

217988

**BEFORE THE  
SURFACE TRANSPORTATION BOARD**

---

**STB EX PARTE NO. 665**

**RAIL TRANSPORTATION OF GRAIN**

---

**COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS**

---

**Of Counsel:**

Richard E. Weicher  
Michael E. Roper  
BNSF Railway Company

Theodore K. Kalick  
Canadian National Railway Company

Paul Guthrie  
Canadian Pacific Railway Limited

Peter J. Shudtz  
Paul R. Hitchcock  
CSX Transportation, Inc.

Robert B. Terry  
David C. Reeves  
The Kansas City Southern Railway Company

George A. Aspatore  
John Scheib  
Norfolk Southern Corporation

J. Michael Hemmer  
Louise A. Rinn  
Union Pacific Railroad Company

Louis P. Warchot  
Association of American Railroads  
50 F Street, N.W.  
Washington, DC 20001  
(202) 639-2502

Counsel for Association of  
American Railroads

Dated: October 30, 2006

**BEFORE THE  
SURFACE TRANSPORTATION BOARD**

---

**STB EX PARTE NO. 665 — RAIL TRANSPORTATION OF GRAIN**

---

**COMMENTS OF  
THE ASSOCIATION OF AMERICAN RAILROADS**

---

The Association of American Railroads (AAR) submits these comments in response to the Surface Transportation Board's (Board) request for views on issues related to the transportation of grain by rail. AAR members account for the vast majority of North American freight railroad mileage, employees, and revenue.

The more than 560 freight railroads operating in the United States 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 and serve nearly every agricultural, industrial, wholesale, retail, and resource-based sector of our economy.

As the AAR noted a year ago in its statement to the Board regarding the impact, effectiveness, and future of the Staggers Rail Act of 1980, 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 hundreds of billions of dollars into improving the

performance of their infrastructure and equipment — to the immense benefit of their customers (including their grain customers) and our nation at large.

Looking ahead, our economic prosperity and our ability to compete successfully in the global marketplace will depend critically on the continued viability and effectiveness of our freight railroads. But to be viable and effective, 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 Board 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. Simply put, railroads need returns today to make investments for tomorrow.

Thus, any policy — especially a swing in the regulatory environment back to excessive 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 limit railroads' ability to engage in differential pricing and 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. No shipper, of grain or anything else, should welcome such a result.

By adhering to the general guiding principles that railroads must be able to engage in differential pricing and that they must have the opportunity to generate revenues

sufficient to allow essential reinvestment, the Board will help ensure that any action it takes in consideration of the issues raised in this proceeding is consistent with the governing statute and with the compelling public interest in continued improvement in the nation's rail infrastructure.

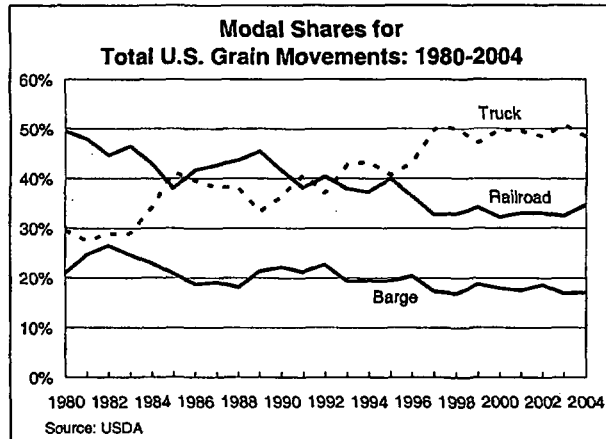
It is certainly true that rail earnings have improved over the past year or two. Improved rail profitability should be viewed as a welcome development because it means that railroads are better able to justify and afford the massive investments needed to keep their existing networks in top condition *and* make the huge investments in new capacity needed to meet the sharply higher freight transportation demand expected in the years ahead. Even after recent improvements, though, rail earnings are no better than average among all industries — and thus hardly “excessive.”

#### **Overview of Grain Transportation**

The grain logistical chain in the United States is complex. Production, movement to storage, and movement out of storage to domestic and export markets depend on a variety of interdependent factors. Railroads, along with barges and trucks, are a critical part of this chain.

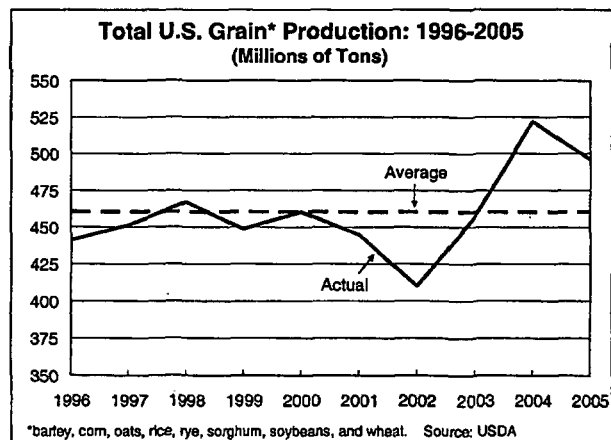
Shippers in most grain production and consumption regions benefit from strong competition among railroads, trucks, and barges to carry grain. In fact, trucks have gained market share from railroads over the past 20 years. According to the most recent U.S. Department of Agriculture (USDA) data available, the truck share of tons of grain transported rose from 30 percent in 1980 to 48 percent in 2004, while the rail share fell from 50 percent in 1980 to 35 percent in 2004. The barge share fell too, from 21 percent to 17 percent.

The increase in market share for trucks is, among other things, a function of significantly increased local processing of grain (for example, the sharp increase in the number of ethanol facilities located in corn-growing regions) as well as an increasing tendency of farmers to purchase trucks for their own use.



A variety of unpredictable factors affect grain transportation. For example, year-to-year grain production fluctuates widely in response to weather, government policies, crop prices, the financial condition of the farm sector, trends in markets overseas, and many other factors. From 1996 to 2005, average annual U.S. grain production was 460 million tons, but actual production ranged from 410 million tons to 522 million tons. Significant variability occurs within states as well.

For example, Kansas wheat production rose from 8.1 million tons in 2002 to 14.4 million tons in 2003 (a 77 percent increase), only to fall again to 9.4 million tons in 2004 (a 34 percent decrease) and rise to 11.4 million tons in 2005 (a 21



percent increase). Moreover, forecasts of crop size, even when made close to the time of harvest, are often inaccurate, making proper planning by those involved in grain logistics that much more difficult.

Regional variances add considerable complexity. For example, hot dry spells or floods may suppress yields in one region, while other regions enjoy average or exceptional growing conditions. The majority of grain transported by rail in the East is used as feed for poultry and hogs. Exports are relatively low, hauls from production areas are often relatively short, and demand is generally more consistent over the course of the year. In the West, on the other hand, exports are more important, hauls are generally longer, and demand for transportation is less stable throughout the year and from one year to the next. In part because of these regional differences, no one-size-fits-all approach to grain issues, including transportation, can address all circumstances.

Like grain production, grain exports fluctuate over time because they are a function of many factors including global grain production; economic conditions in importer and exporter countries like China, Argentina, and Australia; exchange rates; grain prices; government policies; and ocean freight rates. All of these can (and often do) change significantly from one year to the next.

#### **Overview of Railroads and Grain**

Grain<sup>1</sup> has long been one of the most important commodities for U.S. freight railroads. In 2005, Class I railroads originated 1.4 million carloads of grain (4.4 percent of total carloads) carrying 133 million tons (7.0 percent of total tons) and earning gross revenue of \$3.3 billion (7.0 percent of total revenue). Grain is also one of the top three commodities for around one third of the more than 550 non-Class I U.S. freight railroads.

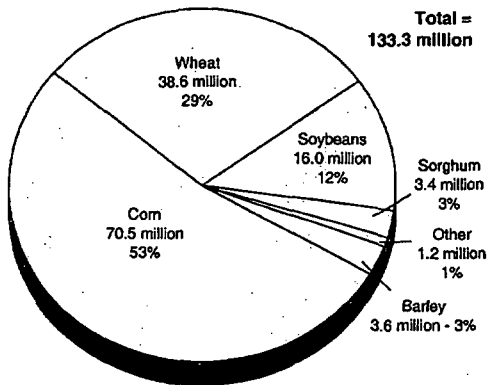
Corn is the dominant grain carried by U.S. railroads: from 2001 to 2005 it accounted, on average, for 69 million tons (52 percent of total originated rail tons of grain)

---

<sup>1</sup> Grain is defined here as barley, corn, oats, rice, rye, sorghum, soybeans, and wheat.

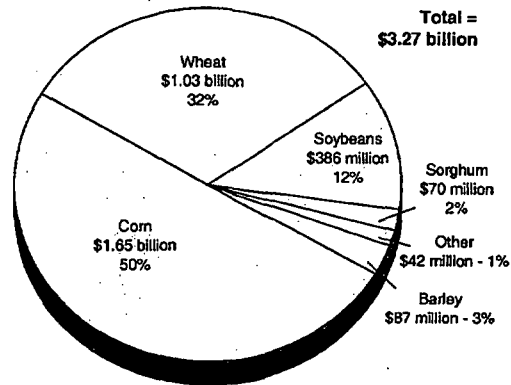
### U.S. Class I Railroad Grain Traffic: 2005

**Tons**



Source: AAR

**Gross Revenue**

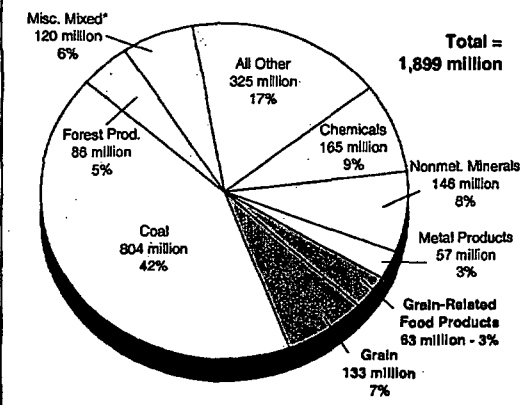


Source: AAR

and \$1.35 billion in gross revenue (49 percent of total rail revenue from grain), well ahead of wheat (37.5 million tons, \$856 million) and soybeans (17 million tons, \$333 million).

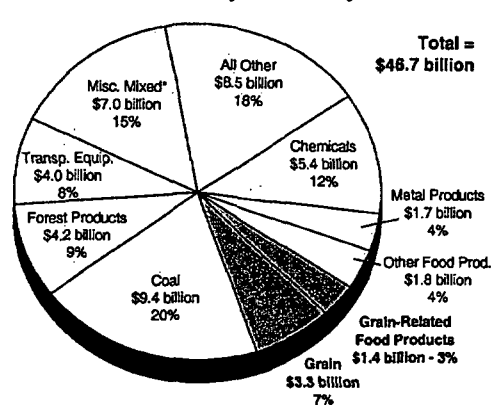
In addition, a significant portion of the food products that move by rail are derived from grain, including flour and other grain mill products; animal feed; corn syrup and corn starch; milled rice; and soybean oil, cake, and meal. In 2005, grain-related food products accounted for 705,000 rail carloads (2.3 percent of the total), 62.5 million tons (3.3 percent of the total), and \$1.45 billion (3.1 percent of total gross revenue) for Class I railroads.

**Percentage of Class I Railroad Tons Originated by Commodity: 2005**



\*Mostly intermodal, some of which is also in other categories. Source: AAR

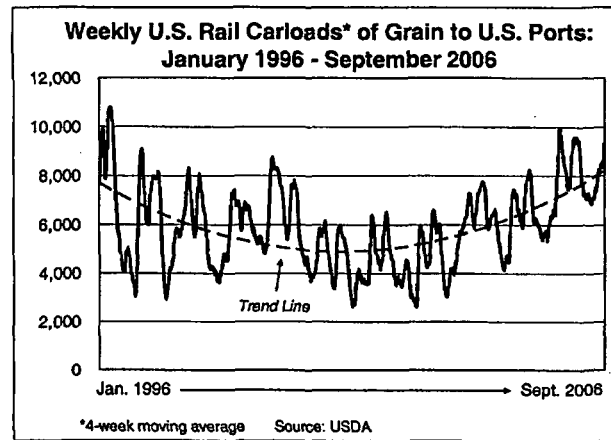
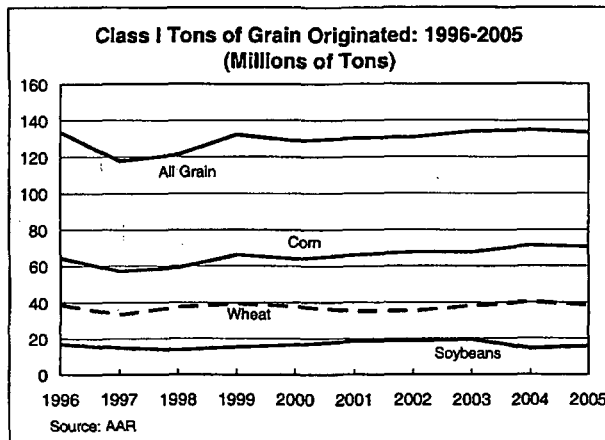
**Percentage of Class I Railroad Gross Revenue by Commodity: 2005**



\*Mostly intermodal, some of which is also in other categories. Source: AAR

All told, in 2005 grain and grain-related food products accounted for 2.1 million carloads (6.6 percent of total carloads), 196 million tons (10.3 percent of the total), and \$4.7 billion in gross revenue (10.1 percent of the total).

Over the past decade, rail shipments of grain have been essentially flat. This compares with an upward trend in overall rail shipments and an upward trend in grain production. Over the past five years or so, according to USDA data, rail export grain movements have risen markedly, reflecting the critical and beneficial role railroads play in export grain movements.

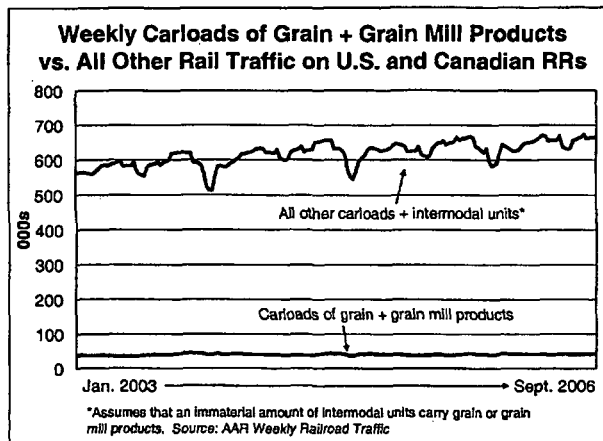


#### Grain Movements in the Context of the Overall Rail Network

Clearly, grain and grain-related movements are very important for railroads. But it must be recognized that grain is just one of many industries that railroads serve with limited resources and limited capabilities.

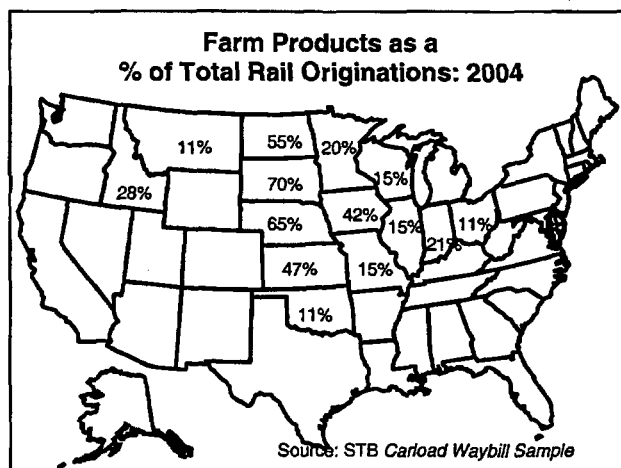
This point is illustrated by the chart at the top of the next page. The line at the bottom is average weekly carloads of grain plus carloads of grain mill products from January 2003 through September 2006 for U.S. and Canadian railroads, as calculated from AAR *Weekly Railroad Traffic* figures. This total has been relatively flat at around 41,000

carloads. The line on top is all remaining carloads plus intermodal units — a composite “units hauled by rail” figure — that has been steadily increasing and now regularly exceeds 650,000, a figure that dwarfs the corresponding grain-related total.



Even in the Midwest, grain accounts for a majority of rail traffic originated in just three states, and in no state does grain account for a majority of traffic terminated.

The point is that U.S. freight railroads must meet the needs of an extremely diverse set of shippers, and in fact railroads move tens of thousands of railcars to and from thousands of origins and destinations every day. This means that the desires of individual customers — whether grain, coal, industrial



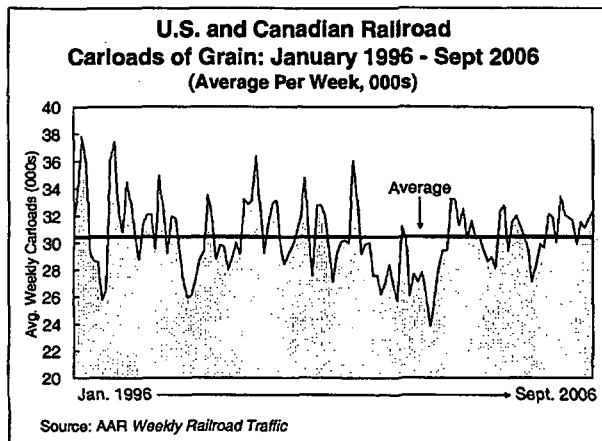
minerals, chemicals, or anything else — must be considered in the context of the needs of the overall system. An agricultural shipper might want a railroad to, say, pick up or drop off ten cars of wheat each day for three weeks from July 30 to August 20. But the railroad might determine that to accommodate other customers or for reasons of system efficiency, it can only pick up or drop off a 50 cars every five days during this period. Railroads cannot be all things to all shippers.

Likewise, a railroad must balance the desires of each customer to pay the lowest possible rate with the requirement that the overall network take in enough money to pay for all the things needed to keep the network functioning now and into the future.

In short, railroads cannot put aside the needs of the overall system in favor of the needs of individual shippers. Unless a single shipper has enough freight for a full train, different customers have to share the same train, and different customers have to share the same right-of-way. Railroads have to decide who shares which train, when the train is going to run, and who is going to share the track and when. And then railroads have to collect money from their customers to pay for it all. It is neither a simple system, nor, given the economics of railroading, a “fair” system, if “fairness” means treating everyone equally. But it is the best freight rail system the world has ever seen.

#### **The Railroad Grain Car Fleet and Grain Car “Shortages”**

The volume of grain transported by rail (and other modes) varies considerably from year to year. Moreover, within any given year, the volume of grain transported within a region or by an individual carrier can be highly cyclical and can even be volatile week to week. For example, from January 1996 through September 2006, U.S. and Canadian railroads originated an average of just over 30,400 carloads of grain per week — but the peak week was 59 percent higher than the lowest week.

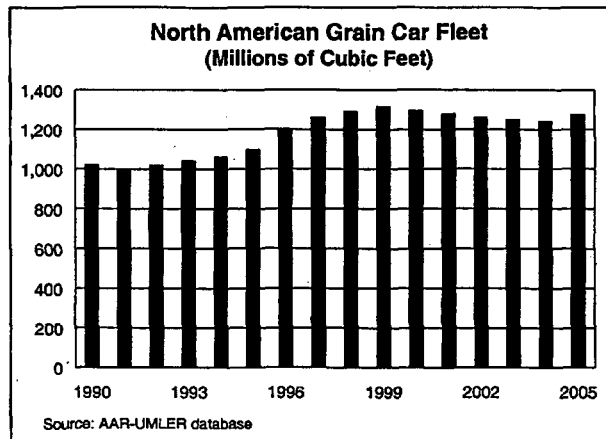


During times of particularly high demand (generally during or immediately following harvests), so-called “shortages” of rail grain cars might occur. During these periods, not all grain shippers who want rail cars are able to obtain them easily. Conversely, during periods of relatively low demand, it is common for thousands of grain cars to sit idle on rail sidings, sometimes for long periods.

Railroads know that adequate grain car capacity is critical to efficient grain marketing and transportation, which is why they and other freight car providers work hard to supply a fleet that is as large as can be justified economically. Moreover, when car “shortages” do occur, railroads and others work diligently to move as much traffic as possible as quickly as possible.

The North American railroad grain car fleet is huge: as of year-end 2005, it consisted of more than 263,000 cars (owned by both railroads and non-railroads) with a total capacity of 1.28 billion cubic feet — a 25 percent increase over the comparable figure for 1990. New grain cars are constantly being added to the fleet.

Almost all new cars have significantly larger capacity than the cars they replace, making a focus solely on the number of



cars in the fleet misleading. Moreover, because of substantial improvements in utilization through efficiency improvements like unit trains (and especially “shuttle trains”), a given grain car today typically moves more grain than even just a few years ago.

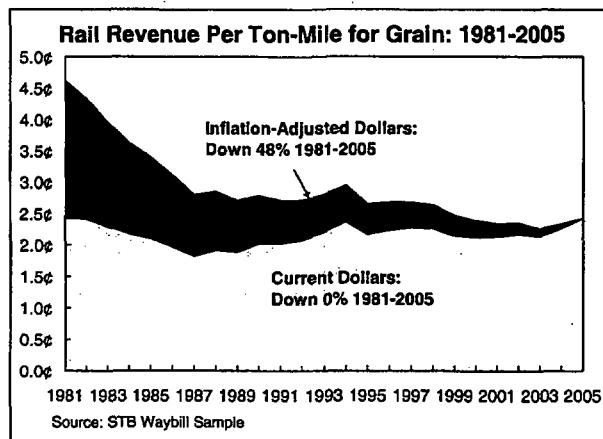
Simply buying more grain cars is not the answer to the occasional car supply shortage problem. The cost of owning a grain car — the purchase price alone of a new jumbo grain hopper is many tens of thousands of dollars — is a significant sunk cost that must be recovered over the productive life of the car, including peak and non-peak periods. For the same reason that “you don’t build a church for Easter Sunday,” it is not economical to incur the costs of providing high levels of stand-by equipment to meet unpredictable and temporary surges in traffic, only to have that same equipment sit idle for much of the time.

This point is known not only to railroads, but also to the various non-railroad entities that now own close to half the grain car fleet. Like railroads, they will invest in more cars only if the expected returns justify the investment, and they find it uneconomic to maintain an inventory of railcars sufficient to accommodate all the potentially temporary peak demand periods.

Put another way, unless agricultural interests are willing to pay for excess rail capacity — something they show no inclination to do — periodic grain car shortages can be expected to occur.

#### **Rail Rates For Grain**

Like most rail shippers, grain shippers have historically enjoyed rail rates that trended down for many years. As measured by rail revenue per ton-mile (RPTM), a useful surrogate for rail rates, average U.S. rail grain rates fell 48 percent in inflation-adjusted terms from 1981 to 2005.



A number of studies have examined the behavior of rail grain rates. In October 2006, for example, the Government Accountability Office (GAO) released a report entitled Freight Railroads: Industry Health Has Improved, But Concerns About Competition and Capacity Should Be Addressed. In the report, the GAO noted the general decline in rail rates over the past 20 years, finding that overall rail rates in 2004 were “20 percent below 1985 rates” in non-inflation adjusted terms. The GAO found that rail rates “have not declined uniformly,” (*i.e.*, railroads engage in differential pricing, as explained further below) and that grain rates rose slightly in non-inflation adjusted terms from 1985-2004. (The GAO did not calculate inflation-adjusted rate changes, but if it had it would have found a significant decline in railroad grain rates over this period.)

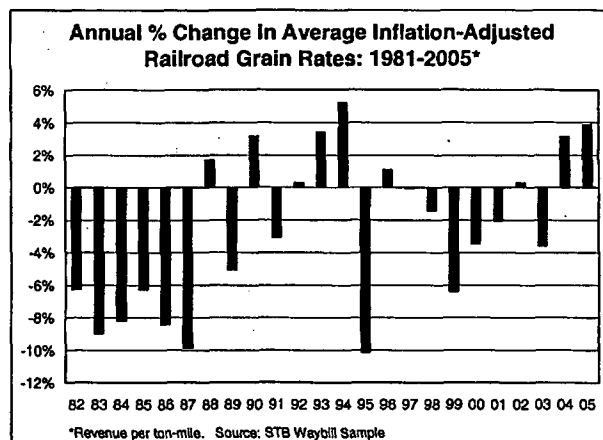
In June 2002, the GAO issued a report entitled Railroad Regulation: Changes in Freight Railroad Rates from 1997 through 2000. After examining various commodities and rail corridors, GAO concluded that rail rates had fallen since 1990, both overall and generally for specific commodities. The GAO wrote, “Our analysis of rail rates since 1990 for coal, grain (corn and wheat), chemicals (potassium, sodium, plastics, and resins), and motor vehicles and motor vehicle parts in selected high-volume transportation markets generally showed that rates continued to decrease from 1997 through 2000.” This report was a follow-up to an April 1999 GAO report which covered 1990–1997 and found similar results.

In a December 2000 study, the Board itself found that rail rates (as measured by inflation-adjusted revenue per ton-mile) for farm products (made up almost entirely of grain) fell by 34 percent in the East and 39 percent in the West from 1984 to 1999. Rates

as measured in inflation-adjusted revenue per ton also fell sharply — down 19 percent in the East and 28 percent in the West.

In January 1999, Canada's Organization For Western Economic Cooperation noted that "In the U.S. the specific process of deregulation allowed railroads to operate more efficiently and simultaneously resulted in more efficient shipping practices, thereby reducing their costs and ultimately reduced rates. These effects were pervasive throughout the system and even those regions with relatively concentrated rail sectors (*e.g.*, Montana, North Dakota) benefited from these productivity changes in terms of reduced rail rates."

Like average rail rates for some other commodities, average rail rates for grain have increased over the past couple of years. But also like other commodities, in aggregate the added costs to grain shippers associated with recent price increases do not come close to matching the tremendous savings grain shippers have experienced over the years due to rate decreases.



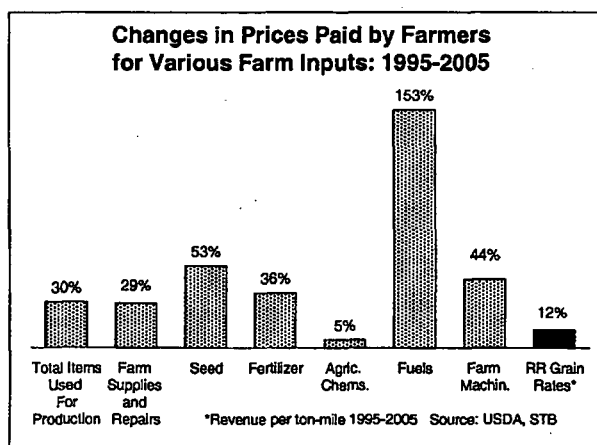
Moreover, as noted earlier, if railroads are to remain viable and effective, especially in the face of huge projected increases in freight transportation demand over the next 20 years, they must be able to earn enough to invest adequately in their networks.

This point is especially important in today's capacity-constrained environment. Since Staggers, U.S. freight railroads have worked off large amounts of excess capacity and made huge productivity gains. On many critical corridors and locations, excess rail

capacity no longer exists. This means that as their traffic continues to grow, railroads will have to concentrate increasingly on building substantial *new* capacity in addition to maintaining their *existing* extensive infrastructure and equipment. Because railroads must earn sufficient revenue to make the massive investments in infrastructure and equipment needed to address service and capacity challenges, and because future productivity growth will be increasingly difficult and expensive to attain, the past quarter century of aggressive railroad rate reductions cannot be presumed to be a barometer for the future

Even after rail rate increases in 2005, the behavior of rail grain rates is in sharp contrast to the prices of other farm inputs. According to USDA data, from 1995 to 2005 the prices paid by farmers for most farm

inputs rose: up 29 percent for farm supplies and repairs; up 53 percent for seed, up 36 percent for fertilizer, up 153 percent for fuel, and up 44 percent for farm machinery. The average price paid by farmers for total items used for



production rose 30 percent. During this

same period, the average rail rate for grain (as measured by grain RPTM) rose 12 percent.

This shows that railroads are doing their part to keep U.S. grain competitive.

#### **Grain Shippers and Differential Pricing**

In its report on freight railroads released in October 2006, the GAO correctly noted that not all rail shippers, including grain shippers, have seen their rates behave in the same way. In part, this is because railroads practice demand-based differential pricing.

Because economies of scale exist in the railroad industry (that is, the costs of transportation decline as traffic volume increases), marginal costs are usually lower than average costs. In other words, the cost to the railroad of handling an additional unit of traffic is usually less than the average cost of handling each unit of traffic. Because of their high fixed costs associated with track, facilities, and equipment, railroads cannot price all their traffic at marginal cost and still cover their fixed costs. Any firm that cannot cover all costs, including fixed costs, ultimately cannot survive.

Nor can railroads price on the basis of average costs. Because of competition, much rail traffic moves at rates below average costs but above variable costs. Any traffic moving at rates above variable cost makes at least some contribution to fixed costs and is, therefore, better than no traffic at all. If the rates on that traffic were raised to the average cost level, much of it would be diverted to other modes and that traffic's contribution to fixed costs would be lost. If this happens, railroads must either raise rates on their remaining traffic to make up for the contribution of the lost traffic to fixed costs or reduce their fixed costs by shedding lines or other means.

Only by recognizing and pricing in accordance with the varying demands for rail service can a railroad have any opportunity to recover its full costs. Indeed, differential pricing benefits all shippers because lower (differential) prices generate revenue which otherwise would not be realized.

The principle that railroads should be allowed to price differentially based on demand in order to allow them the possibility of recovering their total costs of service (including the cost of capital) has long been recognized by the Board and the Interstate Commerce Commission (ICC) before it. In adopting Constrained Market Pricing ("CMP")

as the guiding principles governing rail rate regulation, the ICC concluded that “the cost structure of the railroad industry necessitates differential pricing of rail services.” *Coal Rate Guidelines - Nationwide*, 1 I.C.C.2d 520,526 (1985) (“Coal Rate Guidelines”), *aff’d sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987). The ICC held that differential pricing is “central” to CMP principles, and stated that “[a]ny means of allocating [unattributable] costs among shippers other than *actual market demand* is arbitrary and may not permit a carrier to cover all of its costs.” *Id.* at 525-526 (emphasis added).

Since the adoption of CMP in the Coal Rate Guidelines, these sound economic principles have been reaffirmed by the ICC and Board, and approved by the courts, in numerous cases.<sup>2</sup> Without differential pricing, the rail industry could not have achieved its tremendous gains in operating efficiency and financial health, which allowed railroads to make massive investments in their networks, accommodate large increases in freight volume, offer competitive rates, and provide improved service to shippers.

Thus, in considering the issues in this proceeding, the Board should take care to ensure fidelity to first principles of rail rate regulation, including sound, time-tested and judicially-approved principles of demand-based differential pricing. These principles

---

<sup>2</sup> See, e.g., *Consolidated Rail Corp. v. United States*, 812 F.2d at 1448-49; *Potomac Electric Power Co. v. ICC*, 744 F.2d 185, 193 (D.C. Cir. 1984) (in enacting the Staggers Act, Congress understood the “necessity of such differential pricing”); see *id.* at 194 (the “concept of differential pricing ... necessarily contemplates that the carrier will maximize its profits on traffic for which it has no competition so as to offset its lower earnings on competitive traffic”); *MidAmerican Energy Co. v. STB*, 169 F.3d 1099, 1106 (8th Cir. 1999) (affirming application of differential pricing to so-called “bottleneck” shippers; noting that the “Board has recognized that an important part of achieving revenue adequacy is differential pricing”); STB Docket No. 42072, *Carolina Power & Light Co. v. Norfolk Southern Ry. Co.*, slip op. at 33 (served Dec. 23, 2003) (“[d]emand-based differential pricing is essential in the railroad industry because railroads serve a mix of captive and competitive traffic”; non-demand-based cost apportionment methods do not necessarily permit carriers to recover costs) (reconsideration granted on other grounds in STB Decision served October 20, 2004).

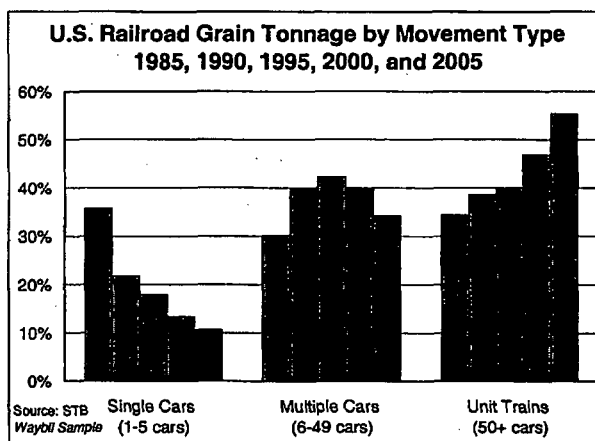
remain vital to the financial health and continued viability of the rail industry and the essential service it provides to its customers.

### **Railroad Grain Service Programs**

Grain customers can choose from a variety of rail service offerings the ones that best meet their needs.

For example, railroads offer a variety of movement options (single car, multiple cars, or unit trains) to grain shippers. On a per car basis, multiple car and unit train movements are less costly (in terms of cars, locomotives, fuel, etc.) to railroads than single car movements. Railroads pass on their cost savings in the form of lower rates for more efficient movements.

Rail traffic data show a pronounced trend toward more efficient movement types. Single car movements (typically defined as 1–5 cars) accounted for 36 percent of total U.S. grain carloads in 1985. By 2005, that figure had fallen to 11 percent. Meanwhile, multiple car shipments (defined as 6–49 cars) went from 30 percent in 1985 to 34 percent in 2005.



Unit trains (50+ cars) rose from 34 percent in 1985 to 55 percent in 2005.

The continuing shift to train load and large volume operations in the grain industry is not the result of monopoly railroads dictating to grain marketers, as some in the grain industry charge. Rather, the trend toward unit trains and efficient long-hauls is a response to market forces that call for grain transportation to be as efficient as possible. The market

is generally finding that the traditional system of single car and small volume rail operations over numerous branch lines is too costly for railroads *and* shippers.

By offering incentives (lower rates) that reflect their cost savings for more efficient shipments, the railroads allow the market to decide whether to invest in facilities designed to handle them. This approach *reduces* the overall cost of getting grain to market. To ignore the economics of grain transportation by requiring less efficient shipments to be priced the same as more efficient shipments would reduce domestic transport efficiency and harm the competitiveness of U.S. grain on the global market.

Some railroads also offer reservation programs that allow shippers to reserve grain cars in advance. These programs help inform railroads how many grain cars their customers will need, as well as when and where they will be needed.

#### **Off-Peak Rate Discounts**

At times of relatively low demand for grain cars, railroads may offer incentive rates in an effort to stimulate the movement of grain in storage. Doing so is designed to “smooth out” some of the peaks and valleys that characterize grain transportation. However, because rail rates are a relatively small portion of the delivered price of grain, these incentive rates and discounts alone are rarely enough to nudge grain out of storage and into the market. Consequently, rail attempts to stimulate grain movements in this way have been only marginally successful.

#### **Railroad Mergers**

Some in the grain shipper community claim that post-Staggers rail mergers have increased the number of singly-served rail customers in the grain community. This claim is without foundation.

The argument that railroad mergers have caused a reduction in competition ignores the fact that most rail shippers have always been served by just one railroad. In addition, 25 years ago the U.S. rail network was largely balkanized. Two-thirds of rail ton-miles were accounted for by movements over two or more railroads involving the inefficiencies of traffic transfer between railroads. Movements involving three or more carriers were common. The rail industry was plagued with excess capacity, and few railroads could achieve meaningful economies of density because of the declining traffic base and the multiplicity of routes.

The trend toward consolidation in the rail industry has been a market-driven effort to achieve cost savings through the creation of more efficient rail networks. Railroads exhibit economies of density and scope. By increasing the volume (density) of traffic moving over the rail network, railroads are better able to cover their fixed costs. And by expanding the scope of their service offerings, railroads can improve their ability to recover common costs, such as the costs of rolling stock and terminal facilities. Accordingly, most railroad combinations of recent years have been predominantly vertical or end-to-end in nature, allowing the combined carriers to offer extended single-line service into new markets and attract higher volumes of traffic to single-line routes.

If anything, the stronger railroads created through mergers in the post-Staggers era have enhanced competition, not reduced it. It is simply not reasonable to claim that our nation's farmers would be better served if the balkanized, less efficient rail system that existed prior to Staggers were still in place today.

Moreover, since Staggers the initiatives of railroad applicants and the oversight of the Board (and the ICC before it) have ensured that no rail customer would change from

multiple- to single-railroad service as a result of a rail merger. In fact, in some instances, the number of railroads serving a customer has increased as a result of a transaction.

Finally, since Staggers, the extent of rail consolidation among major railroads has been much lower than rail critics commonly claim. After accounting for various factors, including a major change in 1992 in the definition of what is a Class I railroad, approximately 22 Class I railroads in 1980 have merged to form the seven existing Class I railroads. Claims or inferences that mergers since 1980 have reduced the number of Class I railroads from 40 to 4 (or similar numbers) are false.

### **The Dangers of Reregulation**

Self-interested advocacy groups, including some representing grain and other agricultural interests, 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. The AAR made this point in its statement on the impact, effectiveness, and future of the Staggers Rail Act of 1980 one year ago, but the point is important enough to warrant repeating.

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. After all, 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 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 the need of shippers of grain and every other product that moves by rail.

At the most basic level, proponents of railroad reregulation believe that railroads charge too much and that the use of differential pricing by railroads is unfair. These proponents apparently fail to understand that, as noted earlier, 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 Board 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.

Some in the grain industry seem to prefer an outcome in which rail-on-rail competition would be pervasive and rail rates would be driven down close to marginal costs. But no one who favors such a scenario has explained how railroads could be expected to sustain themselves as private enterprises under such a regime. In an era of capital starvation that would result from the sort of reregulatory reforms that some in the agricultural sector support, the first rail lines to suffer — in the form of reduced service, disinvestment, deferred maintenance, and the like — would likely be relatively low density lines, many of which are in largely rural areas and carry grain traffic.

Second, Staggers did not bestow on railroads a special public service obligation, verging on the governmental, to subsidize other businesses or industries, compensate for regional disadvantages or characteristics, or serve as the instrument for advancing other local or national objectives at the railroads' own expense.

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 grain 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 Board 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 Board 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. Railroads recognize the desirability of a less complex, less expensive process to accommodate complaints of truly small shippers and have been working diligently to find reasonable ways to improve the current system.

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

#### **Rail Industry Profitability**

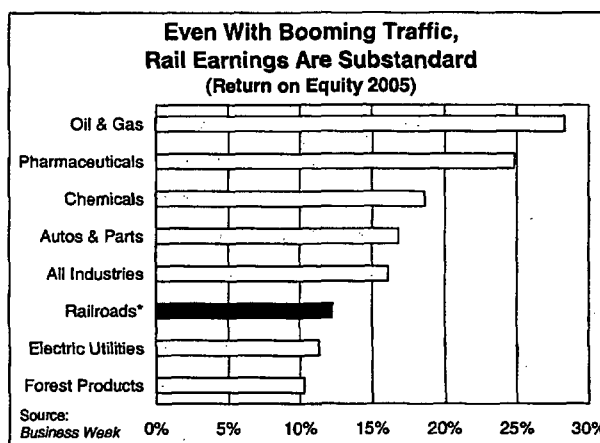
Railroads today are continuing to see the results of fairly major shifts in the transportation sector that began several years ago. These shifts are the result of numerous factors, including high fuel costs, which favor the significant energy-efficiency advantages that rail has over trucks; capacity constraints in the trucking industry driven largely by its inability to find enough people who want to be long-haul truck drivers and increasingly congested highways; booming international trade, which includes, among other things, a continuing surge in imports from Asia and higher agricultural exports from our farmers; high natural gas prices, which in turn cause utilities to burn more coal for power generation; and a continuing strong domestic economy, which has included an overall increase in industrial production. As a result of these and other factors, U.S. freight railroads today in aggregate are hauling more freight than ever before.

Concurrent with record rail traffic has been record rail revenues. Compared to what railroads have been used to seeing, the industry's financial results in 2005 and so far

in 2006 are impressive. Unfortunately, some rail critics have seized upon improved rail earnings to claim that railroads are making so much money now that they can afford — indeed, some would claim morally obligated — to reduce their rates. Railroads disagree with the claim that they are making too much money.

No one should be confused regarding railroads' *relative* profitability. In 2005, when railroads were hauling record levels of traffic and had sharply higher-than-historical profitability, rail industry earnings were *still* substandard compared to other industries.

Return on equity (ROE) is commonly used as an indicator of profitability. According to *Business Week* data covering the S&P 500, in 2005 the average ROE for the four largest U.S. railroads was 12.3 percent — a substantial improvement over the



7.8 percent recorded in 2004, but still well below the 16.1 percent average for all firms in the S&P 500 for 2005.

Data from the *Fortune 500* tell a similar story. In 2005, the median ROE for the railroads in the *Fortune 500* was 14.1 percent, less than the *Fortune 500* median of 14.9 percent and well below the ROE of

| Fortune 500 Return on Equity: 2005 |       |                                |              |
|------------------------------------|-------|--------------------------------|--------------|
| Industry                           | ROE   | Industry                       | ROE          |
| Household & Personal Prod.         | 41.5% | Aerospace and Defense          | 16.3%        |
| Petroleum Refining                 | 25.8% | <b>Fortune 500 Median</b>      | <b>14.9%</b> |
| Mining, Crude-Oil Prod.            | 23.6% | Motor Vehicles & Parts         | 14.6%        |
| Pharmaceuticals                    | 23.4% | <b>Railroads</b>               | <b>14.1%</b> |
| Food Consumer Products             | 21.8% | Pipelines                      | 13.5%        |
| Industrial & Farm Equip.           | 21.1% | Electronics, Electrical Equip. | 12.1%        |
| Computers, Office Equip.           | 19.7% | Engineering, Construction      | 11.8%        |
| Oil & Gas Equip., Services         | 18.9% | Utilities: Gas & Electric      | 10.4%        |
| Metals                             | 18.3% | Energy                         | 7.4%         |
| Chemicals                          | 18.1% | Food Production                | 6.2%         |
| Medical Products & Equip.          | 17.3% | Packaging, Containers          | 4.6%         |
| Beverages                          | 16.4% | Telecommunications             | 4.2%         |

Source: Fortune 500

numerous major rail customer groups.<sup>3</sup> In each of the 20 years from 1986 to 2005, 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.

Thus, even the improved rail earnings in 2005 are generally no more than (and in most cases less than) what non-regulated companies and industries earn.

In any case, 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 primary question vis-à-vis those who want to impose earnings restrictions on railroads is whether a railroad’s long-term profitability has reached the point at which regulatory or legislative reactions should be contemplated. Short-term improvements in profitability, short-term attainment of adequate revenues, 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 exceeding the cost of capital over a *sustained* period can begin to indicate a sustainable financial environment.

This point is especially important today. As the Board is well aware, railroads and their customers are presently facing a significant capacity challenge. For the foreseeable future, overall demand for rail freight transportation is projected to continue to grow rapidly. The U.S. Department of Transportation, for example, has estimated that demand for rail freight transportation will increase 55 percent by 2020 from 1998 levels, and the

---

<sup>3</sup> The median railroad ROE for *Business Week* and *Fortune 500* differs because different definitions were used. *Business Week* uses net income excluding discontinued operations; *Fortune* uses net income including discontinued operations. *Business Week* uses average shareholders’ equity for a year; *Fortune* uses end-of-year shareholders’ equity.

American Association of State Highway and Transportation Officials has projected that freight tonnage will grow by almost 57 percent between 2000 and 2020. Together, existing capacity constraints and projected increases in demand for rail transportation service make rail capacity improvement one of the most significant issues facing the railroad industry and its customers today.

AAR members have made substantial capital investments in recent years in order to address capacity challenges created by the continuing growth in demand for rail services. Improved revenues and returns have been the primary factors that have enabled American rail carriers to make much-needed investments aimed at improving and maintaining capacity. Continued rail revenue growth will be essential to allow railroads to make the additional investments necessary to meet continuing increases in demand. It is therefore critical that the Board, when considering the issues in this proceeding, bear in mind rail carriers' needs for revenues sufficient to allow the additional investment required to improve capacity.

Allowing railroads the opportunity to earn revenues sufficient to support critical infrastructure investment is not only in the national economic interest, it is fully consistent with the goals of the National Rail Transportation Policy ("RTP"), including the Board's statutory mandate to maintain regulatory policies designed to promote long term revenue adequacy for rail carriers. *See generally* 49 U.S.C. §§ 10101; 10704(a)(2).

For example, the Board's governing statute expressly mandates that it maintain standards and procedures necessary to allow rail carriers to earn revenues sufficient to "attract and retain capital in amounts adequate to provide a sound transportation system in the United States." 49 U.S.C. § 10704(a)(2)(B). Similarly, the RTP requires that rail

regulation seek to “*allow, to the maximum extent possible*, competition and the demand for services to establish reasonable rates for transportation by rail”; “to minimize the need for Federal regulatory control over the rail transportation system”; “to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues”; and “to foster sound economic conditions in transportation and to ensure effective competition and coordination between rail carriers and other modes.” 49 U.S.C. § 1010(1)-(3), (5) (emphasis added).

The objectives and requirements of the RTP and other governing statutes, including those highlighted above, provide the overriding principles that must guide the Board’s considerations in this proceeding. Any proposal that does not advance these statutory requirements should be rejected as inconsistent with the Board’s statutory mandates.

Railroads think the Congressional Budget Office summarized the situation appropriately when it recently noted, “As demand increases, the railroads’ ability to generate profits from which to finance new investments will be critical. Profits are key to increasing capacity because they provide both the incentives and the means to make new investments.”<sup>4</sup>

## **Conclusion**

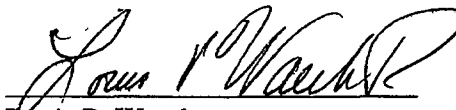
As noted earlier, U.S. freight railroads today do a remarkable job in meeting the needs of an extremely diverse set of shippers in a capacity-constrained environment. The vast majority of rail shipments, including grain shipments, arrive in a timely manner, in good condition, and at rates that shippers elsewhere in the world would love to have.

---

<sup>4</sup> Congressional Budget Office, *Freight Rail Transportation: Long-Term Issues* (January 2006), p. 11.

Looking ahead, the United States cannot prosper in an increasingly competitive global marketplace if our freight railroads are unable to meet our growing transportation needs, and having adequate railroad capacity is critical in meeting these needs. That's why it is so important for railroads to be financially healthy. Railroad financial health means that railroads can better justify and afford investments in added capacity. And that's also why policymakers at the Board and elsewhere should reject calls to reregulate railroads. Reregulation would make it impossible for railroads to earn enough to sustain their operations and attract the capital necessary for expansion, thereby suppressing the rail industry's ability to meet our nation's grain transportation needs.

Respectfully submitted,



Louis P. Warchot  
Association of American Railroads  
50 F Street, N.W.  
Washington, DC 20001  
(202) 639-2502

Of Counsel:

Richard E. Weicher  
Michael E. Roper  
BNSF Railway Company

Theodore K. Kalick  
Canadian National Railway Company

Paul Guthrie  
Canadian Pacific Railway Limited

Peter J. Shultz  
Paul R. Hitchcock  
CSX Transportation, Inc.

Robert B. Terry  
David C. Reeves  
The Kansas City Southern Railway Company

George A. Aspatore  
John Scheib  
Norfolk Southern Corporation

J. Michael Hemmer  
Louise A. Rinn  
Union Pacific Railroad Company

Counsel for Association of  
American Railroads

Dated: October 30, 2006