroads

are described as a “declining marginal cost industry,” because marginal cost is less than average cost. In layman’s terms, this means that cars added to a train cost less to handle than cars that require a new train to be run. And trains that run over an existing track cost less to handle than those that require a new track to be built. This means that two competing side-by-side railroads will price new business down to the level of marginal cost—the cost of adding a few cars to the train. That low price makes the railroad winning the business better off in the short term, but the price does not cover the average, or total, cost of the new traffic. In other words, there is intense competition between railroads and there are lower prices for the shipper until the track wears out. Then the higher cost main line will go out of business, a single route will re-emerge, and prices will rise to the level sufficient to maintain the railroad for the long term.

Some will say that it is fanciful to suppose that Union Pacific or BNSF or other Class I’s will abandon main lines simply because paper barriers are abolished on a few short lines. But remember that we are talking about policy and principle in a regulatory proceeding and that what starts with a “few” cases will surely spread to become the norm.

There is ample historical precedent for my concern. If one looks at the Northeast in the 1960’s, one can find six separate trunk line routes from New York to Chicago. There was virtually open access to the cities at both ends through the reciprocal switching rights that were then universal at very low prices, sometimes only a few dollars a car (in other words, there were no “paper barriers”). Subsequently, every one of those trunk line carriers went bankrupt.

They were consolidated into Conrail, and physical abandonment of many of the lines occurred. Many prices rose, and the federal government subsidized massive rehabilitation of the track that remained, track that had deteriorated when revenues were insufficient to maintain it.

Today, the health of the industry is better, but the principle is unchanged. The Class I carriers need to increase their capacity to handle the new business they are facing. Increased capacity means increased investment. Increased investment occurs only where returns are attractive. If money from short line traffic is transferred from carriers to shippers through an abrogation of the economic terms that were agreed upon when the short lines were formed, returns will go down, and the investment will not occur. (Remember, railroads are only just beginning to be considered attractive investments by Wall Street, and recent reports by DoT and AASHTO, among others, say that the amount of future investment required is far from assured, even at today's price levels).

There are three reasons why short lines fear such an outcome. First is thwarted growth. Many of the large railroads I have talked to have told me that there simply will not be dispositions of potentially viable branches if paper barriers cannot be created and the revenue flows from those lines are endangered. (Some of the petitioners in this case are coal shippers. It is hard for me to understand why a rational Class I would dispose of any coal-hauling branch line in the future if limitations on paper barriers threaten the coal rate structure that will provide the revenue to maintain and expand main line physical plant.) Not only are future line acquisitions needed to increase the scale and

efficiency of short line operators, but it is also evident that the kind of retail business handled on most branch lines is in jeopardy unless the kind of individual customer attention provided by short line management can be provided to customers on additional lines. Whole industries like lumber and paper and metals are dependent upon a mechanism to handle "loose cars" on a retail basis, something that the short lines do better than most Class I's. (Anyone who doubts the declining role of mixed freight on the Class I systems should ride on almost any American main line and note the overwhelming dominance of unit train traffic—coal, containers, and automobiles).

Second, many short lines risk non-renewal of their leases. G&W leases parts of its system in Oregon, Pennsylvania, and elsewhere from Class I's. If the rules of the game are changed to make the leases less attractive to the owners of the lines, the likelihood of renewal of those leases becomes very small.

The third reason why short lines fear regulatory interference with existing economic agreements is more immediate. At a time when the national system is strained, many large carriers are performing a sort of triage. Unit trains are embraced, marginal traffic is seeing its prices increased, and substandard traffic is being demarketed, either explicitly or in a number of indirect ways. The danger to short lines and their customers is that some regulatory action that makes short line traffic less attractive to large railroads would put our traffic into that third class, the class that is demarketed, or at least neglected. In other words, lower rates arising from regulatory action could simply cause the service to disappear. Rather than running trains of mixed freight, the Class I's could make the

economically rational decision to run only unit trains on their capacity-constrained plant. The shippers of existing freight would have a pyrrhic victory.

Before turning away from “old” traffic to “new,” I would like to point to some of the comments made by the Federal Trade Commission in its recent paper titled Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases.²

The FTC does not regulate the railroads, but the economic, antitrust, and political policy principles faced by the FTC following a roughly tripling in gasoline prices are somewhat similar to the issues faced by the STB. Despite some findings of issues at the local level requiring further investigation, the report supports the dramatic recent increases in gasoline prices as economically appropriate under recent market conditions. The report notes that margins can be expected to increase during periods of strong demand in any competitive market, and it notes the role that strong prices play in the decision whether to expand capacity—expansion that may dampen the need for yet higher prices.

*Consumers might be better off in the short run if they did not have to pay higher prices for the same quantity of goods; in the long run, however, distortions caused by controls on prices would be harmful to consumers' economic well-being*³.

The FTC report is appropriate to the paper barrier situation because of two salient facts that are common to the railroad and gasoline businesses. First, affected customers in both cases are hopeful of lower prices (although gasoline

² <http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf>

³ *Id.* at 183.

users have seen price increases far exceeding rail price increases). Second, both industries are in a period of capacity shortage. The railroads in particular are considering large capital investments needed to improve capacity.

These common facts bear directly upon the paper barriers issue. The issue is not simply that lower prices relating from regulatory interference with the barriers may slow rail investment at an uncertain future time. The issue is a much more immediate one: Will Class I railroads continue to provide service for branch line and short line traffic if regulatory action reduces the margin on that traffic? The FTC noted that gasoline refiners redirected their product line to highest margin products in time of capacity shortage. Just so, the Class I railroads can, and should, favor the traffic that will produce the highest margins until the capital can be raised to construct market-clearing increases in capacity.

It hardly needs restatement here that the traditional carload model of railroad business needs improvement. That carload traffic, sometimes called "retail" or "merchandise" or "loose car" traffic, has been widely cited as producing substandard returns on investment. That same carload traffic is the very heart of short line business and predominates on the remaining branch lines that are candidates to become future short lines. A number of committed private sector groups, including the American Forest & Paper Association, the National Industrial Transportation League, the AAR, and individual railroads are seeking ways to improve margins on carload traffic so that it can compete for scarce main line capacity. The last thing that this endangered business needs is regulatory

action that could endanger its margins and impede the change that is needed to make it economically competitive.

Now, let's turn from "old" traffic to "new" traffic, where somewhat different factors are at work. (In scanning some of the early pleadings in this case, it strikes me that most of the petitioners are "old" traffic shippers seeking lower rates rather than "new" traffic shippers seeking broader opportunities.)

"New" traffic is different because, at least in principle, almost everyone agrees that paper barriers applying to new traffic should be much more limited. Indeed, some paper barriers explicitly exclude "new" traffic, and the Railroad Industry Agreement (RIA) administered by the Rail Industry Working Group (RIWG) provides that Class I's shall have only a right of first refusal on new traffic. (Reilly McCarren is planning testimony to say more about the workings of RIWG). If a Class I won't accept new traffic at a price competitive with other modes, it must lift the paper barrier to permit alternative rail routes.

The difficulty comes in separating the old from the new, often a difficult and contentious process. But there are mechanisms in place to make this separation, ranging from normal and common bi-lateral negotiations to the more formal, but reasonably expeditious, RIWG.

There are really two kinds of "new" traffic, one of which presents few problems. That easy case is traffic to of from a wholly new shipping location. The case is easy because the shipper has the ability to make sure that paper barriers have been waived before committing to the facility. The shipper

possesses considerable bargaining power because of the possibility that the new facility could be placed at a different location not having paper barriers.

The other case involves existing rail shipping locations. The difficulty here is that the Class I railroad wants to be assured that it is not subsidizing an unexpected and unintended revenue drain. For example, a shipper on a short line that has paper barriers requiring onward movement by Red Railroad may ask for the opportunity to ship the same commodity to a point served only by Green Railroad. The issue for Red Railroad is whether the freight at the Green Railroad destination will be transloaded to truck or otherwise substituted for traffic moving to the existing destination on Red Railroad.

These negotiations are often frustrating because of the detailed factual inquiries that they require. But it is precisely those factual inquiries that make the private sector, and not regulation, the better way to solve the problem.

G&W's experience in Oregon is instructive. There are three short line railroads that are virtually contiguous. One is a former BNSF network between Portland and Eugene. A second is a former UP (Southern Pacific) network that is interlaced with the first and that serves important paper, lumber, and steel mills generally southwest of Portland. Those two railroads are subject to paper barrier agreements that restrict former BNSF traffic to BNSF line haul movement and former Southern Pacific traffic to UP movement. G&W operates the two lines together under the name of Portland & Western (P&W) but adheres to the routing requirements of the separate linehaul agreements. The third railroad is a RailAmerica property known as Central Oregon & Pacific (CORP) that comprises

former UP (Southern Pacific) lines south and west of Eugene. The P&W and CORP are physically separated by a few hundred yards of UP yard track at Eugene.

When G&W took over the properties comprised in the P&W, there was virtually no local business or business with the lines that are today CORP. However, continuing negotiation with BNSF and UP has allowed increasing movement of local traffic between the two parts of the P&W system and between P&W and CORP so that today inter-system (that is, traffic originating on one of the three short lines and terminating on another) composes about 17% of P&W's total revenue. This illustrates exactly how the private process can work to allow "new" traffic to move around paper barriers.

My conclusion is that no one, not shippers, not short lines, and not Class I railroads, wants paper barrier agreements to impede the creation and flow of "new" traffic. Given this mindset, and given the effective industry remedies that are available, it is unlikely indeed that regulatory action could improve the result. On the other hand, regulatory action that spilled over into the area of "old" traffic and affected or even created doubts about the economics of that traffic could have serious, negative, and immediate deleterious effects upon both short line railroads and their customers.

Let me add one point before closing. That point is that I believe that some of the "moderate" or "compromise" regulatory solutions that I have heard proposed could be just as destructive as the seemingly more extreme measures. Examples of such "moderate" measures are that paper barriers might be

abrogated after some period of time, say, ten years, or that paper barriers would be forbidden only for new short line transactions. These ideas are deeply dangerous, because they create the illusion that the economic effects will be small. I am convinced that any regulatory interference in the formation of voluntary agreements between Class I's and short lines will bring the formation of new short lines to a virtual halt and will result in the non-renewal of many existing short line leases. Moreover, it will stigmatize short line traffic and cause Class I's to pursue other traffic that they perceive to have more certain profitability.

Requests for regulation of paper barriers should be rejected.