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**ASSOCIATION OF
AMERICAN RAILROADS**

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April 17, 2008

**Honorable Anne Quinlan
Acting Secretary
Surface Transportation Board
395 E St., S.W.
Washington, DC 20423**

Re: STB Ex Parte No. 677, Common Carrier Obligation of Railroads

Dear Acting Secretary Quinlan:

Pursuant to the Decision served by the Board on February 22, 2008, the Association of American Railroads (AAR) hereby submits its written testimony in the above proceeding. Mr. Edward R. Hamberger, AAR's President and Chief Executive Officer, will appear at the hearing in the proceeding on April 24, 2008. Mr. Hamberger will be accompanied by the undersigned, as counsel, to address specific legal questions.

Respectfully submitted,

Louis P. Warchot

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American Railroads**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 677

COMMON CARRIER OBLIGATION OF RAILROADS

**WRITTEN TESTIMONY OF
THE
ASSOCIATION OF AMERICAN RAILROADS**

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April 17, 2008

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I. Introduction

By Notice served February 22, 2008, the Surface Transportation Board ("Board") scheduled a public hearing (on April 24-25, 2008) on the railroads' common carrier obligation. The Association of American Railroads ("AAR"), whose members account for 75 percent of U.S. freight rail mileage, 92 percent of employees, and 95 percent of revenues, intends to testify at the hearing and hereby submits this written testimony as directed by the Board in its Notice. Individual AAR member railroads will also testify separately in this proceeding. The AAR's testimony will focus on the current environment for rail transportation in order to provide the context within which the railroads' common carrier obligation must be viewed.

II. Overview of Railroads' Common Carrier Obligation

As the Board noted in its decision, the common carrier obligation derives from 49 USC § 11101(a), which requires that a carrier provide transportation or service upon reasonable request. The basis for the common carrier obligation arises from common law precepts which carried over into section 11101(a).

However, the common carrier obligation is not absolute. The statute itself states that transportation must be provided only upon "reasonable request." In addition, the statute provides an exception to the common carrier obligation for railroads when they are fulfilling reasonable contractual commitments (49 USC § 11101(a)). Also, a carrier is excused from providing transportation if it is unable to properly perform its obligation because of physical constraints (see e.g., G.S. Roofing Prods. Co. v. Surface Transp. Bd., 143 F.3d 387, 391 (8th Cir. 1998)) and it is usually at the discretion of the railroad as to how it wishes to satisfy its obligations (see e.g., Midamerican Energy Co. v. STB, 169 F.3d 1099, 1106 (D.C. Cir. 1999)).

Ultimately, in the event of a controversy, the question of what is a “reasonable request” for transportation under the statute is left for the Board and the courts to decide (see e.g., National Grain and Feed Ass’n v. United States, 5 F.3d 306, 310 (8th Cir. 1993)). And, in assessing what may be reasonable, there should be two avenues of inquiry. The first is whether the “request” for service is reasonable. As noted in Consolidated Rail Corp. v. I.C.C., 646 F.2d 642, 647 (D.C. Cir. 1981), “[l]ong ago the Supreme Court made it clear that ‘[no] party has the right to insist upon a wasteful or excessive service for which the consumer must ultimately pay.’” The second is the reasonableness of the carrier’s response. Even if it is determined that a “reasonable request” has been made, a railroad obligation to provide service is not absolute. A carrier is only required to take reasonable steps to provide adequate service under the circumstances (see e.g., Granite State Concrete Co., v. STB, 417 F.3d 85, 92-94 (1st Cir. 2005); see also Chicago and North Western Transportation Co. v. Kalo Brick & Tile Co., 450 U.S. 311, 325 (1981)).

These tests of reasonableness require the assessment of the totality of circumstances involved with any particular matter at issue. The common carrier obligation does not provide that everyone must be served who requests service: “The common law of old, in requiring the carrier to receive all goods and passengers, recognized that ‘if his coach be full’ he was not liable for failing to transport more than he could carry.” (see e.g., Pennsylvania R. R. v. Puritan Coal Mining Co., 237 U.S. 121, 133 (1915)). As the Court further held, where a common carrier’s capacity is limited, the carrier is required only to allocate the limited capacity in a reasonable manner.

The AAR believes that in order to properly evaluate the reasonableness of carrier and shipper obligations in particular instances and to address the specific questions raised in the

Board's decision, the current transportation environment in which the railroads operate must play a significant role.

Many of the questions raised by the Board arise from actions taken by the railroads as a result of the unprecedented demand for rail service over many facilities that are already capacity constrained. The Board needs to take into account the nature of those constraints and what the railroads are doing, and can do, to address those issues. Individual railroads will address matters relevant to their operations and concerns. The AAR offers this additional context for those railroads' testimony.

III. The Rail Network Faces Significant Capacity Challenges

As the National Surface Transportation Policy and Revenue Study Commission recently noted, "Congestion [is affecting] every mode of surface transportation for ever-lengthening periods each day, as a result of the mismatch between demand and supply of limited capacity." (Report of the National Surface Transportation Policy and Revenue Study Commission, Volume 1, p. 4.)

To be sure, there is a tremendous amount of strength and flexibility in our nation's transportation systems, and freight is still being delivered by all of the modes. But it is clear that all freight transportation modes in the United States are facing capacity challenges today.

Freight railroads are no exception, thanks largely to substantial and sustained increases in rail traffic. From 1990 to 2006, Class I railroad tons originated rose 33 percent, carloads originated rose 47 percent, car miles rose 49 percent, and revenue ton-miles rose 84 percent. In each successive year from 1998 through 2006, Class I railroads originated more tons than ever before. Beginning in 2002, they moved more carloads in each year than ever before. Growth in intermodal traffic has been especially rapid. Beginning with the second quarter of 2002, U.S.

rail intermodal traffic rose for 20 straight quarters, sometimes by double-digit amounts compared with the same period in the previous year. (See chart 1)

There was a slight decline in rail traffic in 2007, due mainly to the severe problems in the housing and automotive sectors. Even so, railroads operating in the United States moved more freight in 2007 than in any previous year except 2006. (See chart 2)

As a result of these substantial traffic increases, average freight rail traffic density has increased sharply. Just from 1990 to 2006, Class I car-miles per mile of track owned rose 84 percent and revenue ton-miles per mile of road owned rose 116 percent. (See chart 3)

The increase in traffic and traffic density have led to capacity constraints on some rail corridors and points on the rail network. Railroads may differ in the degree to which their capacity is constrained, but there is no question that there is much less room on the U.S. rail network today than there was even a few years ago.

In recent years, solid growth in the economy (the current slowdown notwithstanding) and population, improved rail service offerings, expanding international trade, increasingly-congested highways, sharply higher fuel prices, and other factors have pushed more and more freight to railroads. Notwithstanding the current lessened traffic demand due to the present economic conditions, analysts generally expect more freight to move by rail in the years ahead. As a result, the long-term forecast is for freight rail traffic to trend steadily higher. For example, the U S. Department of Transportation recently forecast that freight railroad demand will rise 88 percent by 2035. If the increase in rail traffic in the 15 years following 2006 simply matches the rate of growth over the 15 years prior to 2006, by 2021 Class I carriers will be originating approximately 41 million carloads — up from 32 million in 2006. (See chart 4)

The magnitude of the looming freight rail capacity issue was also borne out by a recent study by Cambridge Systematics, a prominent economic and transportation consulting firm. The purpose of the study, which focused on 52,000 miles of primary rail corridors, was to estimate the cost of the expansion in capacity necessary for U.S. freight railroads to handle the 88 percent increase in freight rail traffic forecast by the DOT for 2035.

The study found that if rail capacity needs are not properly addressed, by 2035 some 16,000 miles of primary rail corridors — nearly one-third of the 52,000 miles covered in the study — will be so congested that a comprehensive service breakdown environment on the railroads affected would exist. Because the rail system is so interconnected, this outcome would mean that the entire U.S. freight rail system would, in effect, be disabled.

The significance of the network aspects of rail operations cannot be overemphasized. As lines are operated at or near full capacity, the importance of efficient utilization (to include the predictability of operations) becomes more critical. A disruption of service caused by inefficient utilization of resources can have impacts not only on the railroad involved but potentially throughout the entire rail network where traffic is interchanged or where common facilities are used.

All of this means that the characteristics of the U.S. freight railroad industry today are significantly different than they were in the past, when traffic levels were much reduced and capacity was much less an issue. The rail network faces capacity challenges now and could face a capacity crisis in the future. Looking ahead, as their traffic continues to grow, railroads will continue to need to concentrate increasingly on not only maintaining and replacing their existing capacity, but also building new capacity and finding ways to better utilize their capacity.

IV. The Railroads Are Making Substantial Efforts to Expand Capacity

The railroads are committed to work to address the present and projected transportation demands by addressing the host of factors that influence the fluidity and resiliency of their operations as well as the operations over the entire rail network. Examples of the railroads' efforts are as follows.

Spending on Infrastructure and Equipment

Of the many factors that affect how well a rail network functions, the basic amount and quality of infrastructure and equipment are among the most significant. For this reason, U.S. freight railroads have been expending, and will continue to expend, enormous resources to improve their asset base (see chart 5). From 1980 through 2007, U.S. freight railroads have invested approximately \$420 billion on capital spending and maintenance expenses related to infrastructure and equipment — more than 40 cents out of every revenue dollar. In recent years, Class I railroads alone have been devoting between \$18 billion and \$20 billion per year to these purposes.

In fact, the high level of rail spending for these purposes in recent years demonstrates the diligence with which railroads are responding to the capacity issue. Based on reports from the railroads and other sources, it is expected that Class I capital commitments (excluding maintenance expenses) in 2008 will be approximately \$9.0 billion, down just slightly from the record level of expenditures in 2007. (A slight decline in 2008 should be expected given the current uncertainty regarding the overall economy.) In 2003, by contrast, Class I capital spending was \$5.9 billion.

The following is just a sampling of the diverse types of capacity-enhancing investments individual railroads have recently made or will soon be making:

- **BNSF** plans a \$2.45 billion capital commitment program for 2008, including leasing 200 locomotives at a cost of around \$400 million and \$200 million in track and facility expansion. The 2008 capacity expansion program comes after a record capacity expansion program in 2007. Major 2008 capacity expansion programs include continuing to double- or triple-track the Southern Transcon route, including a second main line across Abo Canyon in New Mexico; continuing to install double-track on a major coal route in Nebraska and Wyoming; expansions of intermodal facilities in Kansas City, Los Angeles, and Memphis; and sidings between Fort Worth and Houston.
- **Canadian National** plans capital spending of around \$1.5 billion in 2008, including approximately \$1.1 billion on track infrastructure, \$140 million on equipment, and approximately \$250 million on transload facilities and distribution centers to grow the business. More than \$300 million in rail infrastructure projects will be in the United States. Among many other projects, CN plans to complete the multi-year \$100 million upgrade of the Johnston Yard in Memphis.
- **Canadian Pacific** plans capital spending of \$885 million to \$895 million in 2008, about equal to what the railroad spent in 2007. Funds will go to freight cars, locomotives, track renewal, and other key areas.
- **CSX** plans \$5 billion in capital spending from 2008 to 2010. The railroad plans to spend some \$200 million each year for the next three years on new locomotives and more than \$100 million per year on freight cars, mainly for coal and automotive traffic. Infrastructure projects include terminal expansions in Atlanta, Buffalo, Charlotte, and Jacksonville, as well as a new intermodal terminal in northwest Ohio.
- **Kansas City Southern** plans capital expenditures of approximately \$278 million in the U.S. in 2008. KCS also plans to expend about \$65 million to lease 30 new locomotives for U.S. operations.
- **Norfolk Southern** plans to spend, in 2008, approximately \$1.5 billion on capital investments (an increase of \$148 million, or 11 percent, over 2007). Investments in 2008 will include a new locomotives and freight cars; the construction or expansion of facilities in Columbus and Maple Heights, Ohio; and major investments in expansion projects related to the Heartland Corridor (from the East Coast to the Midwest) and the Crescent Corridor (which will link the Northeast, Mid-Atlantic, and Central Southeast).
- **Union Pacific** plans to invest a total of \$3.1 billion for capital projects in 2008. Major investment categories include \$840 million to increase network and terminal capacity, especially on coal, ethanol, and intermodal routes and in the Houston region. UP also plans to invest \$1.6 billion to maintain and strengthen track infrastructure; \$490 million to upgrade the locomotive and freight car fleet, including the acquisition of 175 high-horsepower locomotives and new covered hoppers; and \$170 million to upgrade information technology systems.

The massive investments railroads must make in their systems are a reflection of the extreme capital intensity of railroads. By any of a variety of measures, railroads are at or near

the top among all U.S. industries in terms of capital intensity. In fact, from 1997 to 2006 (the most recent year for which data are available), the average U.S. manufacturer spent 3 percent of revenue on capital expenditures. The comparable figure for U.S. freight railroads was 17 percent, or more than five times higher (see chart 6). Likewise, in 2006, railroad net investment in plant and equipment per employee was \$662,000 — nearly eight times the average for all U.S. manufacturing (\$84,000).

As a further illustration of the magnitude of rail infrastructure spending, the four largest Class I railroads spend far more on capital outlays and maintenance of track and roadway than the vast majority of state highway agencies spend on their respective highway networks. For example, only the highway agencies of Texas, Florida, and California spend more on roadway capital and maintenance than Union Pacific and BNSF spend on their networks. CSX and NS are in the top 10 compared with all states as well (see chart 7).

Hiring New Employees

In addition to equipment and infrastructure, personnel are an important determinant of rail capacity, and railroads have been aggressively hiring and training crews to expand capacity. Rail employment began to rise in 2004: Class I railroads had 11,000 more employees in December 2007 than they did in December 2003, a 7 percent increase and a reversal of a decades-long trend of fewer employees. The number of “train and engine” employees — mainly engineers and conductors who operate trains — was up 11 percent during this period, the number of maintenance of way and structures employees was up 5 percent, and the number of maintenance of equipment employees was up 7 percent (see chart 8).

Infusion of Technology

Technology has always played a key role in expanding rail capacity. Signaling systems have become more sophisticated; trains have become longer and heavier; locomotives have become more powerful and more reliable; and track structures have become more robust and thus less prone to outages for maintenance or because of failure.

Freight railroads have always been at the forefront in the use of computers and information technology, and today railroads are rapidly expanding their use of these technologies to improve overall efficiency and the fluidity of their operations, thereby adding capacity in ways other than just adding infrastructure.

For example, railroads use advanced computer modeling software in a wide variety of rail applications, from automating rail grinding schedules and improving customer demand forecasting to optimizing yard operations. CN, for example, is implementing what it calls “SmartYard,” complex computer software that identifies and analyzes every possible combination and outcome for sequencing cars in a large classification yard and simultaneously updates and communicates the car processing plan. The result is more efficient, faster yard operations. Other railroads are engaged in similar efforts.

Recognizing that another way to add capacity is to move more trains faster over the same length of track, railroads are also working with their suppliers to design, implement, and improve innovative computerized “trip planning” systems. These highly-complex systems automatically incorporate and analyze a mix of ever-changing variables (*e.g.*, crew and locomotive availability, terminal congestion, the different priority status of loads of freight, track conditions, maintenance plans, weather, etc.) to optimize how and when cars are assembled to form trains, when those trains depart, and how they are sequenced across the railroad in conjunction with the other trains that are operating.

Trip-planning systems are just one way that railroads are trying to improve equipment “cycle time” — *i.e.*, the total time it takes for a freight car to be loaded, hauled to destination, unloaded, returned to the same or a different shipper, and loaded again.

The benefits of increased efficiency can be seen through the results of rail efforts to “supersize,” automate, and increase the velocity of traffic flows where practical. For example, railroads and certain grain customers have collaborated to consolidate grain loading at high-speed “shuttle loader” elevators which improve the efficiency of rail operations; and that improved efficiency can be striking. At BNSF, for example, a typical grain car in shuttle service hauls approximately three times more grain over the course of a year than a typical grain car in non-shuttle service.

Expanded over a network, this type of operational efficiency can free up substantial capacity for other uses. Union Pacific, for example, has estimated that a one mile-per-hour increase in system-wide velocity frees approximately 250 locomotives, 5,000 freight cars, and 180 train and engine employees to move additional traffic.

Cooperative Alliances and Collaborations

Railroads are also entering into operational alliances with each other which often rely on non-standard techniques to achieve the desired results of improved capacity utilization, lower costs, and better service.

As just one example, in October 2007, Norfolk Southern and Union Pacific announced new westbound intermodal train service that will shorten by a day the trip for standard intermodal freight from the southeastern United States to Los Angeles. This shift began with the completion of the first phase of improvements on the Meridian Speedway – Norfolk Southern’s and Kansas City Southern’s joint venture corridor between Meridian, Miss., and Shreveport. In

establishing this route, the railroads eliminated almost 130 route-miles by moving this freight from the Memphis gateway.

V. Adequate Returns are Critical to Rail Capacity Investment

As described above, the railroads are diligently doing everything they believe to be prudent to maintain and expand their capacity to provide service, including making record levels of investment.

However, it is important to note that, because the railroads are privately owned and must finance the vast majority of their infrastructure spending themselves, capacity investments can be accompanied by substantial financial risk. As the Government Accountability Office noted in a recent report, “Rail investment involves private companies taking a substantial risk which becomes a fixed cost on their balance sheets, one on which they are accountable to stockholders and for which they must make capital charges year in and year out for the life of the investment.” (Government Accountability Office, Freight Railroads: Industry Health Has Improved, But Concerns About Competition and Capacity Should Be Addressed, October 2006, p. 56.)

Accordingly, railroad capacity investments must pass appropriate internal railroad investment hurdles — *i.e.*, the investments will be made only if they are expected to generate an adequate return.

For this reason, adequate rail earnings are critical for capacity investment. As the Congressional Budget Office has 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.” (Congressional Budget Office, Freight Rail Transportation: Long-Term Issues, January 2006, p. 11.) If a railroad is not financially sustainable over the long term, it will not be able to make

capacity investments to maintain its existing network in a condition to meet reasonable transportation demand, or make additional investments in the replacement or expansion of infrastructure required by growing demand.

To be sure, railroads in recent years have seen financial results that are much better than their historical norm. In 2006, U.S. railroads carried more freight than ever before, and their net income was higher than ever before as well. The railroads enjoyed relatively good financial results in 2007 as well.

But these financial results need to be kept in context. Statements about railroads' "record profits" often ignore the fact that rail profitability in earlier years was relatively poor. Thus, an improvement from earlier years may be a "record," but still far from stellar in comparison to the many other industries against which railroads compete for capital. In fact, that is the case with the rail industry. Rail industry profitability has consistently lagged most other industries — and that is still the case today. (See chart 9)

Return on equity (ROE) is a common profitability measure. According to data compiled by Value Line (a financial information firm), the ROE for the rail industry in 2006 was 14.0 percent — possibly the best ROE the U.S. rail industry has ever had. (Value Line's railroad universe includes BNSF, CSX, CN, CP, KCS, NS, UP, and Genesee & Wyoming.) By contrast, the median ROE in 2006 for the 88 industries (encompassing around 1,700 firms) for which Value Line calculates ROE was 16.5 percent — 18 percent higher than the rail figure. In fact, in 2006 railroads ranked tied for 58th among the 88 industries for which Value Line calculates ROE aggregates. Preliminary Value Line data for 2007 indicate that the railroad median (14.0 percent) will again fall short of the industry median (16.0 percent). Data from the Fortune 500

tell a similar story: the median ROE for the four major railroads in the Fortune 500 in 2006 was 15.0%. By contrast, the median ROE for all Fortune 500 firms was 15.4. (see chart 10 and 11.)

In other words, while recent years may have been the best financial years ever for railroads, they have not been sufficient to bring railroads even to the median among all industries. The need for financial sustainability is as pronounced today as ever before, especially in view of the projected investment requirements the industry will be facing.

According to the Cambridge Systematics study referenced earlier in this testimony, an investment of \$148 billion in 2007 dollars (of which \$135 billion is for Class I railroads) will be necessary for rail infrastructure expansion to keep pace with economic growth, meet the DOT's forecast demand, and maintain rail's current market share. That is in addition to the hundreds of billions of dollars necessary to maintain and replace existing rail infrastructure over the same period, and in addition to similar amounts required to maintain and replace locomotives, freight cars, and other equipment. (Class I railroads are anticipated to be able to generate only \$96 billion of the amount needed, leaving a shortfall of \$39 billion.)

Railroads will continue to spend significant amounts of their own funds to address the capacity challenges described above. However, they are, and will continue to be, unable to pay for all of the capacity that would be required to serve all shippers' needs all of the time. Since the amount of rail capital available for investment is limited, investment decisions in these circumstances focus on which investments to choose between rather than solely whether a specific investment should be made. In all such instances, those investment decisions should be based on projected returns that will most favor the long-term sustainability of the railroad's network.

VI. The Common Carrier Obligation Must be Viewed in the Context of the Railroads' Capacity Challenges and the Efforts Undertaken in Response

As noted earlier, the assessment of whether a railroad is complying with a “reasonable request” for service to meet its common carrier obligation must be made in the totality of circumstances in which the request was made. A carrier’s ability to provide service is critical to any assessment of a common carrier obligation. A railroad (or any common carrier) cannot and should not be required to provide a service that it cannot reasonably or practicably perform. This is especially relevant where the carrier does not have the capacity to provide the service (see e.g., Pennsylvania R. R. v. Puritan Coal Mining Co., 237 U.S. 121 (1915)).

As also noted above, railroads are already heavily investing in their systems. However, like firms in every other industry, railroads have limited resources and limited capabilities, meaning they must prioritize investments and asset utilization. That means they cannot be all things to all shippers, and they sometimes must make decisions regarding resource allocation that not all shippers will like. In other words, railroads must meet the needs and wants of individual rail shippers within the context of the overall rail system; and, in a capacity-constrained environment, the options and flexibility available to railroads to do this is reduced. Any evaluation of railroads’ common carrier requirements must keep this in mind.

For example, a small manufacturer might want to locate a new plant on a railroad’s busy mainline. The railroad could disrupt its main line service to pick up a carload now and again from that manufacturer, but doing so would introduce enormous inefficiencies to the railroad’s overall network. This particular shipper might benefit, but the vast majority of shippers — and the public at large — would not. Likewise, a grain elevator might want a railroad to pick up or drop off ten cars of wheat each day for three weeks from July 30 to August 20. But the railroad might decide that, to accommodate other customers or for reasons of system efficiency, it can

only pick up or drop off a lot of 50 cars every five days during this period. Again, the railroad's common carrier obligation does not, and should not, necessarily preclude the railroad from doing this.

If, in the above or comparable circumstances, the Board were asked to consider requiring a railroad to provide a specific service, serve a specific shipper, or provide a certain facility, the Board must evaluate, in determining whether there would be an appropriate legal basis for such an action, the impact on the railroad's ability to serve other shippers, the impact on the railroad's ability to maintain its level of investment elsewhere in its system, and the impact on the ability of the railroad to sustain the efficiency and fluidity of its network operations. The railroads' physical structure is constrained and they have limited resources for investment to meet transportation demands and maintain the fluidity of the rail network. In its regulatory oversight role, the Board must take into account the effect of a particular request for service or facilities on overall service to shippers generally. .

Many of the conflicts between customers and railroads (and especially between smaller customers and railroads) over service requirements result from the fact that railroads run a network operation with exceedingly diverse services for a wide variety of customers. Trains carry different commodities going to different destinations. Different customers often have to share the same train, and different trains have to share the same right-of-way or facility. Railroads have to decide what customers share which train; when each train is going to run; and who is going to share the track and when. Even under the best of circumstances, this is an exceptionally complicated system. When capacity is constrained, it becomes much more complicated because network efficiency has to be maintained and that must be the overriding goal. Maintaining efficient and fluid rail operations for the benefit of the network and shippers

in general must take precedent. The railroads' common carrier obligation must be viewed within this context and the impact of any requirement that the Board may consider imposing upon a railroad must also be viewed taking into account its effect on network efficiency.

VII. Railroads Do Not Have an Obligation to "Serve All"

Some rail critics seem to believe that no allocation of service is necessary and that the railroads' common carrier obligation equates, or should equate, to an obligation to serve all shippers in all situations or to otherwise impose a set of minimum service standards for railroads. For example, a representative of a segment of the electric utility industry stated:

"We contend that the railroad industry should – like electric utilities – also have an obligation to serve the national public interest. This obligation may sometimes be called a "common carrier" obligation, but in the end it is an obligation to serve. Further, this obligation to serve means the obligation to provide reliable transportation service to all customers at fair and reasonable prices." (Testimony of Glenn English, CEO, National Rural Electric Cooperative Association, to the House Committee on Transportation & Infrastructure Subcommittee on Railroads, April 26, 2006.)

The claim that railroads should have an obligation to serve all shippers like utilities have ignores the difference between the industries and the competitive and regulatory environment in which they operate. An obligation to serve everyone is feasible for electric utilities only because they have "peak demand" capacity built into their asset base for ratemaking purposes. In other words, electricity rates are set by regulation high enough to cover utilities' costs and provide them a reasonable return on their investments — including on peaking plants that might be used only a handful of times, or not at all, each year. Utilities' customers have no choice in the matter: they must pay rates to cover all of the utilities' costs.

But that is not what an obligation to serve everyone for railroads would mean. Instead, those that equate railroads' common carrier obligation with an obligation to serve everyone believe that railroads should have to invest in whatever assets might possibly be needed to overcome any potential obstacle to reliable and efficient service -- in effect "peak demand"

capacity. But there would be no concurrent obligation by railroad customers to pay for those assets.

This is a critical point. By definition, “just-in-case” assets are only rarely used. History shows that, given the choice, rail customers are not willing to pay for them, and unlike utility customers, rail customers have this choice. That means that railroads would have no realistic way to earn a reasonable return on their investment in these assets. No law can force outside capital providers to fund uneconomic investments, which these would be, so capital providers simply would not tolerate having their capital used in this way. Nor, given their fiduciary duty to shareholders, could rail managers use internal funds for these investments.

The net effect, then, of an obligation to serve everyone for railroads would be to force capital away from the rail industry, making it that much more difficult for railroads to handle the nation’s growing freight transportation needs.

Of course, railroads and their customers do their best to forecast future demand to help ensure that railroads have enough assets to handle the traffic tendered to them. At times, though, demand for rail service exceeds railroad and shipper expectations or markets shift suddenly (e.g., the recent increased demand for ethanol transportation). That has happened in recent years, as record demand for rail service has led to capacity constraints and delays at certain junctions and corridors of the rail network. As noted earlier, railroads have spent billions of dollars to address this capacity issue. Unfortunately, when business is unexpectedly strong, railroads cannot expand capacity immediately. Locomotives and freight cars can take a year or more to be delivered following their order; new employees take six months or more to become hired, trained, and qualified; and it can take several years to plan, permit, and build new infrastructure (see section VIII below).

Unforeseen events also hinder railroads, just as they hinder other firms. The U.S. rail network is, in effect, a 140,000-mile outdoor assembly line. Events over which railroads have little or no control — such as bad weather, accidents, mine shutdowns, port congestion, strikes at customer facilities, and much more — can impede rail operations for days, weeks, or, in the worst cases, even months at a time. Seasonal factors can also play a role — *e.g.*, grain harvests can quickly fill a rail network to capacity, much like a church might fill to overflowing on Easter Sunday.

When railroads experience an unexpected surge in traffic or unexpected problems, they may be temporarily unable to meet their customers' requests as quickly as they or the customers might like. Firms in every industry periodically find themselves in similar situations. But there is nothing in railroads' common carrier obligation that requires them to provide a uniform level of service to all customers or at all times under every possible situation.

VIII. The Railroads' Capacity Expansion Efforts Continue to Face Constraints From Local Interests

As referenced in the preceding section, there are a number of serious impediments to meeting the rail capacity challenge which in many cases have prevented, delayed, or significantly increased the expense of realizing the desired capacity improvements. The interplay of these challenges and any assessment of whether a railroad is complying with a "reasonable request" for service to meet its common carrier obligation can also be impacted by local opposition to rail projects.

It is well settled that the ICC Termination Act ("ICCTA") establishes a comprehensive regulatory regime as to preempt state and local regulations (with the exception of local health and safety regulations) that unreasonably interfere with railroad operations.

However, despite the preemption provisions of federal law and the fact that, when required, environmental reviews will identify the impacts of railroad infrastructure projects and determine necessary mitigation measures, often some members of the affected local communities may still oppose a particular rail expansion project. Moreover, their opposition will tend to be quite vocal and sophisticated. Trains do make noise, rail operations may at times be disruptive to those who live or work nearby, and the benefits of rail freight service are often not readily apparent to the general public. Even those who recognize the benefits of rail freight service may prefer that railroads run their trains next to somebody else's house or through some other town. In many cases, railroads face a classic "not-in-my-back-yard" problem.

In the face of local opposition, railroads try to work with the local community to find a mutually satisfactory arrangement. These efforts are usually successful. When agreement is not reached, however, projects can face interminable delays and higher costs. For example, Norfolk Southern had to endure almost five years of delay and uncertainty to construct and operate its terminal in Austell, Georgia needed to handle rapidly-increasing intermodal traffic. More recently, Union Pacific continues to suffer delays in double tracking its Sunset Corridor in Arizona due to issues with a state agency.

Often, local communities allege violations of environmental requirements to challenge the proposed project. Railroads understand the goals of environmental laws, and appreciate the need to be responsive to community concerns, but community opposition to rail operations can serve as a significant obstacle to railroad infrastructure investments, even when the opposition has no legal basis.

The National Surface Transportation Policy and Revenue Study Commission, in its final report released in January 2008, stated that, "Simply put, the Commission believes that it takes

too long and costs too much to deliver transportation projects, and that waste due to delay in the form of administrative and planning costs, inflation, and lost opportunities for alternative use of the capital hinder us from achieving the very goals our communities set.” (Commission Report, vol 1, pg 11) The Commission’s point often applies to rail infrastructure expansion projects, including projects that involve little or no public financial participation.

These types of delays can have significant negative affects on the costs of rail projects, and, in turn, the ability of railroads to respond to service requests. Based on railroad cost index data from the AAR, just in the five years from the first quarter of 2003 through the first quarter of 2008, railroad wage rates rose 15 percent, wage supplements (fringe benefits, such as health insurance for employees) rose 11 percent, and the cost of materials and supplies (which includes such items as rail, crossties, and ballast) rose 52 percent.

Railroads will continue to advocate that the time required for these review processes be shortened without adversely affecting the quality of that result, but until that happens, rail expansion projects will often be negatively impacted.

IX. Rail Rates and Rate-Related Matters Should be Viewed Separate From the Common Carrier Obligation

The Board has solicited comments on the impact of volume requirements or incentives on the common carrier obligation. To the extent this question seeks comments on the appropriateness of rates or rate-related terms, the AAR believes that this is not a “common carrier obligation” issue. The source of the common carrier obligation is 49 U.S.C. § 11101. The only obligations this section imposes as to common carrier rates are that a railroad must (i) provide such rate and service terms on request (and, where agricultural products are involved, must publish them), (ii) give at least 20 days notice of certain changes in such rate or service

terms, and (iii) provide transportation or service in accordance with such rates and service terms, § 11101(b)-(e). This section imposes no substantive standards or requirements as to a rail carrier's common carrier rate or service terms. Those issues are covered by other provisions of ICCTA. Under § 10701(c), a rail carrier is expressly permitted to establish any rate for transportation or other service it provides "unless a rate is prohibited by a provision of this part" (and in the case of rate reasonableness, the rail carrier has market dominance). The "provisions of this part" imposing substantive requirements on common carrier rates or rate related terms include § 10701-02 (reasonable rates, rules and practices), and § 10741 (rate relationships). The Board is not permitted to create obligations relating to rates and rate-related terms beyond those specifically provided in ICCTA.

As discussed earlier, under current conditions, railroads will be extremely hard pressed to make the optimal level of investments needed to meet expected future freight rail transportation demand. However, doing so would be impossible if railroads were unable to offer their investors adequate returns. No law or regulation can force investors to provide resources to an industry whose returns are lower than investors can obtain in other markets with comparable risk. Therefore, using the railroads' common carrier obligation as a justification for taking rate-related regulatory actions whose net effect would be to undermine railroads' ability to pay for the investments that are needed would be completely counterproductive. It would undermine the goal of increasing the capability of railroads to offer efficient, reliable, and safe service to their customers.

X. The Rail Transportation of Highly-Hazardous Materials Remains a Significant Concern

In its decision, the Board sought comments on the railroads' transportation of highly-hazardous materials in the context of the common carrier obligation.

Each year, 1.7 to 1.8 million carloads of hazardous materials (hazmat) is transported by rail in the United States, with two-thirds moving in tank cars. “Toxic inhalation hazards” (TIH) — gases or liquids, such as chlorine and anhydrous ammonia, that are especially hazardous if released — are a small subset of hazardous materials. Railroads typically transport around 100,000 carloads of TIH each year, virtually all in tank cars. The rail hazmat safety record is extremely favorable. In 2005 (the most recent year for which data are available), 99.997 percent of rail hazmat shipments reached their final destination without a release caused by an accident. Railroads reduced hazmat accident rates by 86 percent from 1980 through 2005.

Despite this positive trend, the current environment for the rail transportation of highly-hazardous materials, especially TIH, is untenable. Today, because of railroads’ common carrier obligation, railroads must transport these materials, whether they want to or not. But every time railroads move one of these shipments, they (and their shareholders) face potentially ruinous liability.

Arguments have been made that if the commodities move in accordance with Department of Transportation-approved safety regulations, the railroads should not be concerned. This is not true. Some accidents cannot be prevented by the railroads. Moreover, that does not address the problem. The revenue that highly-hazardous materials generate does not come close to covering the potential liability to railroads associated with this traffic. While accidents involving highly-hazardous materials on railroads are exceedingly rare, railroads could be subjected to multi-billion dollar claims, even for accidents where the railroads do nothing wrong because of the unusual characteristics of the TIH commodities themselves.¹

¹ In recognition of this liability, AAR continues to object to the Board’s use of unadjusted URCS in rate proceedings.

Of course, railroads are taking numerous steps to ensure the safety of hazardous materials. For example, railroads participated in an industry committee that recently established new standards for tank cars carrying TIH; help communities develop and evaluate emergency response plans; train or assist with the training of tens of thousands of emergency responders each year; provide emergency responders with critical information to help mitigate hazmat incidents; and use special operating procedures on trains carrying TIH.

Railroads also strongly support efforts to replace, where feasible, TIH and other highly-hazardous materials with less hazardous substitutes and new technologies. As the National Research Council (part of the National Academy of Sciences) has noted, “the most desirable solution to preventing chemical releases is to reduce or eliminate the hazard where possible, not control it.” (Terrorism and the Chemical Infrastructure: Protecting People and Reducing Vulnerabilities, National Research Council – Board on Chemical Sciences and Technology, May 2006, p. 106) If the commodities are not produced and do not move, the liability issues are resolved and no one is at risk.

However, notwithstanding all of the railroads’ efforts, the transport of highly-hazardous materials has become a “bet the company” public service that the federal government makes railroads (but no other transportation providers) perform. As a matter of fundamental fairness, it is inappropriate to force railroads and their shareholders alone among all industries to bear this burden. It is also frustrating that railroads face these huge risks for a tiny fraction of their business. Shipments of TIH, for example, constitute only about 0.3 percent of all rail carloads.

But the issue goes beyond fairness. Railroads do not produce TIH, do not use TIH, do not own the tank cars used to transport TIH, and do not make the decisions on where TIH will be transported. Yet, railroads are the only participants in the production, distribution and

consumption chain for TIH which are required to handle these commodities, even where substitutes are available. Moreover, even among transportation companies, railroads are the only entities required to handle TIH – no one requires motor carriers, barge operators or air transporters to handle this traffic.

This system is clearly not in the public interest. The correct public policy should be one which encourages the entities who are making the decisions to produce, ship and use TIH to find product alternatives to TIH wherever possible. Further, where product alternatives are not possible, public policy should strongly discourage unnecessary shipment of TIH. This traffic should not be moving long distances across the country to further the commercial interests of producers or receivers when closer sources of supply are available. The current system works contrary to these goals. Far from discouraging unnecessary use or shipment of TIH, the system actually encourages these activities by insulating TIH producers and receivers from some of the risks of their commercial decisions by allowing them to shift those risks to the railroads, who cannot refuse to handle the shipments, and may not be allowed to fully reflect any of the extraordinary risk in their rates.

Unless and until TIH and other highly-hazardous materials are replaced or the industry's potential liability exposure is otherwise addressed, the enormous risk to the railroads in transporting these materials will continue and increase. For this reason, the Board should institute a proceeding that will focus solely on TIH transport and seek to implement regulatory changes or recommend legislation to address the present untenable situation facing the railroads. The Board should not necessarily limit its consideration of the TIH issues to those arising solely in the context of the railroads' common carrier obligation and a separate proceeding would allow the full range of issues and potential solutions to be fully evaluated.

XI. The Board's Decisions and Criteria Governing Embargoes and Abandonments Provide Appropriate Guidelines

With respect to the Board's questions regarding the application of the common carrier obligation in the context of embargoes and abandonments, individual AAR members will respond to specific factual situations. As a general matter, the AAR believes that the Board's decisions and criteria governing embargoes and abandonments provide appropriate guidelines to be applied in specific cases.

Regarding embargoes, the Board recognizes that what constitutes a valid embargo is a fact-specific inquiry to be determined on a case-by-case basis (see Bar Ale, Inc. v California Northern Railroad Co and Southern Pacific Transportation Co, STB Finance Docket No. 32821, slip op. at 6-7 (STB served July 20, 2001)). The Board has made clear that an embargo is an emergency measure that only temporarily excuses a carrier from its common carrier obligation. The embargo must at all times be reasonable and cannot be used by the carrier to unilaterally abandon or discontinue service on a line without seeking and obtaining specific authorization from the Board under 49 U.S.C. 10903 (see Bar Ale at 6-7; see also Central Oregon & Pacific Railroad, Inc -- Coos Bay Rail Line, STB Finance Docket No. 35130 slip op at 3, 5 (STB served April 10, 2008)("Coos Bay")).

The Board has also found that embargoes are typically valid if justified by physical conditions affecting safety, such as weather and flood damage and tunnel deterioration or operating restrictions such as congestion (see Bar Ale, at 6; Coos Bay at 3). Under applicable Board law, whether an embargo is reasonable is determined by balancing a number of factors, including the length of the service cessation, the intent of the railroad, the cost of repairs, the amount of traffic on the line, and the financial condition of the carrier (see Bar Ale, at 6; Coos Bay at 3). The AAR believes that the Board's practice of evaluating these factors "in a non-

formulaic way” (see Coos Bay at 3; see also Bolen-Brunson-Bell Lumber Company v CSX Transportation, Inc., STB Finance Docket No. 34236, slip op at 4 (STB served May 15, 2003)) provides an appropriate basis for determining whether an embargo is reasonable under all the circumstances.

The Board’s general principles and criteria governing abandonments and discontinuance of service are equally well-established and provide appropriate guidelines to be applied in specific factual circumstances. (The Board also has in place detailed procedural rules governing abandonment and discontinuance proceedings, including for implementation of the statutory provisions for offers of financial assistance, public use, and interim trail use. 49 C.F.R. 1152 et seq.)

Under the statutory standard, the issue is whether the present or future public convenience and necessity permit the proposed abandonment or discontinuance 49 U.S.C. 10903(d). In implementing the standard, the Board balances the potential harm to affected shippers and communities against the present and future burden that continued operations could impose on the railroad and interstate commerce (see Colorado v. United States, 271 U.S. 153 (1926)). The Board takes into consideration and weighs the following factors in making its determination: avoidable costs; rehabilitation costs; opportunity costs to the carrier of continuing to operate the line; traffic and revenue potential of the line; availability of alternative service to shippers; and shipper and community interests (see, e.g., Union Pacific Railroad Company – Discontinuance – In Utah County, Utah, STB Docket No AB-33 (Sub No. 209), slip opinion (STB served January 2, 2008)).

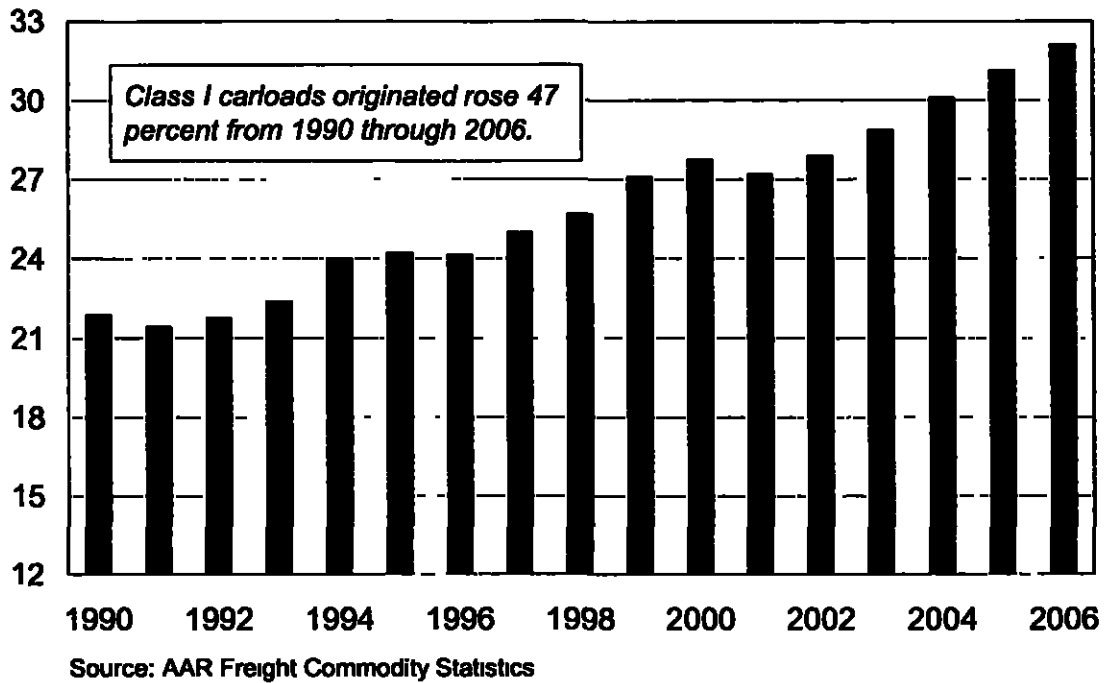
The AAR believes that the established principles and relevant factors used by the Board in applying the “public convenience and necessity” standard in abandonment and discontinuation

proceedings allow the Board to reach a fully-informed judgment on the issue and do not need to be revisited in the “common carrier obligation” context.

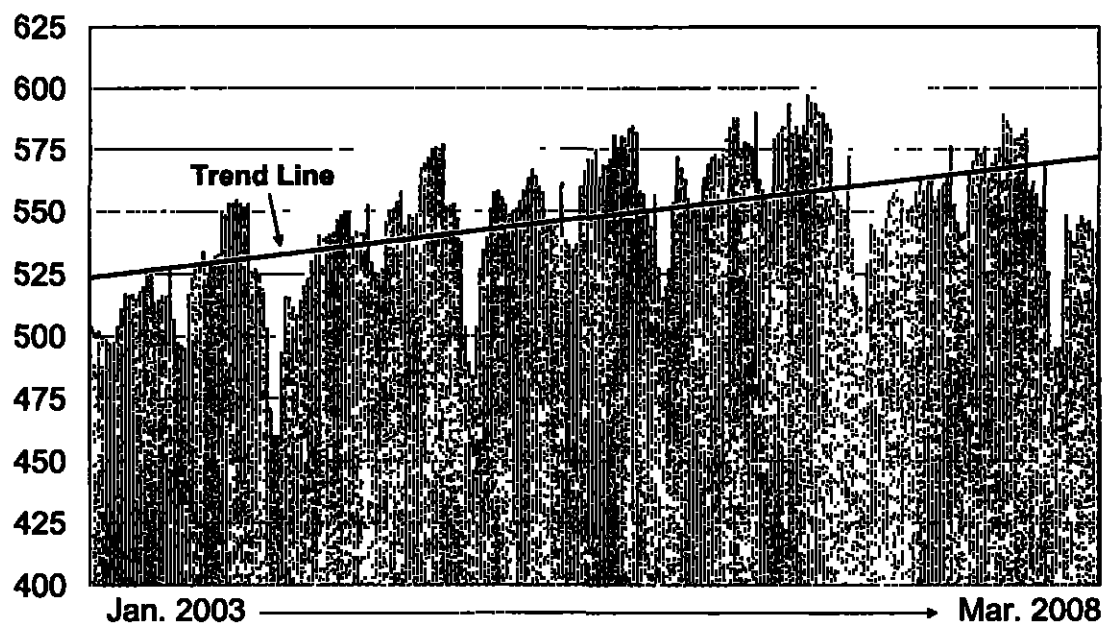
XII. Conclusion

The railroads’ common carrier obligation, as set forth in 49 U.S.C. § 11101(a), requires that a railroad must provide transportation or service upon “reasonable request.” The obligation is not absolute. In the event of a controversy, the question of what is a “reasonable request” under the statute has been left for the Board and the courts to decide. A railroad is not required to provide service to every shipper who requests it; but, if the railroad cannot, it must allocate its limited capacity in a reasonable manner. The tests for reasonableness require an assessment of the totality of the circumstances. In today’s environment, the consideration of what may be a reasonable common carrier obligation must take into account the present and prospective capacity constraints facing the railroad industry. Priority must be given by the railroads to maintaining efficient operations for the benefit of the network and shippers in general; and that must take precedence over any shipper’s individual requests. The railroads’ common carrier obligation must be evaluated in this context.

**Chart 1: Class I Carloads Originated
(millions)**

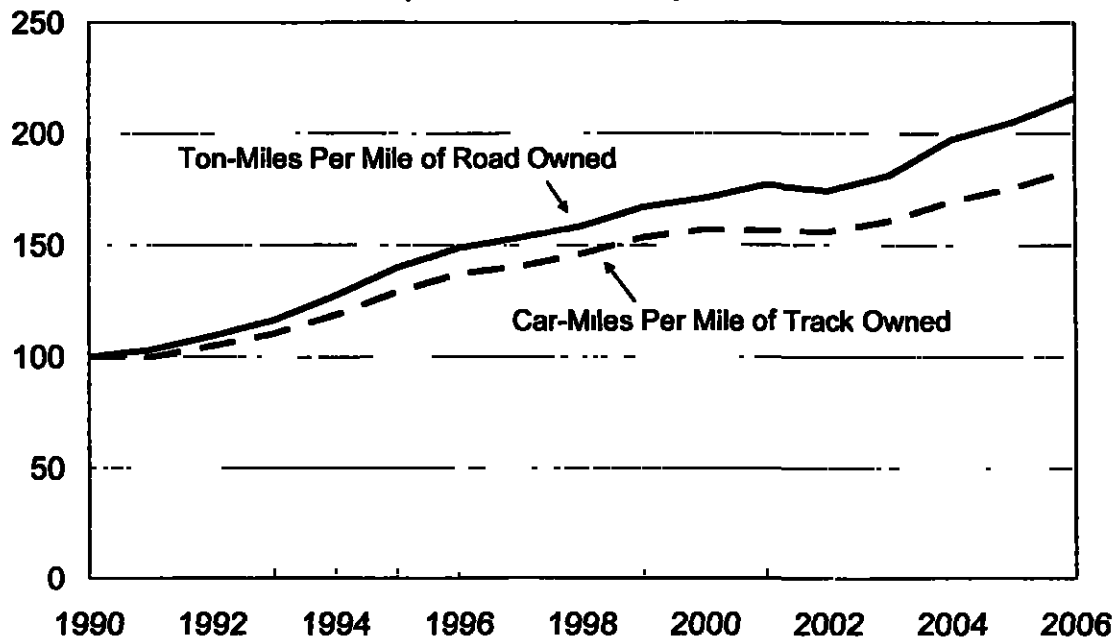


**Chart 2: A Steady Upward Trend in U.S. Rail Traffic
Weekly Carloads + Intermodal Units (000s)**



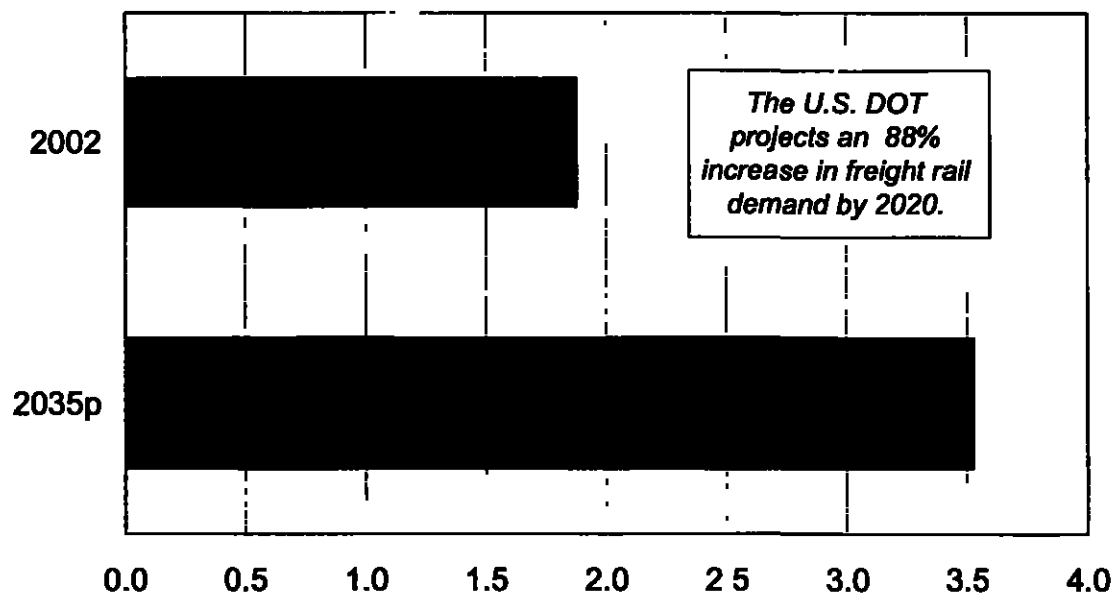
Excludes U.S. operations of Canadian railroads. Source: AAR Weekly Railroad Traffic

Chart 3: Freight Rail Traffic Density is Up Sharply
(Index 1990=100)



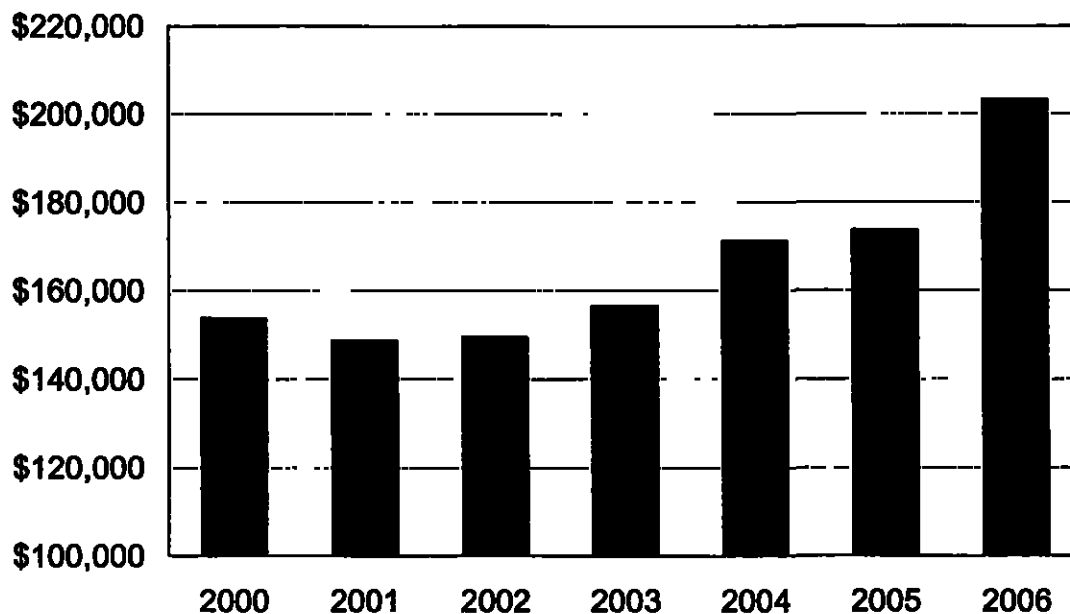
Source: AAR analysis of data in individual railroads' R-1

Chart 4: Demand For Freight Rail To Rise Sharply
(Billions of Tons Transported)



p - projected Source: FHWA Office of Freight Management and Operations

Chart 5: Class I Infrastructure and Equipment Spending* Per Mile of Road Owned: 2000-2006



*Capital spending + maintenance expenses - depreciation Source: AAR

Chart 6
Capital Expenditures as a % of Revenue
for Various U.S. Industries: Avg. 1997-2006

Average all manufacturing	3%
Food manufacturing	2%
Petroleum & coal products mfg.	3%
Machinery manufacturing	3%
Motor vehicles & parts mfg.	3%
Wood product mfg.	3%
Fabricated metal product mfg.	3%
Chemicals manufacturing	4%
Plastics & rubber products mfg.	4%
Paper manufacturing	4%
Computer & electr product mfg.	5%
Nonmetallic mineral product mfg.	5%
Electric utilities	13%
Class I Railroads	17%

Note: Utilities are 1999-2006

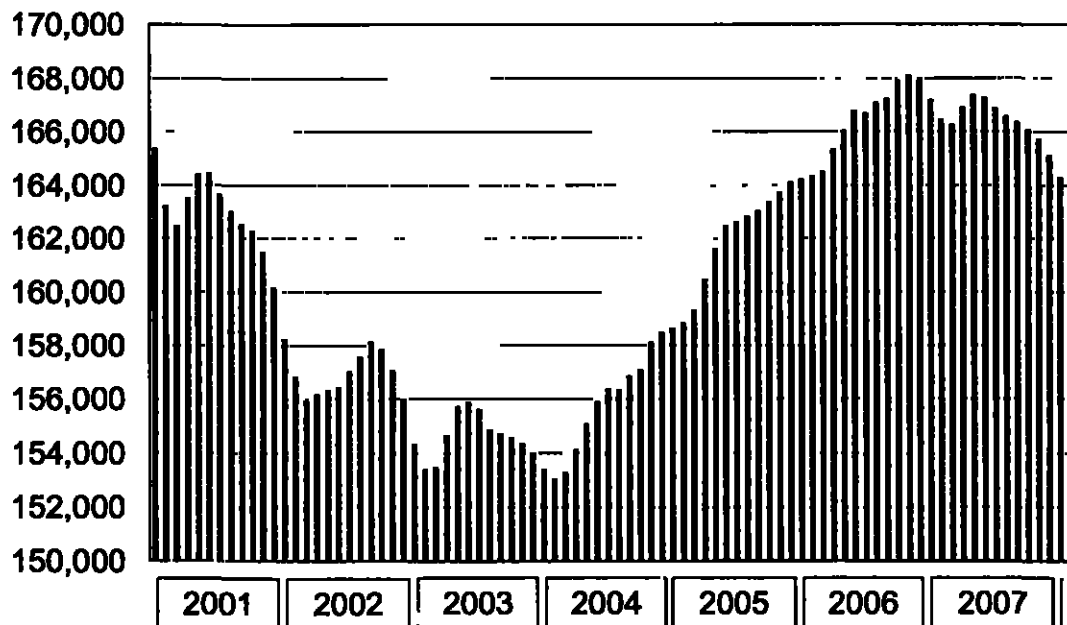
Source U.S. Bureau of the Census, AAR, EEI

Chart 7
RR Spending on Way & Structures
vs. State Highway Agency
Spending: 2006
(\$ billions)

	<u>Total</u>
1. Texas	\$7.57
2. Florida	\$5.69
3. California	\$4.19
Union Pacific	\$4.17
BNSF	\$3.89
4. New York	\$3.59
5. Pennsylvania	\$3.30
6. Illinois	\$3.30
CSX	\$2.62
7. Michigan	\$2.61
8. North Carolina	\$2.48
9. Ohio	\$2.14
Norfolk Southern	\$2.12
10. Georgia	\$1.88

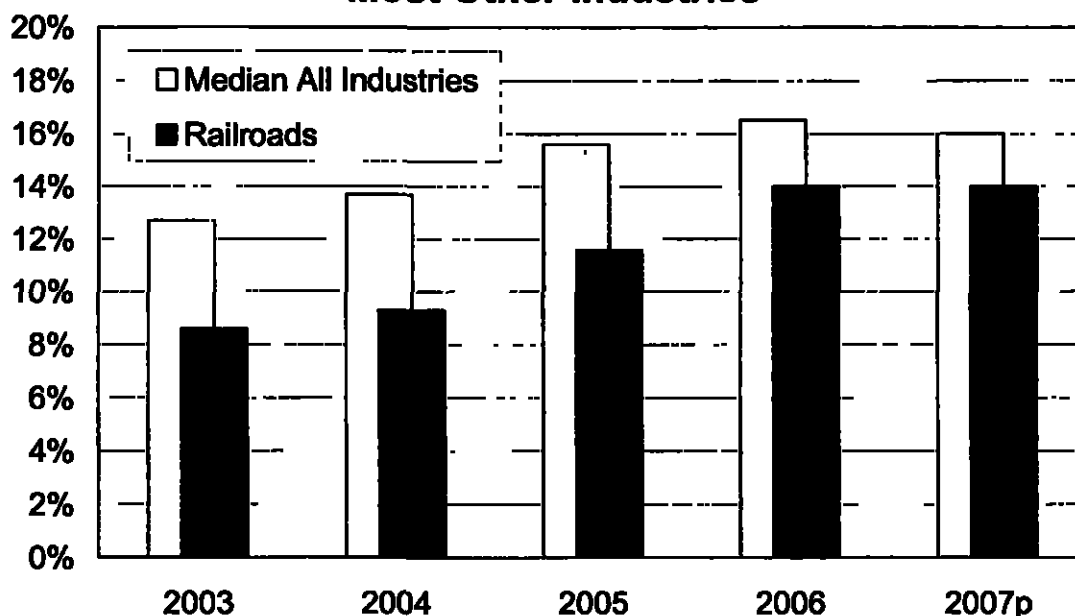
Data include capital outlays and maintenance expenses. Sources: FHWA Highway Statistics Table SF-12 and AAR analysis of R-1 annual reports

Chart 8: Class I Railroad Employment
Jan. 2001 - Feb. 2008



Data are 3-month moving average, not seasonally-adjusted. Source: STB

Chart 9: Rail Industry Profitability* Lags Most Other Industries



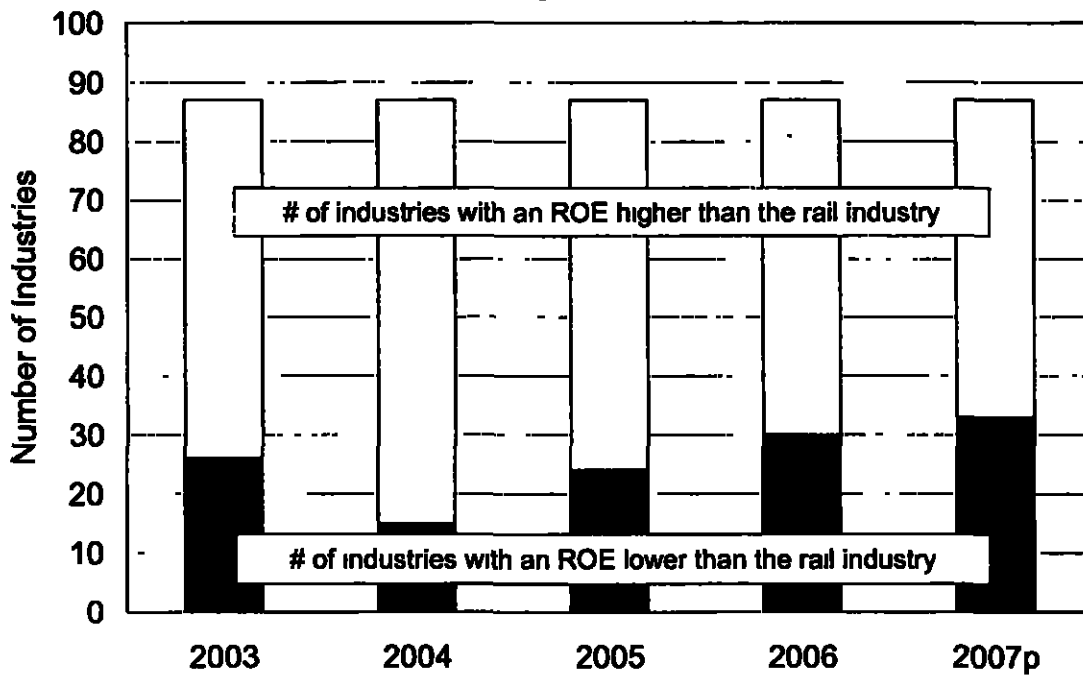
*Return on equity (net income divided by year-end shareholders' equity)
p - preliminary
Source: Value Line

**Chart 10
Fortune 500 Return on Equity: Selected Industries, 2006**

Industry	ROE %	Industry	ROE %
Oil & Gas Equip., Services	31.8%	Fortune 500 Median	15.4%
Petroleum Refining	30.7%	Food & Drug Stores	15.4%
Metals	30.3%	Railroads	15.0%
Household & Personal Prod.	24.6%	Energy	14.9%
Pharmaceuticals	24.2%	Food & Grocery Wholesalers	14.8%
Industrial & Farm Equip.	22.6%	Engineering, Construction	13.8%
Mining, Crude-Oil Prod.	21.8%	Motor Vehicles & Parts	12.6%
Aerospace and Defense	21.5%	Pipelines	12.6%
Chemicals	20.9%	Utilities, Gas & Electric	10.6%
Food Consumer Products	20.5%	Packaging, Containers	9.6%
Computers, Office Equip.	18.5%	Telecommunications	6.4%
Beverages	18.0%	Food Production	-3.1%

Source: Fortune (April 30, 2007)

Chart 11: Return on Equity*- RRs vs. Other Industries



*net profit divided by year-end shareholders' equity p - preliminary Source: Value Line