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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Ex Parte No. 766

**JOINT PETITION FOR RULEMAKING TO MODERNIZE ANNUAL REVENUE
ADEQUACY DETERMINATIONS**

REPLY OF JOINT SHIPPERS

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The Chlorine Institute

Dated: September 21, 2020

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REPLY OF JOINT SHIPPERS

The American Chemistry Council, Corn Refiners Association, American Fuel & Petrochemical Manufacturers, The National Industrial Transportation League, The Chlorine Institute, and The Fertilizer Institute, (collectively “Joint Shippers”) hereby reply to the Joint Petition For Rulemaking filed by three Class I railroads (“Joint Petitioners”)¹ in the above-captioned docket on September 1, 2020 (the “Joint Petition”). The Joint Petitioners have petitioned the Surface Transportation Board (“STB” or “Board”), pursuant to 5 U.S.C. § 553, to adopt their proposed changes to how the Board makes its annual determination of revenue-adequacy under 49 U.S.C. § 10704(a)(3). For the reasons set forth herein, the Joint Shippers oppose this Petition.

¹ The three Class I railroads are Canadian National Railway Company, Norfolk Southern Corporation, and Union Pacific Railroad Company.

I. Overview of the Railroad Proposal.

Pursuant to 49 U.S.C. § 10704(a)(3), Congress has required the Board to determine annually which Class I railroads are earning adequate revenues based on the standards and procedures in paragraph (a)(2), which states:

(2) The Board shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under this part that are adequate, under honest, economical, and efficient management, for the infrastructure and investment needed to meet the present and future demand for rail services and to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. The Board shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph. Revenue levels established under this paragraph should—

(A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

(B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

As summarized at pp. 12-14 of the Joint Petition, the Board and its predecessor, the Interstate Commerce Commission (“ICC”), have employed the same standard for measuring revenue adequacy, with few significant changes, since 1986. That standard uses accounting book values to determine whether each railroad earns a return on investment (“ROI”) that exceeds the rail industry cost-of-capital which the Board also determines annually. If so, the STB determines that railroad to be revenue-adequate in that year. The Board, however, has declared that revenue-adequacy for regulatory purposes is a long-term concept that requires a sustained level of revenue-adequacy over time.²

The Joint Petition proposes a fundamental change to how the Board determines revenue-adequacy. With one exception, the treatment of deferred taxes, the proposal preserves the

² *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520, 536 (1985) (“*Guidelines*”).

Board's existing measure of ROI based upon accounting book values. But instead of comparing a railroad's ROI to the industry cost-of-capital to determine revenue-adequacy, the Joint

Petitioners ask the Board to adopt a different comparison that encompasses the following steps:

- First, the Board would calculate the ROI of each S&P 500 firm (excluding railroad, financial and real estate firms) the same way it measures ROI (as adjusted by Petitioners).
- Second, the Board would calculate the cost-of-capital for each S&P 500 industry group in the same way that it calculates the rail industry cost-of-capital.
- Third, the Board would subtract from the ROI of each S&P 500 firm its corresponding industry cost-of-capital to determine the extent to which each firm earned returns above its industry cost-of-capital.
- Fourth, the Board would calculate the median of the foregoing differential in step 3 across this entire S&P 500 group.
- Fifth, the Board would only deem a railroad to be revenue adequate when its ROI exceeds the rail industry cost-of-capital by the median differential of the entire S&P 500 group calculated in step 4.

In brief, whereas the existing measure of revenue-adequacy asks whether each railroad has an ROI above the rail industry cost-of-capital, the Joint Petition asks whether each railroad has an ROI that exceeds the rail industry cost-of-capital by more than the median S&P 500 firm's ROI exceeds its cost of capital over the same time period. Although the Joint Petitioners perform the foregoing analysis over the combined period from 2006 through 2019, they do not specify what should be the appropriate time period for the Board to examine.

II. The Joint Petition Moves the Revenue-Adequacy Goal Posts To Obtain An Unwarranted Regulatory Advantage.

The undisguised objective of the Joint Petition is to move the revenue-adequacy goal posts to avoid the regulatory implications of a determination that one or more Class I railroads has attained the level of revenue-adequacy contemplated in the statute. Under the current measure of revenue-adequacy, several Class I railroads are, and have been, revenue-adequate on

an annual basis for up to a decade. It also is apparent that the rest of the Class I railroads are on the cusp of attaining a sustained level of revenue-adequacy by this measure. That could alter the regulatory landscape with respect to rate regulation, bottleneck rates and competitive access where revenue-inadequacy has long been cited to foreclose the use of alternative rate reasonableness methodologies and access to rail competition. The Joint Petition seeks to avoid these changes by modifying the measure of revenue adequacy in a way that would render all Class I railroads revenue-inadequate and likely maintain that status for decades to come. No change is warranted, however, because the current measure of revenue-adequacy already sets a conservatively high bar.

A. Because the current revenue-adequacy determination sets a conservatively high bar, there is no justification for raising that bar as proposed in the Joint Petition.

Shippers have long protested that the current measure of revenue-adequacy sets a conservatively high bar because all Class I railroads were deemed to be revenue-inadequate for so long under that standard despite having no difficulty attracting capital. Shippers were making this point as far back as 2005 in STB Ex Parte No. 658, *The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead*. That point is even stronger today than it was then.

The Edison Electric Institute submitted written comments in Ex Parte No. 658 to which it attached the testimony of Dr. Harvey A. Levine presented four years earlier, in 2001, to the Subcommittee on Surface Transportation & Merchant Marine of the U.S. Senate Committee on Commerce, Science and Transportation.³ Dr. Levine's testimony is particularly credible because, for 18 years, he was the Vice President of the Economics & Finance Department at the

³ The Joint Shippers attach a copy of Dr. Levine's testimony as Exhibit A.

Association of American Railroads (“AAR”) and, before that, he had worked for railroads, the ICC, and the Department of Transportation.⁴

Dr. Levine reasoned that the primary objective of the revenue adequacy determination, is to measure the attractiveness to equity providers.⁵ The revenue-adequacy statute seeks to foster revenue levels that are adequate to cover total operating expenses plus a reasonable and economic profit or return on capital, repay debt, and attract needed equity capital to satisfy present and future demand for rail services. In this regard, Dr. Levine noted that by earning any level of net profit, operating expenses and interest charges on debt are covered because such profit is calculated after those payments and income taxes are subtracted from revenue.⁶ That leaves the attractiveness to equity investors as the remaining, and most difficult to estimate, variable in the revenue-adequacy determination. In this regard, Dr. Levine observed that capital “attractiveness is enhanced by a variety of factors including the most recent returns to the providers of equity capital—measured by the ROE—a strong balance sheet, significant cash flow relative to capital expenditures, and sound management policies and procedures.”⁷ Therefore, he concluded that “where railroad capital attractiveness is at issue, annual reports to shareholders and supplemental data to the SEC should be used as the basis for analysis.”⁸

Dr. Levine presented data, analyses, and argument that “the financial health of individual railroads is far better than that projected by the revenue-adequacy determination.”⁹ He pointed

⁴ Ex. A. at 1.

⁵ Ex. A. at 5.

⁶ Ex. A at 5.

⁷ Ex. A. at 5-6.

⁸ Ex. A. at 5.

⁹ Ex. A at 7.

out that, despite no Class I railroad being revenue-adequate under the Board's determination at the time, there was no evidence of any capital shortfalls, railroad equity investors were soundly rewarded for their risks with returns above the 7% level of interest rates prevailing at the time, and railroad data presented to shareholders and the Securities and Exchange Commission often conflicted with data presented to the Board.¹⁰ These facts make an even more compelling case for revenue-adequacy today than they did in 2001.

Also, in 2005 testimony in Ex Parte No. 658, the National Industrial Transportation League analyzed the tremendous financial success of the Class I railroads despite the opposite inference from the Board's annual revenue-adequacy determination.¹¹ Those comments quoted extensively from Wall Street analyst reports, including an observation that BNSF had achieved returns over the prior 20 year period that were 4 percentage points higher than the S&P 500 Index.¹² Not long afterward, Berkshire Hathaway acquired all of BNSF's stock, indicating that its strong confidence in BNSF's ability to generate an ROI above its cost-of-capital and higher than other alternatives among S&P 500 firms.¹³ In other words, Berkshire Hathaway clearly viewed BNSF as revenue-adequate even though the STB did not.

¹⁰ Ex. A. at 4-7.

¹¹ Ex Parte No. 658, *The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead*, "Written Testimony submitted by The National Industrial Transportation League" at 3-8 (filed Oct. 12, 2005) (attached as Exhibit B).

¹² Ex. B at 6 n. 6.

¹³ It is worth noting that very recently two private equity firms offered to purchase all the stock of Kansas City Southern for a far richer price than Berkshire Hathaway paid for BNSF and was rebuffed, presumably because the KCS Board believes it can generate better shareholder returns by remaining public. Sutherland, Brooke, "Not Even a \$23 Billion Buyout Is Rich Enough for a Railroad Anymore," *Bloomberg Business Week* (Sept. 14, 2020) (estimating that Berkshire paid 18x BNSF's expected 2010 EPS, whereas the KCS offer was for 25x expected 2021 EPS), <https://www.bloomberg.com/news/articles/2020-09-14/why-kansas-city-southern-railroad-rejected-a-23-billion-buyout>

Five years later, in 2010, the Senate Committee on Commerce, Science, and Transportation issued a Staff Report on “The Financial State of the Class I Freight Rail Industry,” which it updated in 2013. The updated 2013 Staff Report is attached as Exhibit C. That report found that the Class I railroads routinely were setting all-time company quarterly records for operating ratios, operating income, and/or earnings per share; their stocks had performed significantly better in recent years than the S&P 500 index; and increasing cash flow had enabled them to increase capital expenditures while simultaneously boosting dividend payments and stock buyback programs. Of note, this analysis captured the effects of the Great Recession of 2008 and its aftermath which barely dented this financial progress despite the havoc it wreaked on the U.S. economy. The report also noted that the Board had found BNSF to be revenue-adequate in one year out of seven (before the Berkshire Hathaway purchase), Norfolk Southern in 7 out of 10 years, and UP in the most recent three out of ten years. In response to the AAR’s critique of the 2010 Staff Report for evaluating “accounting” measures, the 2013 update report notes that “[t]his criticism ignores the fact that when top rail industry executives themselves describe their companies’ financial performance to investors and analysts, they repeatedly focus on the very same ‘accounting’ metrics....”¹⁴

In 2014, the Concerned Shipper Associations (which included four of the Joint Shippers) presented the testimony of Dr. Gerald R. Faulhaber in Ex Parte No. 722 (Sub-No. 2), *Railroad Revenue Adequacy*, to once again demonstrate that the Board’s annual revenue-adequacy determinations establish a conservatively high bar.¹⁵ Dr. Faulhaber concurred with the aforementioned Commerce Committee Staff Report suggestion that financial market data

¹⁴ Ex. C. at 3 n. 13; *see also, id.* at 15 & n. 53.

¹⁵ Ex Parte No. 722 (Sub-No. 2), *Railroad Revenue Adequacy*, “Comments submitted by Concerned Shipper Associations,” Verified Statement of Gerald R. Faulhaber at 4-5.

provides a simpler and more compelling determination of revenue adequacy because the participants in capital markets who actually have “skin in the game” are making investment decisions based on that information, not the Board’s annual revenue-adequacy determination.

The Joint Petition should be denied simply because there is no justification for a new methodology that creates the illusion that railroads are revenue inadequate when the current methodology already establishes a conservatively-high threshold.

B. The true intent of the Joint Petition is to avoid the ramifications of revenue-adequacy.

Although the financial markets have treated the rail industry as revenue-adequate for at least two decades, the Board’s annual revenue-adequacy determination has failed to recognize and account for that fact due to the conservatively high bar that the Board’s measure has set. But even that bar has been, or soon will be, cleared by most of the Class I railroads.¹⁶ Long-established and judicially-affirmed Board precedent makes clear that passing the revenue-adequacy goalpost has ramifications for regulatory policy. Most notably, revenue adequacy enables shippers to invoke an additional constraint upon rates charged to captive traffic and it affects the balancing of interests that the Board has weighed when deciding whether to prescribe reciprocal switching or permit bottleneck rates. Thus, it is unsurprising that the rail industry would seek out, by any means available, ways to move the revenue-adequacy goal post.

For years, the rail industry has lobbied to inflate the cost of capital by substituting replacement costs for accounting book values in the Board’s annual ROI calculation. The ICC

¹⁶ Over the most recent 10 years of the Board’s annual revenue-adequacy determinations (2009-2018), UP was revenue-adequate for the last 9 years straight, BNSF and NS for 8 of those years, CP over 5 of the most recent 6 years, CN for 3 years, and CSX just in the most recent year. Worthy of special mention, NS has been revenue-adequate for 11 of the past 15 years. See <https://prod.stb.gov/reports-data/economic-data/>.

and STB have rejected repeated requests to do so, deeming replacement cost accounting too difficult to implement. The Board also should be skeptical of these attempts because the use of replacement costs in the current revenue adequacy determination would only exacerbate the existing disconnect from reality.

With the Board declining to adopt replacement costs and shippers seeking regulatory policies that reflect the revenue-adequate state of several Class I railroads under the existing measure, the Joint Petitioners are taking a new tack. By changing the revenue adequacy benchmark measure to one that establishes a higher bar by comparison to S&P 500 firms, the Joint Petitioners attempt to accomplish what they could not through replacement costs. The Board should not be lured into this version of result-oriented rulemaking.

In their attempt to justify the proposed S&P 500 comparison approach as supported by the statute, the Joint Petitioners unintentionally illustrate why that approach is neither necessary nor appropriate. At pages 28-29, the Petition asserts that “[a]ny significant regulatory movements tied just to cost of capital risks putting railroads at a permanent disadvantage relative to other firms in the economy competing for capital...,” which leads to the Petition’s conclusion that, “[i]f railroads face the risk of heightened regulatory intrusion merely for earning no more than their cost of capital (as calculated by the STB), they would not be able to compete fairly or equally for capital investment, as envisioned by the statutory revenue adequacy definition.” The rail industry, however, has been competing quite effectively for capital with other S&P 500 firms for decades while not even earning their cost-of-capital as determined by the Board. During much of this time, the analysis in the Joint Petition notes, at page 33, that “each of the Class I railroads earned an ROI net cost of capital substantially below the median S&P 500 company in each of the studied years” dating back to 2006, which is around the same time shippers began to

clamor that the rail industry already was revenue-adequate. Therefore, any suggestion that railroads would be harmed or disadvantaged in the future if they are not allowed to exercise their market power to earn an even higher ROI is pure fantasy.

Finally, a *Railway Age* article published just one year ago reported that Wall Street analysts consider the rail industry's true cost of capital to be just 7%, which was five percentage points below the Board's calculation at the time.¹⁷ Thus, the actual disconnect between the Board's annual revenue adequacy determination and reality strongly favors the rail industry. The Board can rest assured that any regulatory decisions it makes based upon its existing revenue adequacy determination will be blunted by a substantial cushion that allows the rail industry to earn revenue that far exceeds its true cost of capital.

III. The Joint Petition Engages In Misdirection, Misrepresentation, and Flawed Analyses To Support Its Proposal.

The Joint Petition attempts to justify its proposed modifications to the annual revenue-adequacy determination through a multitude of flawed arguments, flawed analyses, misrepresentations and misdirection. By focusing on the proper arguments and correcting the flaws and misrepresentations, the proposed modifications are exposed as neither necessary nor appropriate.

First, there is a fundamental disconnect between the statutory standard of revenue-adequacy and the measure proposed in the Joint Petition. Succinctly stated, the statutory objective of 49 U.S.C. § 10704 is to ensure that the rail industry has access to the capital it needs to invest in the rail network to meet present and future demand for rail service. Nowhere does

¹⁷ Wilner, Frank, "STB's Cost of Capital Dilemma," *Railway Age* (Oct. 15, 2019), https://www.railwayage.com/freight/stbs-cost-of-capital-dilemma/?utm_source=&utm_medium=email&utm_campaign=10097

the statute state that the rail industry should have access to capital at a specific level relative to S&P 500 firms, or any other benchmark of firms. Nor is such a comparison implicit in the objective of revenue-adequacy. The rail industry can be perfectly capable of raising the capital it needs at many different levels relative to S&P 500 firms. There is no rational basis to conclude that Congress wanted the rail industry to earn more than its cost-of-capital to the same degree as the median S&P 500 firm, which likely has a different risk profile. Nor is there any reason why the rail industry needs to do so to be revenue-adequate. Indeed, as discussed in Part II.A., above, the rail industry has had ample access to capital for decades, even when most Class I railroads were not earning their cost-of-capital by the Board's conservatively high measure. Notably, the Joint Petitioners do not claim otherwise. Nevertheless, the implication of the Joint Petition is that the rail industry is in jeopardy of being unable to raise capital even at current revenue levels. That message simply is not credible.

Perhaps in recognition of the foregoing deficiency in their claims, the Joint Petitioners attempt to convert the revenue-adequacy determination from a measure of a railroad's ability to attract capital to a measure of a railroad's market power. Professors Kevin Murphy and Mark Zmijewski, who have submitted a verified statement in support of the Joint Petition, describe their proposed S&P 500 comparison approach as answering the question "how to evaluate whether railroads' rate of return exceeds their cost of capital by an amount that suggests a failure of competition rather than the normal variation of rates of return expected in a competitive marketplace."¹⁸ To support their benchmarking proposal, they assert that "[i]n order to understand whether railroads are earning a return on invested capital that is indicative of at least the potential for rates to be unconstrained by competition, it is necessary to benchmark any

¹⁸ Joint Pet., Murphy/Zmijewski V.S. at ¶ 30 (underline added).

revenue adequacy measure adopted by the Board against corresponding measures we observe for firms operating under competitive conditions.”¹⁹ They then select the S&P 500 firms as their proposed benchmark and conclude that “[i]f the railroads earn a rate of return net of cost of capital no higher than the average or median S&P firm, then there would be no presumption that railroads are earning abnormal returns and can set rates without constraint from competition, or that shippers’ current protections under the Board’s SAC and related proceedings are not sufficient.”²⁰ They also criticize the accounting book value measure of ROI because “there is no way in which one can look at accounting rates of return and infer anything about...the presence or absence of monopoly profits.”²¹ The foregoing assessments assume a role for revenue-adequacy as a measure of market power, competitive failure and monopoly profits that Congress never intended. Therefore, such arguments do not support the proposed modifications to the annual revenue adequacy determination.

Revenue-adequacy is a revenue level that Congress has directed the Board to assist carriers to attain when determining whether rail rates, classifications, rules and practices are reasonable. As such, the Board has invoked revenue-inadequacy to justify its regulatory forbearance in the past, such as bottleneck rates.²² As revenue adequacy pertains to rate regulation, it has not been a measure of market power or competitive failure, but instead has been described as a constraint upon the degree to which a railroad may exercise its market power to engage in differential pricing.²³ The existence of market power or competitive failure is

¹⁹ *Id.* at ¶ 32 (underline added).

²⁰ Joint Pet. at 22, *quoting* Murphy/Zmijewski V.S. at ¶ 32 (underline added).

²¹ Joint Pet. at 17 (underline added).

²² *MidAmerican Energy Co. v. STB*, 169 F.3d 1099, 1107 (8th Cir. 1999).

²³ *Guidelines* at 535.

evaluated through the market dominance determination in rate cases, not the annual revenue-adequacy determination. In short, a revenue-inadequate railroad may be granted greater latitude to exercise market power in formulating its rates and practices when that latitude is necessary to become revenue-adequate. Contrary to the representations in the Joint Petition, it is not intended to be a measure of market power or competitive failure. The proper regulatory question thus should focus on the legally-sanctioned use of market power to differentially price captive traffic, or to exploit bottleneck segments to avoid competition, when there is no longer a need to exercise such market power to attain and maintain revenue-adequacy. The Joint Petitioners' proposal provides no information to answer that question.

Next, the Joint Petition continues to propagate the false narrative that a revenue-adequacy rate constraint is by definition a cap on railroad profits or rate-of-return regulation. This was a common theme espoused by railroad parties in Docket No. EP 761, *Hearing on Revenue Adequacy*, last December. The testimony of the American Chemistry Council in that docket, however, debunked that myth by offering a proposed revenue-adequacy constraint that only regulates the degree of differential pricing for individual market dominant movements based upon how much higher pricing above a competitive rate level for such movement is necessary to foster the attainment and maintenance of revenue adequacy.²⁴ It does not impose a system-wide revenue cap and it permits railroads to earn an ROI above a revenue-adequate level from competitive traffic, captive traffic at competitive rate levels, and captive traffic for which the rate has not been challenged. Although some proposals to implement a revenue adequacy rate constraint may take the form of rate-of-return regulation, that is not the inevitable result for all

²⁴ EP 761, *Hearing on Revenue Adequacy*, "Supplemental Written Testimony of the American Chemistry Council" at 4-6 (filed Feb. 13, 2020).

forms of a revenue adequacy rate constraint. Therefore, such arguments neither undermine the existing measure of revenue adequacy nor support the proposed modifications.

Similarly, Professors Murphy and Zmijewski observe that “some stakeholders are urging the Board to impose additional regulatory constraints on railroads’ pricing and operating flexibility based on a misguided belief that the carriers are earning profits suggestive of noncompetitive pricing.”²⁵ This certainly is not what the Joint Shippers contend. Rather, they assert that differential pricing of captive traffic above rate levels on comparable competitive traffic, through the exercise of market power that has been determined to exist through the market dominance determination, should be constrained to the degree needed to be revenue-adequate. The Joint Shippers further assert that, by achieving revenue adequacy, railroads may no longer require the same degree of regulatory protection, and that the Board should take steps to allow effective competition among rail carriers “to the maximum extent possible.”²⁶ The Joint Petition takes the Board further away from these objectives.

The Joint Petition ties together each of the foregoing arguments into a conclusion that, because it is consistent for firms in competitive markets to earn returns above their cost of capital, railroads should be allowed to earn similar excess returns.²⁷ This sets the stage for the proposed revenue-adequacy comparison with S&P 500 firms that is pegged to the median point by which those firms’ ROI exceed their cost of capital. When these claims and

²⁵ Joint Pet., Murphy/Zmijewski V.S. at ¶¶ 13.

²⁶ 49 U.S.C. § 10101(1).

²⁷ The Joint Shippers have no objection to railroads earning more than their cost-of-capital provided that they do so at competitive rate levels instead of through their market power over captive traffic. They have accepted the necessity of such differential treatment of captive traffic to attain revenue-adequacy since the Staggers Act of 1980. But once the railroads attain revenue-adequacy, further progress must come at reduced levels of differentiation until there is no distinction at all between the regulatory treatment of competitive and captive traffic.

misrepresentations are corrected, however, much of the Joint Petition's justification for the S&P 500 comparison approach melts away.

IV. **Conclusion.**

The Board should deny the Joint Petition as an unnecessary and inappropriate attempt to skew the already conservatively-high revenue-adequacy measure to even higher levels for the transparent purpose of avoiding the regulatory implications of attaining revenue-adequacy under the existing measure. Real world financial market data demonstrates that the rail industry has ample access to the capital it needs, which is what the revenue-adequacy determination is intended to measure. Indeed, the rail industry has had access to sufficient capital for decades despite not being deemed revenue-adequate by the STB under the existing measure. The Joint Petition thus is a solution in search of a problem. Moreover, that solution is predicated upon an erroneous characterization of the role that Congress intended revenue-adequacy to play and arbitrary choices in the selection of a comparison group and the proper comparison metric. The Joint Shippers reject the premise of the Joint Petition that this type of ROI comparison across industries is the appropriate measure of revenue adequacy, or that the Board's current measure is below the level necessary to maintain the rail system and attract capital.

Respectfully submitted,



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Dated: September 21, 2020

Counsel for the Joint Shippers

Exhibit *A*

Testimony of
DR. HARVEY A. LEVINE

Before the United States Senate,
Committee on Commerce, Science and Transportation,
Subcommittee on Surface
Transportation & Merchant Marine

On Issues Relating to
the Freight Railroad Industry

May 9, 2001

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present my perspective on issues concerning the freight railroad industry relative to the industry's financial performance, current posture, and future needs. My experience spans over 35 years in the field of transportation in general and railroad economics in particular, including employment with: railroad customers (shippers), the New York Central Railroad, the U.S. Department of Transportation (DOT), several transportation consulting companies, the Interstate Commerce Commission (ICC), and the railroad industry's major trade association, where for 18 years, I was the Vice President of the Economics & Finance Department. I also have taught transportation economics and other business subjects at several universities, written a book on national transportation policy, and co-authored a book on local and regional railroads. Over the past four years, I have provided consultation to a multitude of railroad, shipper, and other organizations involved in, or affected by, freight railroads. As an independent transportation economist and consultant, the views that I present in this testimony are strictly my own, based on what I believe to be the public interest.

No matter what my past professional position, I have always believed that a financially viable, freight-railroad industry is in the public interest. After all, railroads are conduits that serve the function of providing time and place (location) utility to our nation's consumers. Adequately staffed and capitalized railroads are needed for such an important role, but at the same time, it is through the satisfaction of customer needs that railroads have the opportunity to become financially viable. Thus, the achievement of railroad financial adequacy and the satisfaction of rail customer needs are two sides of the same coin. And it is with this concept in mind, that I offer this testimony.

The current state of affairs in freight railroading is controversial, highly contentious, and somewhat beyond the comprehension of many people, but it retains the one constant that has characterized freight railroads since before World War II—a perceived financial need, commonly referenced as a capital shortfall. Railroads, in their presentations to the ICC, Surface Transportation Board (STB), and public policy makers, describe themselves as being burdened with “woefully inadequate earnings,” even if individual carriers were financially stable, and no matter what the railroads earned. The industry gained support for this view from the ICC beginning in 1978, when the first annual revenue-adequacy determination was made. This determination has been continued by the STB since 1996. During more recent years, the

railroads' mantra of "woefully inadequate earnings" has been replaced by "revenue inadequacy." In fact, of the four dominant railroads that currently control the overwhelming portion of railroad traffic, only the Norfolk Southern (NS) has been declared by the regulatory agency to be revenue adequate in more than a single year. The Burlington Northern (BN) was deemed to be revenue adequate in 1989 and the Union Pacific (UP) in 1995. CSX Transportation has never been found to be revenue adequate. However, what CSX's president, as well as other railroad executives, has stated in his company's annual report to shareholders is another matter.

Incredibly, the alleged state of railroad revenue inadequacy prevailed during the early and mid-1990s, even when railroads enjoyed record earnings and the president of the industry's major trade association -- the Association of American Railroads (AAR) -- touted the "Second Golden Age of Railroading." Magazine articles abounded with such positive headlines as "Back on the Right Track," and "Back at Full Throttle." Consider the financial strength at the time of the current four dominant railroads. In 1994, the BN earned an impressive 16.9% rate of return on equity (ROE) -- that is, net profit after fixed charges and incomes taxes are paid as a percent of the value of the owners' investment. Furthermore, the BN had the financial capacity to outbid the UP and acquire the Atchison Topeka & Santa Railroad (ATSF) in 1995 for \$4.1 billion. Similarly, in 1995, the UP earned a 16.7% ROE and completed its purchase of the Southern Pacific Railroad (SP) in the following year for about \$4.0 billion. In 1997, the CSX and NS railroads realized ROEs of 12.4% and 12.6% respectively, and consummated their joint purchase of Conrail for over \$10 billion in 1999. And yet, with the exception of the NS in 1997, these railroads were declared by the STB to be revenue inadequate during those years. At the same time, the four railroads expended billions of dollars in employee buyouts, distributed expected dividends to their shareholders, and paid sizeable bonuses to their executives.

What is especially troublesome about the current state of alleged railroad revenue inadequacy is that it comes when the industry has been merged into four dominant carriers based largely on the theory that such consolidation was necessary to achieve revenue adequacy. As shown below, the number of Class I railroads has shrunk from 109 in 1960, to 36 in 1980 and to seven in 1999 -- with two of these carriers being owned by the Canadian National and Canadian Pacific railroads. Furthermore, the concentration of power has greatly increased among the four largest railroads, rising from 25%

of Class I railroad traffic in 1960, to 43% in 1980, and an astonishingly 95%

<u>Year</u>	<u>Number of Class I Railroads</u>	<u>Percent of Traffic Carried By Four Largest Railroads</u>
1960	109	25%
1980	36	43
1999	7	95

in 1999.¹ These four dominant railroads -- two each in the East and West -- control more than the traffic they handle. They also have significant control over traffic on both local (short line) and regional railroads and either control or heavily influence: industry-wide procedures in regard to operating -- including, interline -- rules; accounting practices; car-repair billing; technological research and development; and, policy development and strategy.

What is additionally astonishing about the four "mega-railroads" is that they were created based on projections of huge financial benefits. For example, the BN's purchase of the ATSF came when the former was already making record profits, and when the BN projected that the purchase would save the railroad \$450 million annually in operating expenses and add another \$110 million in operating income. Similarly, the UP was earning record profits in 1996 when it purchased the SP based on an operating income benefit of \$820 million by the year 2001. And the CSX and NS purchase of Conrail in 1999 came at a time when those railroads were earning moderate profits, and when they projected significant benefits mainly in the form of cost reduction and traffic diversion from motor carriage.

No matter what it is called -- that is, "woefully inadequate earnings," "revenue inadequacy," or even "sub-par financial performance," where railroads can demonstrate a capital need, they have support, if not an outright propensity, for acceptance of their industry-wide, policy positions. The answer to the question of "How can we help the poor railroads?" may come in the form of: tax relief; low-interest loans; outright grants; approval of mergers and acquisitions; rate increases to rail-dependent customers; changes in demurrage provisions; and, the warding off of otherwise desirable market competition.

Consequently, with railroads still being cast as revenue inadequate by the STB, the environment exists for more of the same -- that is, for more railroad

behavior based on alleged capital need; more explanations for inadequate service and increased freight rates; and an even greater concentration of power. This is not to say that in some years, railroads don't have a capital need, and it is not to say that the two railroads in the East are not currently earning sub-par profits. However, the permanent state of alleged railroad financial depravity is a frightening prospect for rail-dependent shippers and should be to the public at large.

The latest rationale of the railroads' alleged revenue inadequacy is that competition forced them to pass on their massive productivity gains to their customers, proving that railroad competition is more than adequate. The productivity gains have been attributed to deregulation as enacted by the Staggers Rail Act of 1980, as is seemingly all good things that have happened to railroads since that time. In turn, the combination of continued capital need and competitive markets means that the railroads cannot afford any more competition. After all, proffer the railroads, new competitors would "skim the cream" off the top and leave the incumbents with little more than the lower-margin, more competitive traffic. This is a picture which on the surface appears to be plausible, for to refute it requires an unusually deep understanding of railroad financial data, statistical methodologies, cause-and-effect relationships, rail-customer service levels, and railroad behavior in general. In essence, railroad issues relating to national transportation policy are often embodied in a mass of statistical information and economic theory.

My perspective of the state of the freight railroad industry is different from that being portrayed by the industry itself. As a reflection of my views, I present three observations below, including summary statements of support and recommendations, followed by a more detailed discussion leading to each of the three observations.

1. Railroad data presented in annual reports to shareholders, and supplemental data to the Securities & Exchange Commission (SEC), is often in conflict with industry-wide data distributed to and by the STB and especially that agency's annual determination of railroad revenue adequacy.
 - o Railroad revenue need is synonymous with capital attractiveness.

- Railroads compete for capital in open capital markets against companies who provide annual financial reports to their shareholders and supplemental financial information to the SEC.
- Potential investors rely upon the financial documents prepared and provided by the owners of businesses in consideration of where and when to invest their funds.
- Consequently, where railroad capital attractiveness is at issue, annual reports to shareholders and supplemental data to the SEC should be used as the basis for analysis.
- At the same time, the link between the STB's annual determination of railroad revenue adequacy and capital attractiveness is at best elusive and in all probability, non-existent.
- The annual STB revenue-adequacy determination should be terminated and railroad financial data submitted to the Board should be consistent with the information presented to shareholders and the SEC.
- Finally, railroad revenue need should be thought of in terms of: (1) individual railroads as opposed to an industry-wide average, (2) as a fluid, and thus temporal state of being, and (3) as a prospective concept.

Railroads are no different than other for-profit companies in that they must pay their operating expenses, meet the interest obligation on their funded debt, and have the ability to attract needed equity capital if they are to provide adequate service to their customers. By earning any level of net profit, operating expenses and interest charges are paid because such profit is calculated after those payments and income taxes are subtracted from revenue. Thus, stripped of its trappings, the issue in regard to railroad financial viability is that of capital attractiveness to providers of equity. This attractiveness is enhanced by a variety of factors including the most recent returns to the providers of equity capital – measured by the ROE – a strong balance sheet, significant cash flow relative to capital expenditures, and sound management

policies and procedures. Many of these considerations are discussed in the railroad's annual reports to their shareholders and other information provided to the SEC. In fact, the "President's Message" sets the tone for the annual report to shareholders. But the overall message, analysis of financial performance, and even thoughts about the future, are not revealed in the annual reports to the STB. They are also not reflected in the STB's annual revenue-adequacy determination. This disparity can lead to contradictory views by the railroad itself, and between the railroad and the STB. Consider an especially egregious case involving the UP in 1996.

By any reasonable standard, 1996 was a great year for the UP and its parent company, Union Pacific Corporation (UPC). As stated by the Chairman and Chief Executive Officer of UPC:

The Union Pacific merger, the spin-off of the Resources company and the full integration of the Chicago and North Western acquisition, made 1996 a banner year that created significant value for shareholders and positioned this company for the future as a highly competitive, premier transportation provider. Through all of these strategic achievements, we kept our eye on the numbers, reporting record financial results. Our income from continuing operations was \$733 million compared to \$619 million in 1995, a gain of 18 percent.²

UPC earned an ROE of 12.4% in 1996, largely sparked by the railroad's ROE of 16.6%. To UPC and the UP, these profits were more than adequate. They not only exceeded the corporate ROE threshold that triggered executive bonuses and the long-term compensation package (stock grants and options), they also exceeded the maximum-payout level to those executives. Consequently, aside from significant amounts of stock distributions, the average bonus given to 138 UPC executives in 1996 amounted to a record \$112,000.³ Furthermore, when in 1997 UPC earnings were below the executive-bonus threshold, the corporation still awarded \$7.1 million to 154 executives because "a balance was available in the reserve fund from prior years."⁴ In essence, surplus profits from 1996 were used to further reward executives in 1997. At the same time, the STB found the railroad to be revenue inadequate in 1996. Rhetorically speaking, who would potential equity investors be most likely to believe? – the company itself or the STB, which based its conclusion on a single, statistical and highly controversial calculation? The unfortunate result of the STB's declaration of revenue inadequacy is not only that it could be applied in

regulatory proceedings involving maximum rates, but that the UP could adopt it as support for its positions of public policy.

In general, the financial health of individual railroads is far better than that projected by the revenue-adequacy determination. Consider the case of the four dominant railroads in 1999. While they were all declared to be revenue inadequate, the BNSF earned a healthy 13.9% ROE and the UP a moderate 9.5% ROE. While these figures may have been below the STB's cost-of-capital calculation, did they really deter either railroad from attracting needed capital? Where is the evidence of such capital shortfalls? With interest rates around seven percent, the equity investors in these two railroads were rewarded for their risk taking, and both railroads spoke of even more promising returns in the future -- that is, in their annual reports to shareholders and in their presentations to Wall Street security analysts. Furthermore, in his oral presentation to the STB regarding the BNSF's proposed merger with the Canadian National system, the president of the BNSF boasted of his railroad being into its strongest financial position in history. The reality is, that the record abounds with examples of railroad executives calling attention to their strong financial results in the annual reports to shareholders, while citing their STB-determined revenue inadequacy in matters of public policy.

In essence, the STB's annual determination of railroad revenue adequacy serves no useful purpose and can be highly misleading. A railroad cost of capital can be estimated without an annual revenue-adequacy determination. At the same time, potential equity investors can employ the more credible railroad annual reports to shareholders, and if desired, supplemental financial reports to the SEC, to help them in their determinations as to where they funds should be invested. Annual reports to shareholders represent the "real world;" the same cannot be said for the STB determination.

2. Railroad deregulation as enacted by the Staggers Rail Act of 1980 has been given far too much credit for both the significant gains in railroad productivity and the ensuing constraints on freight rates, thereby inappropriately inferring that railroad market competition is ubiquitous.
 - o With the exception of liberalized procedures for eliminating light-density branch lines, there is no direct link between the Staggers Rail Act and increases in railroad productivity.

- Aside from a host of other factors, railroad productivity gains have emanated largely from favorable union contracts (supported by Presidential Emergency Boards) resulting in the elimination of many employees.
- The measure of freight-revenue-per-ton-mile is a limited surrogate for actual freight rates, and its use by the railroad industry and the STB results in improper conclusions regarding both freight rates and the impact of deregulation.
- Railroad productivity gains have been shared directly by shippers in competitive markets and the railroads themselves, but no matter how the benefits have been distributed, rail-dependent customers exist and are still faced with the lack of carrier choice.
- The existence of rail-dependent customers is a reality that should not be ignored by the STB -- whose purpose is, in fact, to address the needs of such shippers -- or by national transportation policy.
- In addition to providing adequate carrier choices for rail-dependent customers, an appropriate remedy for their complaints appears to be the "Final Offer Arbitration" (FOA) process available to railroad customers in Canada.
- Professional arbitrators can replace the lengthy and costly STB maximum -rate procedures and as in Canada, complete the process within 60 days.

There is no disputing that since the Staggers Act was passed in 1980, the railroad industry has become more productive, and has passed on a portion of this productivity to some of its customers in the form of constrained pricing. But with the exception of the more liberal provisions to eliminate light-density branch lines, there is no evidence that links the Staggers Act with increased railroad productivity. The major contribution of deregulation was to free the railroads from the unnecessary cost of regulatory proceedings involving competitive traffic. Money was certainly saved in these instances, but this

regulatory efficiency had nothing to do with reducing the bloated labor force, eliminating duplicate facilities, and implementing cost-saving procedures. Those achievements were due to a combination of factors including: a heightened sense of need on the part of management; the introduction of new technology, economies of scale and density associated with mergers and acquisitions, and especially, favorably-negotiated labor contracts (including billions of dollars worth of buyouts). In fact, as shown below, the number of employees working for Class I railroads has been in a long-term decline since its peak of 2.1 million in 1916.

<u>Year</u>	<u>Number of</u> <u>Class I Employees⁵</u> (Thousand)
1916	2,148
1929	1,661
1955	1,015
1970	566
1980	458
1999	178

Mis-casting the Staggers Act as the cause of increased railroad productivity and constrained pricing inappropriately supports a continuation of present market conditions; and yet, this is exactly what the railroad industry and the STB do. They use an industry-wide, unaudited, inflation-adjusted, and deficient surrogate for railroad freight rates -- more specifically, freight revenue-per-ton-mile -- to proffer that railroad rates have declined since 1980, and then automatically tie those alleged decreases to the enactment of the Staggers Act in that year. What is not mentioned is that the rate surrogate had been declining before 1980, and its relationship to actual freight rates is at best, dubious. Furthermore, actual rate surveys undertaken by the AAR in 1980 provide evidence as to the inappropriateness of the surrogate measure.

The reliance on the average freight-revenue-per-ton-mile measure is an example of how the manipulation of large and varied databases can act to confuse issues. The issue before the STB should not be overall, average railroad freight rates. In the first place, freight rates should be related to individual railroads, individual commodities, individual markets, levels of cost, and levels of service. But even more importantly, in regard to railroad matters, the STB exists only because there are rail-dependent customers. These customers, as well as the STB, should not be concerned with averages,

surrogates, and inappropriate cause-and-affect relationships.

The reality is that deregulation did little, if anything, to address the needs of rail-dependent customers. These shippers have become increasingly vocal in regard to their captivity and the railroads' insensitivity to their needs. Similarly, they find virtually no relief in the regulatory process. While the Staggers Rail Act requires *fair and expeditious regulatory decisions*, the "fairness" of current standards is at best, questionable, and there has been nothing expeditious about regulatory decisions. Some maximum rate proceedings have taken more than 10 years to resolve, while regulatory proceedings in general are extremely costly, time consuming, and intimidating to shippers. At the same time, because of fewer and similar operations, railroads have strengthened their common resolve and have the financial resources to employ a delay-and-wear-them-down strategy. This has added to the lengthy and costly regulatory proceedings favoring the staying power of railroads.

An alternative to the ineffective regulatory proceedings administered by the STB, would be the concept of Final Offer Arbitration (FOA), similar to the practice in Canada. In a nutshell, FOA is a process employing either a single arbitrator, or a panel of three arbitrators, to resolve rate and/or service disputes between railroads and their dependent customers. Unless otherwise agreed to by the parties, decisions are binding and last for a stated period of time. Benefits of FOA as applied in Canada, compared with current railroad regulatory practices are as follows:

- The arbitrator's decision is made within 60 days compared with proceedings taking years – in some historic cases, over 10 years.
- Railroad customers would identify their rail dependency by committing to file FOA submissions. They are unlikely to be frivolous submissions because of the accompanying costs. This eliminates the need for theoretical and controversial determinations of "captivity" and "market dominance."
- FOA offers by both parties are likely to be moderate in that the arbitrator must pick one or the other (i.e., baseball-style arbitration). An unreasonable offer is likely to be readily rejected. This brings the dispute into a more practical zone of analysis and encourages a negotiated railroad-customer agreement prior to an FOA decision.

- There are a host of available arbitrators, and thus the process has more credibility than alternative regulatory decisions. Unlike members of the regulatory authority, arbitrators are not political appointees. They are qualified experts whose records and reputations determine whether or not they will be selected for arbitration.
 - The cost of arbitration is shared equally between the railroads and their customers. While the customers' initial experience in arbitration may be somewhat costly, it is far less than that of current regulatory proceedings. Furthermore, customer expenses decline as experience with FOAs is gained.
 - The FOA process takes railroad-customer disputes out of the political process. Often, the disputes are resolved by the involved parties after an arbitration application is filed but before a decision is made. In essence, moving from an FOA-type decision-making process seems to be a win-win situation for railroads and their dependent customers.
3. While prudent railroad cost control is admirable, public policy can best be served if railroads increase their traffic volume, thereby helping to relieve highway congestion, having a positive impact on the environment, and providing relatively low-cost transportation service; adequate competition should help to stimulate traffic growth and improve overall profitability.
- The major economic focus of railroads has been to maximize profits through cost reduction.
 - While intermodal traffic has grown significantly, massive railroad cost cutting has not helped railroads to increase their market share, especially vis-a-vie the motor carrier industry.
 - Traffic growth requires the satisfaction of shipper needs and in turn, this requires a sensitivity to those needs, a commitment to fulfill those needs, and innovative and flexible thinking.
 - The culture of the large freight railroads is one that is slow

to change and has never been known to have keen market sensitivity.

- Adequate railroad competition could add to railroad efficiency, but more importantly, could provide the needed sensitivity to shipper needs.
- The encouragement of railroad competition is consistent with the goals of the Staggers Rail Act of 1980.
- Public policy should not automatically preclude the enactment of provisions that provide for increased access -- and thus, competition -- to the railroad infrastructure.
- The very same public that provided railroads with exclusive rights-of-way and limited competition has the right to adjust the level of competition when conditions demand it.

The railroads' emphasis on cost cutting over the past 20 years is well documented. In fact, projected efficiencies were the major factor supporting the many mergers and acquisitions during these years. For example, in 1980 the railroads' operating expense per ton-mile was 2.75 cents compared with 1.95 cents in 1999.⁶ This decline was realized in the face of virtually a 100 percent rate of inflation during those 19 years. And as previously shown, the reduction in railroad costs was led by draconian cuts in the level of railroad employment. Rational cost cutting is admirable and in the interest of shareholders, but what is also important -- especially to the public at large -- is that railroads recapture some of their lost market share, and here, the story is not good.

The railroads' share of intercity tonnage has steadily declined -- from 46.7 percent in 1950, to 28.7 percent in 1980 and 25.1 percent in 1998.⁷ During the late 1980s and early 1990s there was a leveling off of this downward trend, but it again has started to recede. In 1996 the railroad percent of market share was 25.8 percent, falling to 25.1 percent in 1997 and remaining there in 1998. With the motor carrier industry currently carrying about double the tonnage hauled by railroads, there is a substantial traffic base available for railroad penetration -- or in reality, for market recapturing. This potential traffic base is expected to expand significantly in the future, as DOT

has projected annual average increases in the U.S. domestic freight market of 3.4 percent annual between now and the year 2010.⁸ Furthermore, DOT projections call for an annual 4.0 percent increase in U.S. international traffic over the next decade. Clearly, there is a sizeable market for potential railroad penetration. But such penetration requires more than continued railroad cost cutting. It requires the ability to meet customer service standards at reasonable prices. It requires competition. It requires compliance with the Staggers Rail Act, which recognized the need for competition among railroads.

The Staggers Rail Act supports and encourages the existence of rail competition in the marketplace. One of its policies is, *To ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes, to meet the needs of the public and the national defense.* This policy is supported by two other policy statements: (1) *to reduce regulatory barriers to entry into and exist from the industry,* and (2) *. . . to avoid undue concentrations of market power . . .* These policies are consistent with one of the findings of the Staggers Act, which is that: *Greater reliance on the marketplace is essential in order to achieve maximum utilization of railroads to save energy and combat inflation.*

There are many ways to induce adequate railroad competition in the marketplace. Railroads themselves can generate competition through commercial agreements and voluntary sharing of infrastructure. The selling of branch lines to local and regional railroads — without so-called “paper barriers” is a form of increased competition. So are expanded reciprocal-switching zones. The STB can induce added competition by disallowing bottlenecks in its decisions on maximum rates. And Congress can mandate adequate competition through a change in legislation that provides for increased access, somewhat on the order of the “running rights” provision available to shippers in Canada. In the case of running rights, a railroad would have to petition the STB for the use of another railroad’s facilities, but with over 400 local and regional railroads in existence, such a provision may be useful. The success of such a policy is already well documented right here in the U.S. and by the railroads themselves. Both BN and UP have testified that the application of 4000 miles of trackage rights—which were imposed by the STB as a condition of the UP-SP merger—are working very well for both customers and railroads. And despite claims to the contrary, when railroads oppose policies that would increase access in this way, trackage rights have resulted in no safety or operational problems, at least none reported by the

railroads at this time. The point is, that adequate competition is not evil. In fact, competition is the only route for ensuring long-term financial viability for the rail industry. Deregulation and competition are inseparable. With adequate competition, the partial deregulation that now prevails can be completed and full deregulation can be implemented. Partial deregulation with ineffective regulation is not a formula for traffic growth. Without meeting shipper needs, the future of a privately-owned-and-operated, financially viable, freight railroad structure in this country is dubious. Meeting customer needs is the number one priority of virtually all for-profit companies in competitive markets, and it must be at the core of national transportation policy affecting railroads. Adequate competition is what drives customer satisfaction, and this basic concept of the free-enterprise system is what drives the country's standard of living.

In conclusion, it is my belief that staying the present course -- that is, preventing adequate competition while relying on ineffective regulation -- will do little, if anything, to ease the burden on rail-dependent customers, to make railroads more customer-driven, and to grow the traffic. At worse, it will lead to further consolidation and possibly, to government subsidization of the freight-railroad infrastructure.

I thank you for the opportunity to present my views, and I would be pleased to answer any questions.

ENDNOTES

1. Association of American Railroads, Analysis of Class I Railroads (annual). Interstate Commerce Commission, Statistics of Railways in the United States For the Year 1960.
2. Union Pacific Corporation, 1996 Annual Report, "Letter to Our Shareholders," p. 1.
3. Union Pacific Corporation, Proxy Statement to the Securities & Exchange Commission, 1996, from DGAR database on SEC's Web Site.
4. Ibid, 1997., p. 21.
5. Association of American Railroads, Railroad Facts and Railroad Ten-Year Trends. Interstate Commerce Commission, Railroad Transportation, A Statistical Record, 1911-1951, and Statistics of Railways in the United States For The Year Ended 1929, 1955, 1970.
6. Analysis of Class I Railroads, Ibid.
7. Eno Transportation Foundation, Transportation in America 1999, p. 46.
8. Federal Highway Administration, U. S. Department of Transportation, Freight Forecast Growth Rates, 2001.

Exhibit B

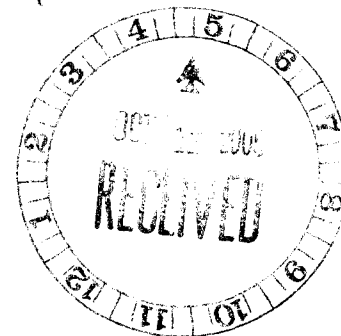
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October 12, 2005

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Via Hand Delivery

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K St. N.W.
Washington, D.C. 20423

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

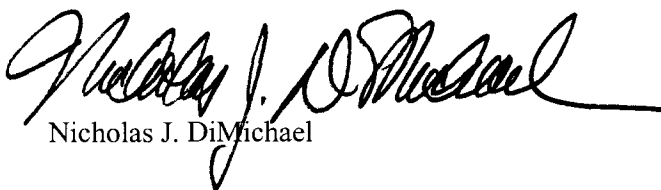
Dear Secretary Williams:

Please find enclosed the original and ten (10) copies of Written Testimony submitted by The National Industrial Transportation League for filing in the above referenced proceeding. Also enclosed is a diskette with a copy of the Written Testimony in Word format.

An extra copy of the Testimony is enclosed for stamping and returning to our offices.

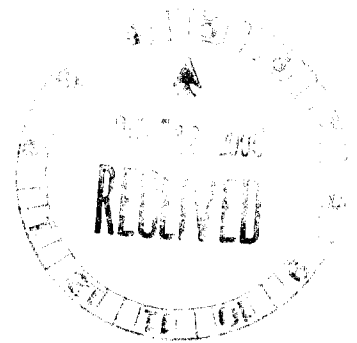
Should you have any questions regarding the foregoing, please do not hesitate to contact the undersigned.

Sincerely,



Nicholas J. DiMichael

BEFORE THE
SURFACE TRANSPORTATION BOARD



Ex Parte No. 658

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

Written Testimony

submitted by

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

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Dated: October 12, 2005

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BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 658

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

Written Testimony

submitted by

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

In a Notice of Public Hearing issued by the Board on September 14, 2005, the Board announced that it would hold a public hearing to provide a forum for the expression of views on the impact, effectiveness, and future of the Staggers Rail Act of 1980 ("Staggers Act" or "Act"). Interested persons, including large and small rail customers, large and small railroad companies, representatives of local communities, and state and federal government officials, were invited to participate. The hearing was intended as an opportunity for interested persons to address broad issues regarding the Staggers Act generally. This Written Testimony is submitted by The National Industrial Transportation League ("League") in response to the Board's Notice.

The League believes that, in a number of respects, the Staggers Act has been a success. In particular, the Act has led to the financial revitalization of the railroad industry, to such an extent that several railroads are now or will likely soon be "revenue adequate" even under the Board's demanding standard. In addition, the Act led directly to the development and wide use

of contracts between shippers and rail carriers, which (at least up until the recent past) became the dominant form of commercial relationship between shippers and rail carriers.

However, since the Staggers Act, there have been substantial changes in the nation's economy and more specifically in the railroad industry. These changes have resulted in new problems for shippers and railroads, and have given rise to new issues for public policymakers, including the Board, to consider. These changes thus make this twenty-fifth anniversary of the Act a particularly appropriate time to evaluate the impact, effectiveness and future of the statute. The League believes that the Board should re-evaluate the future administration of the Staggers Act in light of these changes in the industry. The League therefore warmly commends the Board for holding this hearing, and urges the Board to carefully evaluate the record in this proceeding in order to fulfill both its own regulatory responsibilities in administering the Act, and, if the Board believes it necessary, to fulfill its obligation under 49 U.S.C. 704 to transmit legislative recommendations to Congress.

As noted above, the Staggers Act has clearly been successful in encouraging the financial revitalization of the railroad industry. However, beyond these changes in railroad finances, the past twenty-five years have seen major changes in industry structure, capacity, operations, service, and shipper investment; and in the competition that the rail industry faces from other modes. The League notes that many of the changes in the railroad industry since the Staggers have resulted in an increase in railroad market power and have decreased competitive options for shippers.

In view of these changes, the League believes that the Board needs to become more of an advocate for rail users and more focused on the pro-competitive thrust of the Staggers Act.

Policymakers need to address increasing capacity restraints in the railroad industry, and how to grow capacity in the railroad industry and across all transportation modes. The Board also needs to become more sensitive to service issues, and better design its regulatory processes to address service problems. Finally, the Board should revise its approach to rail-to-rail competition in light of the changes to the industry, and clarify its rate reasonableness standards, in particularly its small case standards and processes.

I. THE STAGGERS ACT HAS BEEN SUCCESSFUL IN SEVERAL KEY RESPECTS

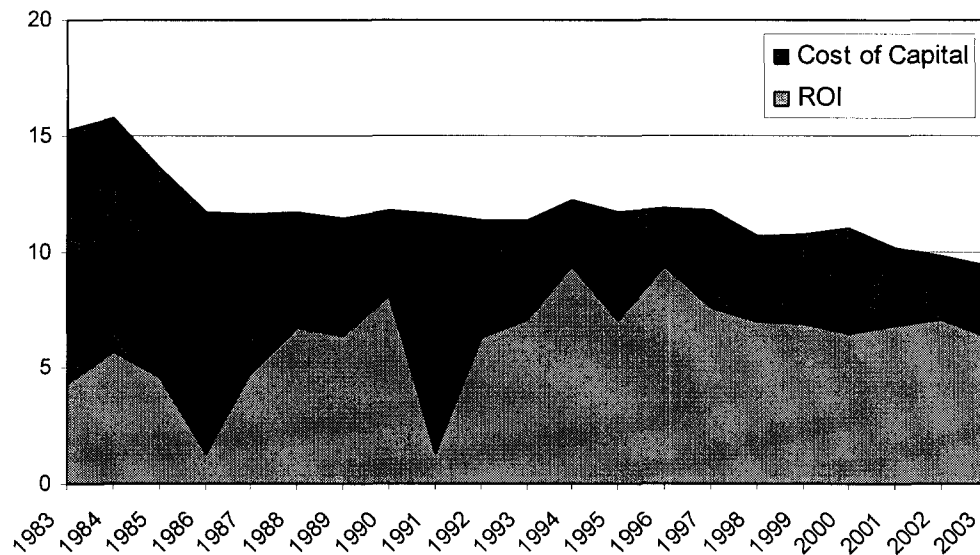
A. The Act Has Been Successful in Encouraging the Financial Revitalization of the Railroad Industry

There is no doubt that the Staggers Act has been a factor in the financial revitalization of the railroad industry. By freeing the industry from unnecessary regulation, the Act permitted railroads to rationalize their systems and to make needed changes in their operations to drive down costs and increase productivity.

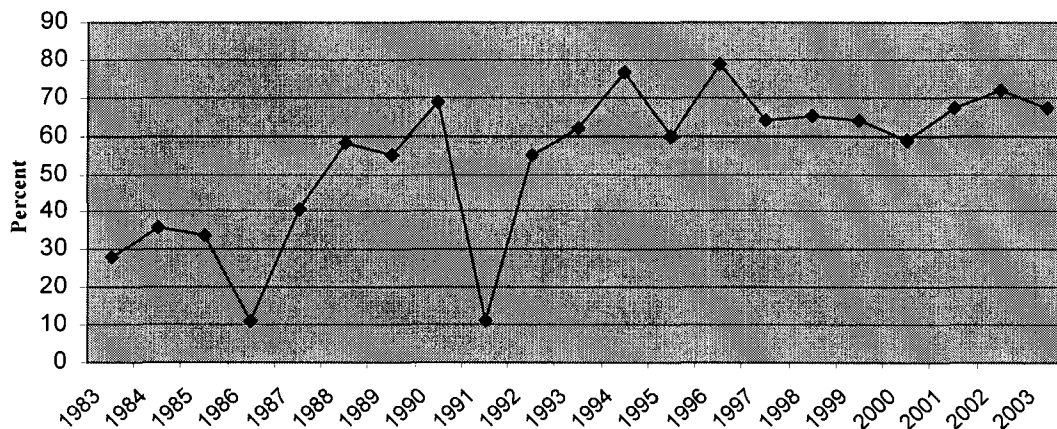
Using just the narrow and demanding regulatory "return on investment" standard followed by the STB and its predecessor the Interstate Commerce Commission, the following graphs show clearly how far the industry has come financially since the passage of the Act. The first graph portrays the railroad industry's cost of capital as determined by the ICC or the STB in each year since 1983,¹ as well as the railroad industry's return on investment over that same time period. The second chart shows the industry's return on investment as a percent of its cost of capital.

¹ The year 1983 was chosen because this was the first year that ROI was calculated on the basis of depreciation accounting, and therefore the industry's ROI in that year is comparable to subsequent years.

Comparison of Railroad Industry ROI and Cost of Capital



Railroad Industry ROI As a Percent of Cost of Capital



In 1983, the return on net investment of the industry was 4.3%, whereas the railroad industry's cost of capital was 15.3%.² In other words, in that year the railroad industry earned just 28% of the cost of capital deemed necessary for revenue adequacy by the Interstate Commerce Commission. In 2003, by contrast, the railroad industry's ROI was 6.33%, whereas

² Association of American Railroads, "Railroad Facts," 1990 edition, pp. 18 and 19. .

the industry's cost of capital was 9.4%.³ Thus, the industry was earning over two-thirds of the cost of capital deemed necessary by the STB for revenue adequacy. In that year, Norfolk Southern had an ROI of 9.1 percent, or just under the 9.4% standard for revenue adequacy determined by the Board.⁴

Since the Board's 2003 revenue adequacy decision published in August 2004, the industry's financial position has improved even further. Though the Board has not officially published its revenue adequacy determination for 2004, it appears that the Norfolk Southern achieved revenue adequacy in 2004 as the Board defines the concept, with a 2004 tax-adjusted ROI of 11.6%, which was well above the likely cost of capital level of around 10%. Moreover, the industry's return on investment is likely to exceed the highest percentage of its cost of capital in any year since the passage of the Staggers Act. The NS is likely to achieve revenue adequacy again in 2005, and the Chief Executive Officer of the Burlington Northern has publicly indicated that his railroad is likely to achieve revenue adequacy in 2005. *Rail Business*, Vol. 11, No. 38 (Sept. 2005), p. 4. Other railroads may achieve revenue adequacy, and even those that don't are likely to close the gap even further. The respected industry analyst James Valentine of Morgan Stanley indicates in a very recent report that in 2005 he expects Canadian National, BNSF, Norfolk Southern and Canadian Pacific – four of the six major Class I carriers --to all earn their cost of capital. James Valentine and Michael Manelli, Morgan Stanley Equity Research, "All Aboard ! Reiterating Bulling View Towards Freight Railroads," September 20, 2005, p. 3. [Hereafter, "Valentine Railroad Report"].

³ AAR, "Railroad Facts," 2004 edition, pp. 18-19.

⁴ *Id.*, pp. 19, 74.

The fact of the matter is, however, that by all standards other than the agency's official determination of "revenue adequacy," the industry has already achieved revenue adequate status as a real-world matter and has likely done so for the past several years. Wall Street has been clearly bullish on the railroad industry for some time, despite the agency's yearly pronouncements that the industry is "revenue inadequate." It is clear that the agency's "revenue adequacy" standard is an extremely demanding one and overstates the financial returns needed for "real world" revenue adequacy. This is likely due to the fact that the industry still has significant investment "on the books" which does not earn its cost of capital, but which also consumes few current resources.

The industry, according to the ICC's and STB's official determination, has not earned its cost of capital for twenty-five years. In fact, according to the AAR as reported by financial analyst James Valentine, the railroad industry had not earned its cost of capital since 1945,⁵ a state that was probably true even long before that. An industry that has not earned its cost of capital for six decades or more should, under conventional economic theory, be long out of business. Yet, the industry survived, and now thrives, despite still being labeled as "revenue inadequate" by the STB -- a situation suggesting that the agency's "return on investment" measurement is an incorrect one when applied to determine the financial condition of the railroad industry. Individual railroads have had no trouble raising capital of any kind for any purpose for a number of years. The industry's stock has in fact outperformed the S&P 500 Index over a long stretch of time.⁶

⁵ Valentine Railroad Report, p. 3.

⁶ Siegel, Jeremy J., *The Future for Investors*, Crown Business (2005), p. 62. Mr. Siegel notes that the stock of the BNSF, which he calls the "star performer" of the four major surviving railroads, "has achieved an astounding 17 percent annual return since 1980, more than 4 percentage points higher than the S&P 500 Index." *Id.*

In the recent report noted above, the respected financial analyst James Valentine was positive about the industry's current financial condition and extremely bullish on the industry's financial prospects for the future. The summary of his report is worth quoting in full:

**ALL ABOARD! REITERATING BULLISH VIEW TOWARDS
FREIGHT RAILROADS**

Conclusion: Even though the six major North American railroads have seen their stocks rally 15%-60% over the past year, we continue to believe there is sustainable momentum, with conservatively another 15%-30% upside by year-end 2006, led by Norfolk Southern.

What's New: The bullish stance that we've had for the past year was reinforced recently during our meetings with four of the freight railroads as well as additional discussions with our industry sources including large railroad shippers. *We have even greater conviction that the industry will consistently earn its cost of capital over the next few years (a feat not achieved in decades), led by secular upward pricing initiatives that should continue into 2006 and beyond.* We expect improved returns and cash flow, combined with the railroad industry's traditionally stable revenue base, to drive the industry's P/E ratio 100-300 basis above its historical 12.5x forward earnings. Using a basket of comparable companies in other industries as a guide, we could argue the better railroads will eventually trade at a market multiple, which would lead to 30%-40% stock price appreciation by year-end 2006.

What's Misunderstood?: Since the drop in railroad valuations in April, we've seen them pull back on days of rising oil prices or negative economic news, which confirms our view that the Street believes the recent wins by the railroads are more cyclical than secular. Over the next 12-18 months, we believe this view will be disproved, namely that *this industry is headed for higher earnings power and higher valuations due to secular changes in freight transportation, regardless of near-term economic or oil price movement.*

Id., p. 1 [emphasis added]. Mr. Valentine concludes that "*returns in the next decade [for the industry] will be in the 8% - 14% range, which will lead to further P/E expansion.*" *Id.*, p. 3. [emphasis added]

The Morgan Stanley analysis of Mr. Valentine is echoed to a large extent by a Bear Stearns Equity Research Report, May 2005, "Railway Rush Hour – How Long Will Tightness in Rail Capacity and Pricing Gains Persist?", which notes, at page 5: "Given our expectation that

infrastructure constraints are likely to support continuing tightness in rail capacity, we believe that the rails are likely to sustain a solid pricing story well beyond 2005. In our view, continued pricing gains should support EPS growth even in a slowing economy.” The Bears Stearns analysis notes that “secular trends support rail growth beyond the economy.” *Id.*, p. 6.

The key point in the data shown above and in Wall Street’s analysis is that this financial trend is not just a single-year or passing phenomenon. In Mr. Valentine’s words, the industry’s financial trend is “secular” rather than “cyclical.” While the industry, over perhaps the first twenty years or so after passage of the Staggers Act, clearly emerged solidly from the financial distress experienced by the industry in the 1970s, something even more profound has happened over the past two or three years: capacity constraints and other developments (discussed in more detail below) which have moved the railroads to a higher financial level, at which even the agency’s demanding (and unrealistically high) return on investment for “revenue adequacy” standard is likely to be satisfied over significant time periods.

It is clear, then, that for the first time since the passage of the Staggers Act, neither the agency nor Congress need be concerned about the financial health of the freight railroad industry for the foreseeable future, and do not need to orient public policy making with solely the financial health of the railroads in mind. From a financial perspective, policy makers can and should treat the railroad industry as a system, composed of both providers and users: the financial health of both need to be kept in mind.

B. Contracting Under the Act Has Been a Success, Though Its Future is in Doubt

The Staggers Act for the first time clearly permitted the development of transportation contracts between shippers and rail carriers. Quickly after passage of the Act, contracts became

the dominant form of commercial relationship between shippers and rail carriers. As envisioned by the Act, contracts permitted carriers to lock in a base of business, and gave shippers certainty in their transportation costs over a period of time, as well as certain service guarantees.

However, there are now real questions about the future of railroad contracts for many shippers. As discussed further below, recent years have seen a significant return to tariff or public pricing by many rail carriers in a number of industry segments, and shippers report to the League that, even where contracts are offered, the term of the contract is decreasing and meaningful service guarantees are becoming much more difficult to come by.

II. SINCE THE PASSAGE OF THE STAGGERS ACT, THERE HAVE BEEN SUBSTANTIAL CHANGES IN THE U.S. ECONOMY AND IN THE RAILROAD INDUSTRY

In the last twenty-five years, the U.S. economy has changed substantially. The country has seen its industrial sector decline in relation to the service sector as production has shifted to Asia, a development that has had profound effects on both global and domestic transportation. Technology has changed dramatically: in 1980, the year that the Staggers Act was passed, there were no personal computers, there was no email, no internet, and a "hybrid" was a rose. The railroad industry has also changed, and a brief discussion of these changes is in order to set the stage for a discussion of the future.

A. Rail Mergers and the Growth of Short Lines

Since 1980, the number of Class I railroads have declined dramatically, from approximately 40 at the time of the passage of the Staggers Act to just seven today. But even those numbers are deceptive: of the 122,293 miles of road operated in 2003 by these seven Class I carriers, 109,548 miles or 90% were operated by just four of these railroads (UP, BNSF, CSX, and NS); and of the total Class I operating revenue of about \$36.6 billion in 2003, about \$34.0

billion or 93% was generated by these four carriers.⁷ Two of these carriers operate largely in the western part of the U.S., and two in the East. By any measure, the industry is now highly concentrated.

At the same time, the railroad industry has seen a dramatic growth in the number of so-called "short line" rail carriers, which were formed directly as a result of some of the changes made by the Staggers Act. According to the American Short Line and Regional Railroad Association, in 2002 there were 545 short line and regional rail carriers, operating 46,474 miles of track and employing 19,688 people. Almost 60% of these were local line haul carriers (operating 350 miles of track or less), and almost 40 percent were switching and terminal carriers. The remainder (six percent) were regional carriers operating more than 350 miles of track and/or with a revenue over \$40 million. Seventy percent of these carriers had begun operation subsequent to the passage of the Staggers Act. ASLRAA, "Short Line and Regional Railroad Facts and Figures, 2004 edition, pp. 6-7. Short line and regional carriers carried over 9.3 million carloads in 2002. *Id.*, p. 8.

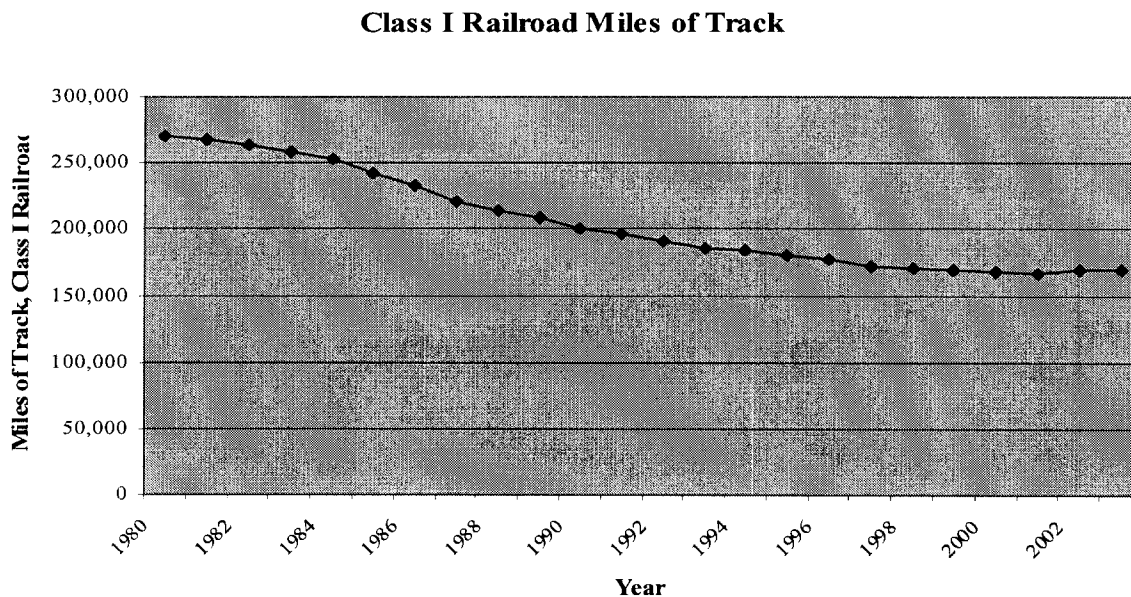
The growth of short lines has been an extremely beneficial development for shippers: these market-responsive and service-focused carriers perform a valuable role, particularly in the "first mile" and "last mile" of rail shipments, and their growth should continue to be encouraged. The Board needs to view these carriers as full partners with the Class I carriers in the shipment of goods by rail.

⁷ AAR, "Railroad Fact," 2004 Edition, Association of American Railroads, pp. 66-67.

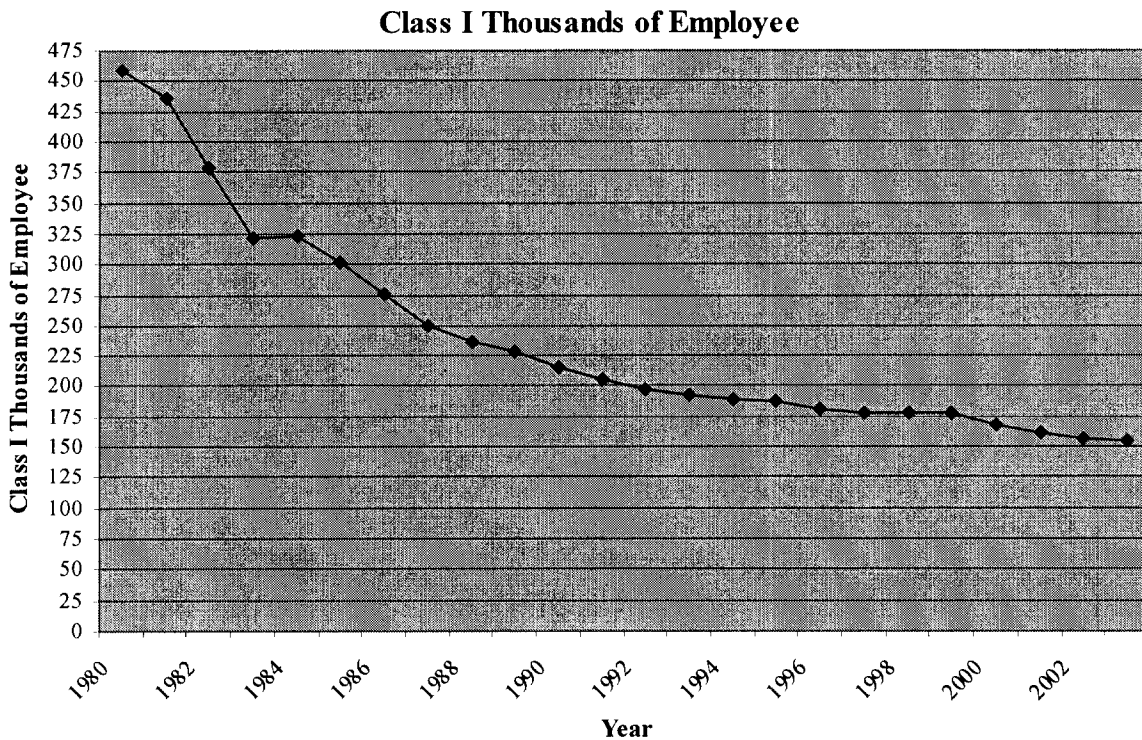
B. Increasing Capacity Constraints in the Rail Industry

Probably the most significant development since the passage of the Staggers Act has been the increasing capacity constraints that are now present in the railroad industry. The Board is well aware of reports from both shippers and railroads indicating that the industry is experiencing substantial capacity limitations. In addition, several kinds of data identify some sources of the constraints now being experienced by the industry.

Since the Staggers Act, the miles of track and the number of employees for Class I railroads have declined dramatically:



Source: AAR, "Railroad Facts," 2004 edition, p. 45, and other years' similar data.



Source: AAR, "Railroad Facts," 2004 edition, p. 56 and other years' similar data

The AAR's figures show that since 1980, miles of track owned by Class I rail carriers have declined by about 40 percent,⁸ and the number of employees have declined by about two-thirds.

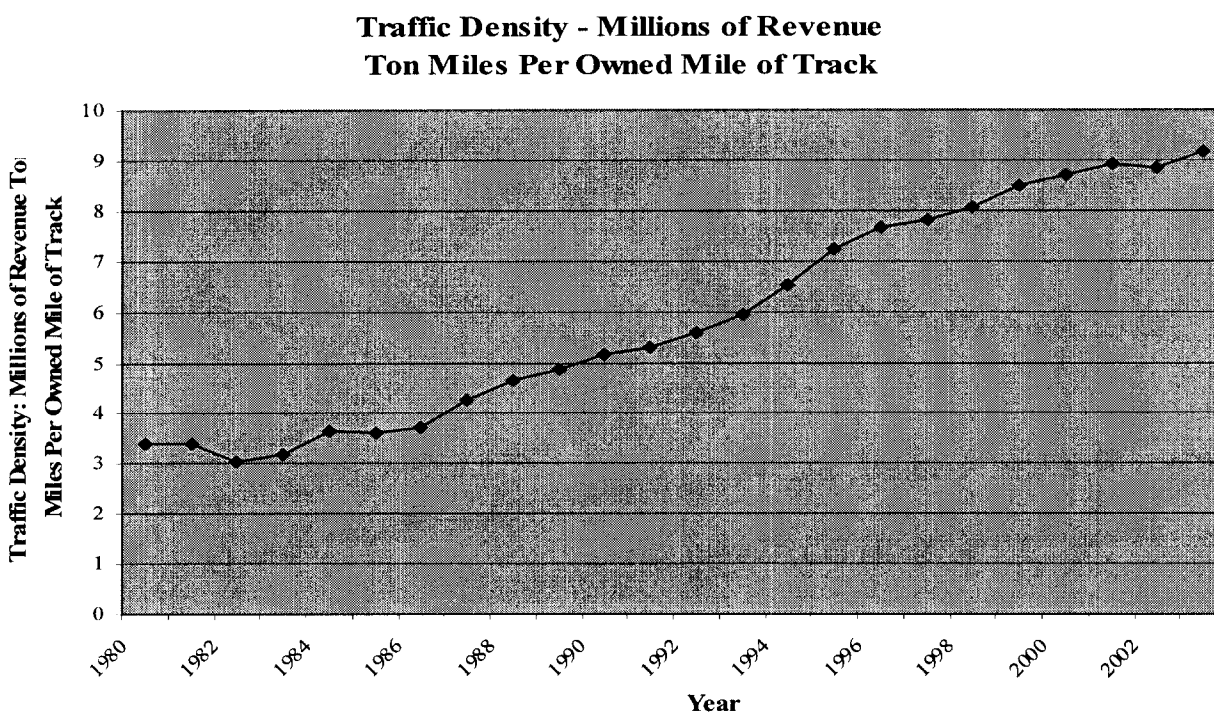
What is important about these figures is not only the magnitude of the declines since 1980, but also the fact that the declines have largely leveled off since about 2000 (in fact, the number of miles of track owned has increased since its low point in 2001, the first time that this has happened since 1929).⁹ This suggests that the rail industry has reached the point at which it cannot shed any more track or employees – it has reached the point that it needs all the

⁸ The decline in the number of track miles by Class I railroads does not come close to being counterbalanced by the increase in the number of short line miles. The total short line industry in 2002 owned or leased about 30,000 miles of track, with government owning about 9,000 miles of track. ASLRAA, "Facts and Figures," 2004 edition, p. 7. Some of this track was owned by short lines even before the Staggers Act. In contrast, between 1980 and 2003, Class I carriers experienced a reduction in over 100,000 miles of track. AAR, "Railroad Facts," 2004 edition, p. 45.

⁹ *Id.*

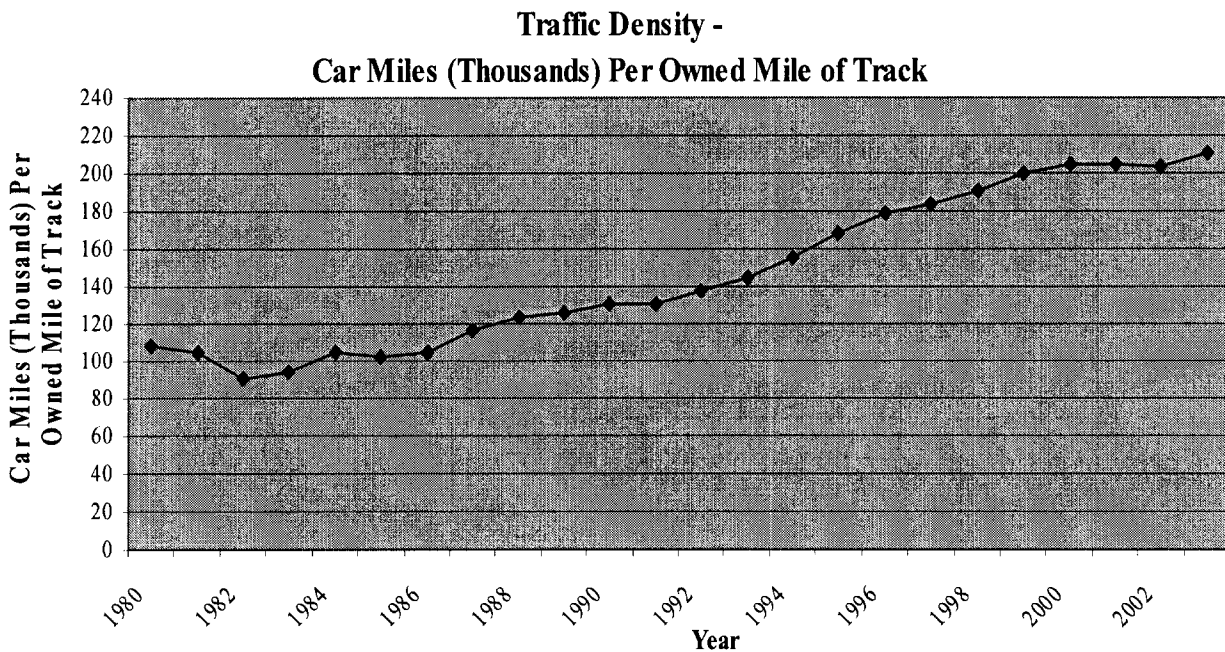
employees and track that it has. Indeed, reports have indicated that some rail carriers are adding employees, for the first time in many, many years.

The significant limitation on railroad capacity is dramatically confirmed by data which the AAR uses to determine traffic density -- millions of revenue ton-miles per owned mile of track -- and a related figure, millions of revenue car-miles per owned mile of track.¹⁰ Both of these figures since the Staggers Act show huge increases in traffic density, plus a recent leveling off of density increases, apparently as the capacity of the system is being reached.



Source: AAR, "Railroad Facts," 2004 edition, p. 42

¹⁰ The car mile figure appears to the League to be a better sign of the possibility of congestion, since ton-miles are affected by the weight of loadings (a factor not important in system congestion), whereas car-miles better capture the amount of "space" on the railroad being taken up by increased traffic.



Source: AAR, "Railroad Facts," 2004 edition, p. 34 and p. 45 and other years' similar data

These figures show that since 1980, ton miles per owned mile of track have approximately tripled, and car miles per owned mile of track have approximately doubled. However, since 2000, these increases have begun to level off.

Significantly, these increases in traffic density have not, on average, come from increases in the number of tons per car or in the number of cars per train. According to the AAR's own figures, the number of tons per carload is less in 2003 than it was in 1980 (67.1 in 1980 versus 62.3 in 2003),¹¹ and the number of cars per train is virtually the same as it was in 1980 (68.3 in 1980 versus 68.9 in 2003).¹² While clearly rail carriers are putting many more tons in some cars than they did in 1980 and more cars on some trains, the changes in traffic mix, including the growth of light-loading intermodal traffic, has apparently kept average growth in these

¹¹ AAR, "Railroad Facts," 2004 Edition, p. 37.

¹² *Id.*, p. 35.

categories flat. Thus, rail carriers appear to be putting, on average, more and more trains on a system whose amount of track and number of employees have significantly declined since 1980. And, given the flattening out of all of these figures over the past two or three years, they do not appear to be able to do this any longer, at least not nearly to the extent that they have in the past. As the AAR notes regarding its traffic density measure: "[a] higher figure [of millions of revenue tons per owned mile of track] indicates greater utilization efficiency, but can also signal the risk of congestion." *Id.*, p. 42. Reports from both shippers and railroads clearly indicate congestion issues in the rail industry.

C. Reductions in Competition from Other Modes

Historically, the major competitors to rail carriers have been motor carriers, across a part of the railroads' traffic base. However, there are many reasons to believe that competition by motor carriers has in recent years been significantly less effective.

Motor carriers have had a difficult time finding drivers, and the recent changes to Hours of Service regulations for motor carriers have only exacerbated the problem. Mr. William Graves, President of the American Trucking Associations, has noted in a recent speech that the "driver market is the tightest it has been in 20 years," and a May 2005 study by the ATA shows that the trucking industry will face a huge shortage of drivers over the next 10 years, a fact that will likely require carriers to pay their drivers substantially more, a result that in turn will have a dampening effect on the competition that motor carriers will provide in the future.¹³ Insurance rates have substantially increased, and dramatic hikes in fuel prices since 2004 have hit the motor carrier industry hard, since fuel is a significantly larger part of the motor carrier industry's

¹³ This increase in the cost of drivers and other costs will have an effect on intermodal traffic as well, whose motor carrier portion is likely to increase.

cost structure compared to the rail industry. The Valentine Railroad Report notes that the trucking industry has been hard-hit by both fuel and non-fuel costs in recent years, *id.* at pp. 9-10, and Mr. Valentine concludes that "truck's pain is railroad's gain." *Id.*, p. 10. Finally, there appears to be little possibility at the present time that size and weight restrictions for the motor carrier industry would be eased, facilitating competition with railroads over a larger portion of the transportation business.

Given the recent hike in fuel and non-fuel costs, there is increasing question as to how much truck competition plays in restraining rail rates for commodities moving more than a few hundred miles. The Valentine Railroad Report indicates that railroads price only about twenty percent of their business against long-haul trucking. *Id.*, p. 9. Indeed, in an even more recent report published by Morgan Stanley, almost 60% of the railroad industry's revenue has a "low" or "somewhat low" sensitivity to being priced directly against truckload motor carriage. Morgan Stanley Equity Research, James Valentine, Chad Bruso, Michael Manelli, "Freight Pulse 9 - Shippers See Railroad Rates and Truck Capacity on the Rise," October 4, 2006, p. 7 [hereafter "Valentine Freight Pulse 9 Report"]. These include such major product groups to the U.S. economy as coal, chemicals, farm products, crushed stone and sand, and petroleum.¹⁴

It is very notable that Mr. Valentine places in this category "Intermodal (international)", which he indicates has a "somewhat low" likelihood that railroads price this segment directly against trucks. Thus, even in a traffic category that conventional wisdom might suggest is highly truck-competitive, the market has changed: evolving international and domestic traffic patterns; shipper, railroad and public investments; and other factors have all combined to

¹⁴ The Valentine Freight Pulse 9 Report characterizes the remaining 22% of the railroads' traffic base as having "moderate" price competition by trucks. This category includes such commodities as motor vehicles, primary forest products, and metals. *Id.*

give rail carriers unprecedented pricing power even in what has been thought of as "truck-competitive" markets.

D. Operational Changes and the Growth of Shipper Investment and Activities

There have been numerous operational developments in the rail industry since the Staggers Act, but two are particularly important: (a) growth in shipper investment in the rail industry and the assumption by shippers of functions that used to be performed by rail carriers; and, (b) the growth of unit trains and the decline in the emphasis on carload operations.

The past twenty-five years have seen a remarkable shift in car ownership in the railroad industry. In 1980, Class I railroads owned 1.168 million cars, and shippers and car companies owned about 440,000 cars, or only about 26% of the total 1.7 million freight car fleet (about 100,000 cars were owned by other than Class I rail carriers). *Id.*, p. 51. By 1990, the total number of freight cars in service had declined precipitously, to 1.2 million cars (a drop of nearly 30%), but the total number of non-railroad cars had increased to about 450,000, a figure that represented 37 percent of the total number of cars. By 2000, the number of railroad cars had dropped again, from 761,000 in 1990 to 692,000 in 2000, a decline of nearly 10 percent, while the number of non-railroad cars had again risen from about 450,000 in 1990 to more than 688,000 in 2000, a massive increase of more than fifty percent. In that year, non-railroad freight cars for the first time comprised more than fifty percent of the total car fleet. By 2003, the total non-railroad freight car fleet was 54 percent of the total number of cars.¹⁵ *Id.*

¹⁵ Not only did the number of shipper-owned cars increase dramatically after the Staggers Act, but the kind of cars owned by shippers changed substantially as well. Before the Staggers Act, a significant percentage of shipper-owned cars were tank cars, which had traditionally been supplied by shippers, with carriers paying a mileage allowance. But in the years following Staggers, many other types of cars began to be owned by shippers, including open-top hoppers for coal movements; covered hoppers for chemicals; and others.

Thus, in the twenty-five years since the passage of the Staggers Act, the number of non-railroad cars increased by more than fifty percent, and comprises more than half of the total rail industry car fleet. In sharp contrast, the number of railroad freight cars declined from 1.270 million to just 590,000, a drop of nearly 55%, and now railroad freight cars comprise less than half the total of rail cars in service. Indeed, if Class I rail carriers are only considered, the drop has been even more precipitous: Class I rail carriers, despite moving and handling virtually every car on the nation's rail system, in 2003 controlled just 467,063 of the 1,278,980 cars in the system, or just 37 percent of the freight cars in the industry. *Id.* This represents a huge change from "traditional" railroading, in which the Class I carriers themselves supplied most of the instrumentalities of transportation. This shift in car ownership means the assumption of much more than just the purchase price of the cars: all related maintenance, taxes, etc. are also shifted.

Beyond car ownership, shippers have invested massive amounts in other incidents of transportation such as rapid loading facilities. Even more importantly, shippers have assumed substantial functions that prior to the Staggers Act were performed by railroads as a part of their railroad service, such as waybilling. Shippers have also invested heavily in and perform new administrative functions such as tracking and tracing, paperless invoicing systems, etc.

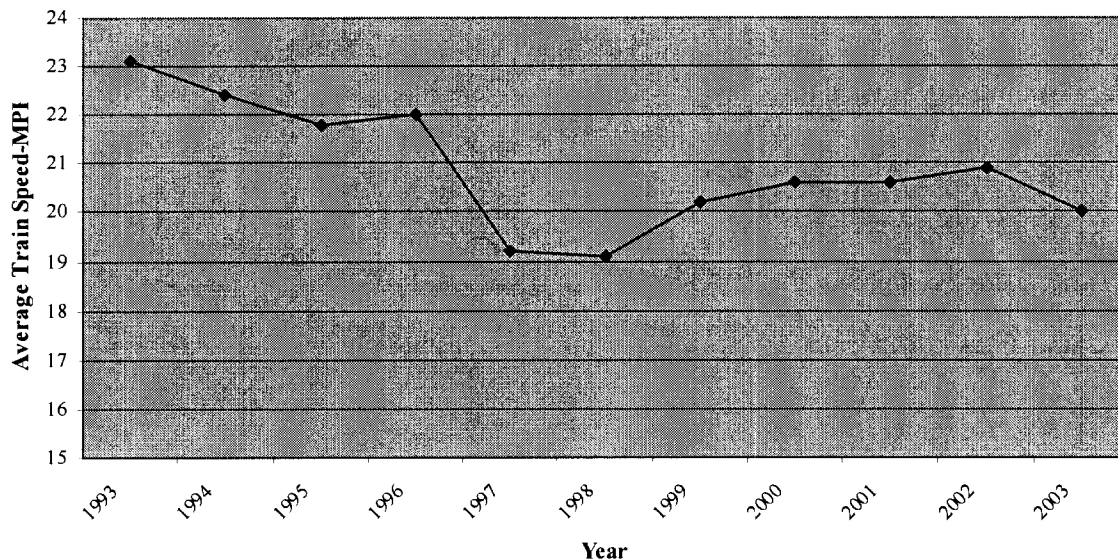
Additionally, the years since the Staggers Act have seen a marked shift in railroad operations, away from carload and multiple car operations, toward unit train operations. Significant parts of the railroad industry's operations are now performed in shuttle or unit-train-type operations, including coal, grain, intermodal, and others. In this shift, carload shippers feel themselves the "stepchild" of the industry, paying more and getting less.

E. Service Trends and Service Problems in the Railroad Industry

The years since the Staggers Act have also seen substantial service problems. Some of these were related to the wave of mergers that took place from 1995 to 2000, and some of the changes in shippers' investment in cars can be traced directly to these problems. In the four years between 1995 and 1999, non-railroad cars increased by approximately 112,000, or more than the number in any four-year period before or since back to 1929, an astounding twenty-percent increase in the number of non-railroad cars in just that four-year period. *Id.* This four-year period was the time of severe service problems in the railroad industry, starting with the UP/SP merger in 1995, and ending with the purchase of Conrail by Norfolk Southern and CSX in 1998. Because of those service problems, shippers that were tied to the railroad system for their transportation had to acquire, and did acquire, large numbers of cars to be able to meet their customers' needs.

There is significant anecdotal evidence from shippers that service in the railroad industry has not improved significantly since the mergers of the 1990s or even since the Staggers Act, but there is little hard data – a topic further addressed below. What limited hard data there is suggests that service levels have not yet recovered from the service problems that began almost a decade ago. For example, the AAR's own figures indicate that average train speed has actually declined between 1993 and 2003:

Average Train Speed



Source: AAR, "Railroad Ten-Year Trends 1993-2002," p. 132; and "Railroad Ten-Year Trends 1994 – 2003," p. 132.

In addition, the AAR also publishes average train speeds, by month, for each of its members, as well as total U.S. figures, for more recent time periods. Attached as Appendix A to these Comments are three charts, showing: the average train speed for the BNSF, CSX, NS and UP from January 2000 through September 2005; a chart showing the Total U.S. average train speed; and a chart showing the average terminal dwell times for each of these railroads from January 2001 through September 2005.¹⁶ Over this recent time period, average train speed for the total U.S. shows a decline from about 23 miles per hour in the year 2000, to less than 22 miles per hour for the most recent 12-month period reported. Since the beginning of 2002, average train speed for all four major U.S. carriers has declined steadily. Similarly, since about the middle of 2002, average terminal dwell for three of these four carriers has remained

¹⁶ The four-carrier charts are through December 2004 for BNSF, which changed its method of calculating terminal dwell and train speed in January 2005.

essentially flat or has deteriorated (i.e., terminal dwell has increased), while terminal dwell has improved for only one carrier.

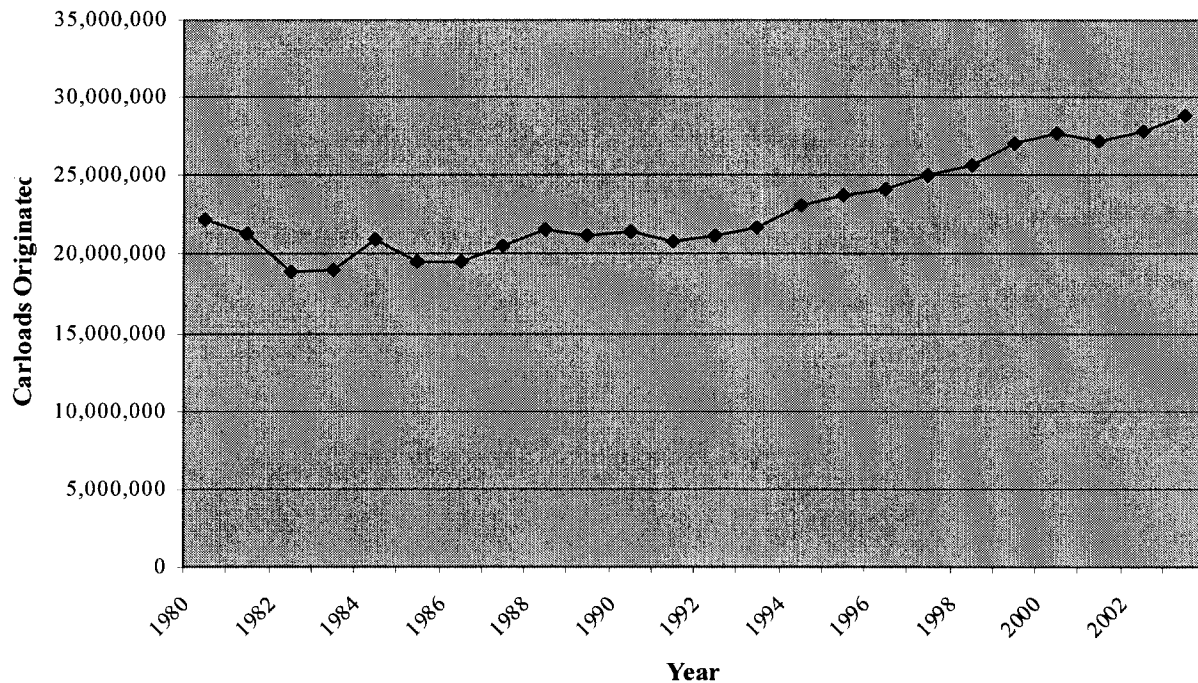
Another source of information is surveys of shippers, which have consistently shown growing shipper dissatisfaction with rail service. The Valentine Freight Pulse 9 Report, for example, notes that, in a comprehensive survey done by Morgan Stanley over a number of years of nearly 300 heavy freight customers, shippers in the survey gave railroads in 2005 a score of only 5.8 out of ten for "delivery when expected," a decline of ten to twenty percent in this key area from scores on this factor reported in 2001 to 2003. Valentine Freight Pulse 9 Report, p. 3.

In short, the chart above, combined with the charts in Appendix A and the reports by shippers, suggests that the service promises of the rail mergers of the mid-1990s have yet to be realized

F. Growth in International and Domestic Intermodal Traffic

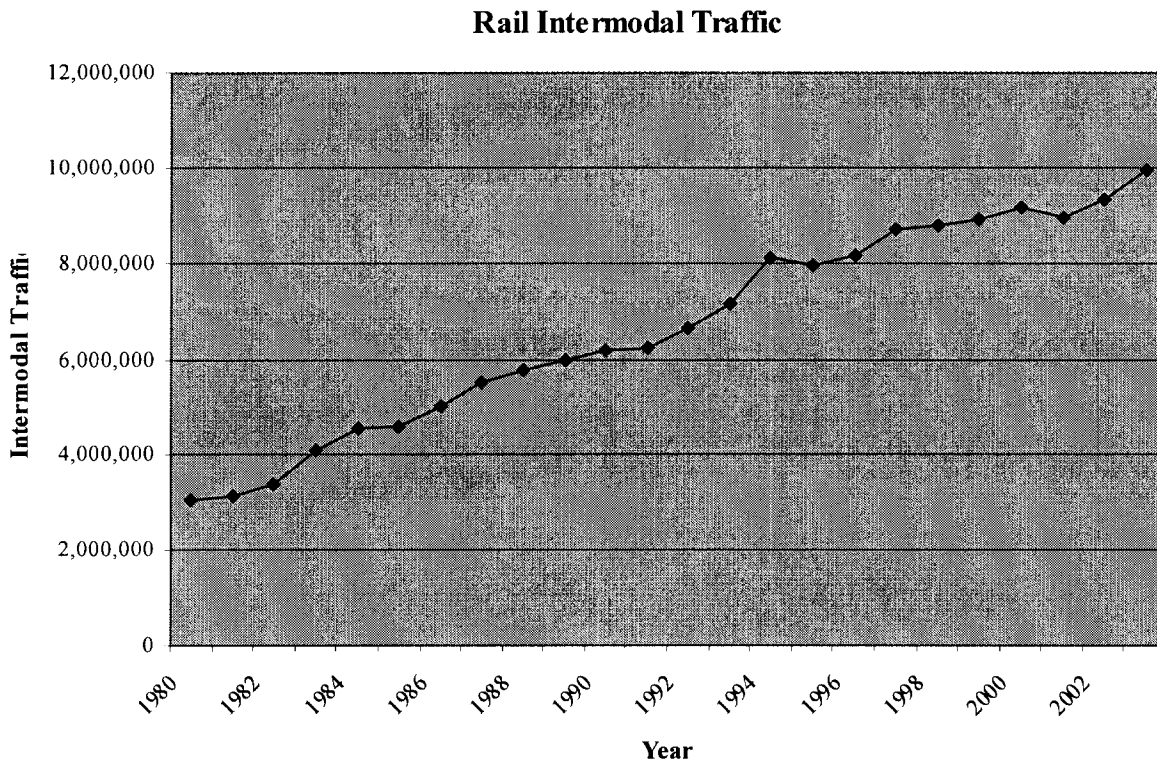
Since 1980, the number of carloads originated by the rail industry has increased approximately thirty percent, though given the twenty-five year time period involved shows only slow growth per year -- an average of only about 1 percent per year. As discussed at page 28 below, in recent years rail carload originations have not kept pace with U.S. industrial production. The chart below shows the number of carloads originated per year since 1980:

U.S. Rail Industry - Carloads Originated



Source: Railroad Facts 2004 edition, p. 24 and other years' similar data

What has changed significantly in railroads' originations over this time period is one particular type of traffic – intermodal. Since 1980, intermodal traffic has more than tripled, increasing from about 3 million units per year in 1980, to approximately 10 million in 2003. Indeed, it appears that the modest growth overall in railroad traffic since 1980 has come almost entirely from massive growth in the intermodal segment.



Source: Railroad Facts 2004 edition, p. 26 and other years' similar data

The growth of intermodal has had profound effects on the railroad system. The traffic tends to be higher speed and higher priority compared, for example, to unit train coal or merchandise traffic, and therefore "takes up" significant "space" on the railroads' network. A significant part of this traffic comes from the West Coast in the form of containers imported from the Far East, a fact that has caused congestion on certain lines, and a significant need to upgrade both West Coast receiving facilities and the intercontinental network from the West. Though intermodal was long believed to be carried at rates just above incremental cost, recent anecdotal evidence suggests that pricing has moved up significantly.

G. Shift From Contracts Back to Public Pricing, and Changes in Contracts

In the past several years, a final significant change has taken place – the shift from contract back to public pricing. This development has been widely reported in the press, and the League is well aware of this change. League members report that the pace of this change seems to be gaining a considerable amount of momentum among the railroads. The change permits railroads to increase prices on little notice, but leaves shippers with little certainty in their transportation arrangements; few remedies for poor service; and subject to extremely restrictive (and perhaps unlawful) rules on loss and damage.

Contracts have been affected as well. While it is impossible to make certain judgments given the confidential nature of contracting, general information from shippers suggests that contracts have become of much shorter duration; contain few if any service guarantees; are subject to a variety of accessorial and surcharges; and often are little more than a promise by the shipper to ship a certain amount or percentage of goods and a price for transporting the goods. In short, it appears that the railroads are implementing a strategy of having few private contracts with shippers that have any real teeth or meaning to them.

III. MANY OF THE KEY CHANGES IN THE RAILROAD INDUSTRY SINCE THE STAGGERS ACT HAVE RESULTED IN AN INCREASE IN RAILROAD MARKET POWER AND HAVE DECREASED COMPETITIVE OPTIONS FOR SHIPPERS

It is very clear that a number of the changes that have taken place in the transportation industry since the passage of the Staggers Act have resulted in an increase in railroad market power and decreased options for shippers.

Railroad mergers have reduced the number of railroad competitors to just two in the East and two in the West. These mergers have reduced the number of competitive routing options as

merged carriers have closed formerly competitive gateways. Combined with the agency's ruling in its 199_ "bottleneck" decision, which eliminated the right of shippers to choose a competitive joint-line route when one railroad could provide single-line service, mergers have extended railroad bottlenecks and have turned potentially competitive routings over at least part of a movement into single-line captive movements. Rail mergers have also decreased even the indirect leverage represented by product and geographic competition, as widely-separated plants are today much more likely to be served by the same railroad. The extreme concentration of the industry, coupled with the increased use of public pricing — itself a practice whose growth has been facilitated by the small number of rail competitors in the industry -- has made the possibility of price leadership and conscious parallelism much more likely. With the growth in public prices, it becomes much easier for the two remaining competitors in the East and West to monitor each other's prices, and by their reactions to each other more easily manage their desired level of prices.

Beyond the competition-dampening effects of rail mergers since the Staggers Act, there have been other developments that have tended to increase rail market power. Increasing shipper investment in instrumentalities of transportation that used to be supplied by rail carriers themselves, such as cars and rapid loading facilities, have tied rail-dependent shippers even more tightly to the use of rail. A shift to truck competition becomes even more difficult if a company has to "write off" millions of dollars in rail-related investments, even as the price of rail transportation increases and the consistency of rail service declines.

As noted above, changes to the trucking industry have also increased the ability of rail carriers to exercise market power, as changes in fuel prices, driver shortages, increases in insurance and other costs, and other factors have caused trucks to be less and less competitive to

rail carriers over a larger segment of the railroads' traffic base. The Valentine Railroad Report noted that non-fuel truckload trucking costs increased twelve percent in the two-year period from 2003 through 2004. They are expected to jump another seven percent this year, for a total non-fuel cost increase of nearly twenty percent in just three years. Valentine Railroad Report, p. 9. When these non-fuel cost increases are combined with the large fuel cost increases recently experienced, this places motor carriers at an even greater competitive disadvantage. As noted above, the Valentine Freight Pulse 9 Report concluded that "approximately 80% of the industry's revenue is generated by customers where modal shift to truck is not a very realistic option" Valentine Freight Pulse 9 Report, p. 7. Even the transportation of motor vehicles, usually considered to be truck-competitive, was rated by the Morgan Stanley team as having only "moderate" truck competition. *Id.*

The move away from contracts and toward public pricing gives rail carriers much more opportunity to change prices quickly, and much less responsibility for the quality of service. Conversely, shippers have less and less certainty over their transportation costs, and at present, few remedies for poor service.

Overarching all of these trends is the growing realization that the rail industry is experiencing serious capacity constraints. As the Valentine Railroad Report notes, "after 90 years, the railroads have run out of excess capacity." Valentine Railroad Report, p. 8. It concludes: "[t]his lack of excess capacity has shifted the railroad's marketing philosophy from one of *incremental pricing* to one of *full cost recovery* pricing, including their cost of capital, a philosophy not used for such a broad range of railroad commodities in at least 50 years." *Id.* [emphasis in original]. The Board is well aware that shippers have been experiencing railroad "de-marketing" of less desirable movements through price hikes, and very substantial rate

increases for the traffic base as a whole. The Morgan Stanley survey confirms these reports: "Shippers responses [to the Freight Pulse 9 survey] confirm our view that *railroad pricing is rising at unprecedented levels.*" Valentine Freight Pulse 9 Report, p. 1 [emphasis added]. This pricing story, more than anything, confirms that rail carriers are under fewer competitive restraints than at any time since passage of the Staggers Act.

IV. PUBLIC POLICYMAKERS NEED TO RE-EVALUATE FUTURE REGULATION OF THE INDUSTRY IN LIGHT OF THESE CHANGES TO THE RAILROAD INDUSTRY

A. The Board Should Be More Balanced in Its Regulatory Approach

For twenty-five years, the ICC and the STB have been focused on protecting the financial health of the railroad industry. The League believes that the regulatory agency went too far in that direction, and did not give enough emphasis to the equally important competitive thrust of the Staggers Act. The very first policy implemented by the Staggers Act was "to allow, to the maximum extent possible, competition and the demand for rail services to establish reasonable rates for transportation by rail." 49 U.S.C. 10101(1). The third policy set forth in the Act, to "allow[] rail carriers to earn adequate revenues," is clearly important, but it is not on a higher plane than the desirability of competition to set prices in the rail industry.

New conditions require new responses. With the financial health of the industry no longer an immediate issue, and with the increasing market power of rail carriers, the Board should be more balanced in its regulatory approach. This does not mean that the Board should return, even if it could, to the comprehensive scheme of regulation prior to the Staggers Act. Rather, increased emphasis must be placed on the creation of value to the shipping public in a competitive marketplace. Perhaps the most consistent "message" that the League hears from its shipper members, especially in the recent past, is: "I wouldn't mind paying for higher rates, as

long as I was getting something for the extra money. But I'm paying a lot more, and getting less."

Indeed, railroads and shippers need to become better partners, not worse. No one wants to return to the highly confrontational structure of direct regulation that existed prior to the Staggers Act. The creation of value will only occur if railroads and shippers, spurred by the overall structure created by the regulatory system, work together to identify sources of productivity gains and cost reductions, and work to change systems and processes to incorporate those changes. Particularly in the service area, there needs to be a greater level of collaboration between shippers and carriers to operate as a true rail network, otherwise the level of service consistency needed in order to maximize current capacity will not be fully realized. The League strongly supports a collaborative approach, but in order for it to work, there must be benefits for shippers as well as railroads, and both parties need to act to ensure that it is successful.

It is highly unlikely that shippers and rail carriers will ever see all of the resources that the rail transportation industry needs to grow the capacity of the system, and therefore the industry, both shippers and carriers, will have to squeeze the very best out of the resources that it has and any increased resources that are brought to bear. As discussed further below, the forces of competition must play a large part in extracting greater and greater efficiencies, since direct governmental regulation has seldom been nearly as effective as the competitive marketplace in increasing efficiency. On the other hand, monopoly or oligopoly has also seldom been effective in creating value or efficiency.

The Board has an important part to play in this relationship. It can establish the overall competitive (or non-competitive) structure of the industry; it can set the rules for the commercial

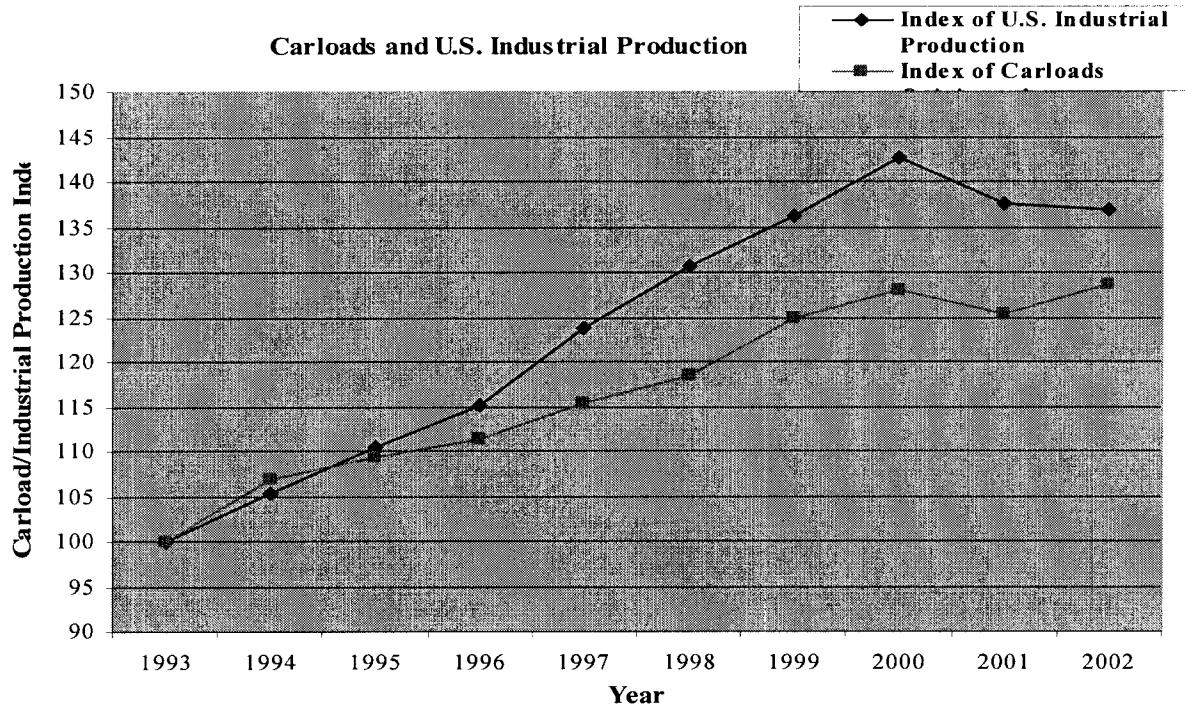
relationship; it can, in the case of market abuse, directly regulate prices and practices. The railroads no longer need to be protected: their financial condition is strong, and getting stronger. Shippers, on the other hand, have fewer effective competitive choices than they had at the time of the Staggers Act and for a number of years beyond. The Board needs to be sensitive to these changing market dynamics, and more sensitive to issues of potential market abuse.

B. The Railroad Industry Must Grow Its Share of Intercity Freight

It is crucial that the railroad industry grows and prospers, for the good of the shipping public and the good of the country. Any projection of future economic growth indicates that the need for transportation will grow dramatically in the next 15 years. The respected "Freight-Rail Bottom Line Report," published by the American Association of State Highway and Transportation Officials ["AASHTO Report"] projects that, with moderate economic growth, U.S domestic and international freight tonnage will grow between 2000 and 2020 from 15.2 billion freight tons to 24.5 billion freight tons, an increase of 67 percent. AASHTO Report, p. 50. Rail tonnage is expected to grow by 44%, or significantly less than the overall growth in freight tonnage. The situation at key choke-points is even worse. The Port of Los Angeles/Long Beach recently released estimates showing that containerized imports through that port will grow from 15.5 million TEUs in 2005 to 19.6 million TEUs in 2010 (a growth of 44%), to 26.6 million in 2015 (a growth of another 34%); to 35.3 million TEUs in 2020 (a growth of another 34%) -- well more than a doubling of traffic through this key facility in just 15 years.¹⁷

But the fact of the matter is that, for a long time, the railroads have not kept pace with the growth of transportation needs. The chart below shows that the rail industry's carload growth has not kept pace with U.S. industrial production in the ten-year period between 1993 and 2002.

¹⁷ See, <http://www.polb.com> and <http://www.portoflosangeles.org>

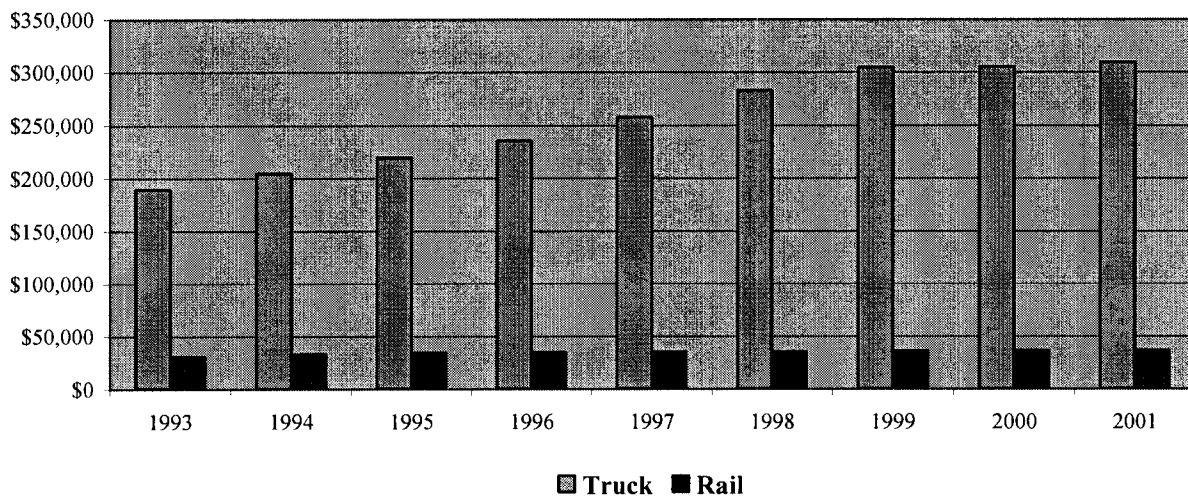


Source: AAR Railroad Ten Year Trends 1993-2002, p. 43 and 44.¹⁸

The carload growth data noted at page 21 above show that rail intercity freight traffic has grown very modestly since the Staggers Act. Other figures show that rail revenue has also grown very slowly, while the revenue of intercity freight traffic carried by truck has grown substantially, even in just the last ten years. Railroad's share of intercity freight traffic revenue has thus dropped significantly over time:

¹⁸ More recent data published by the AAR shows that, even on a ton-mile basis (which is more favorable to rail carriers, who carry heavy-loading commodities), rail ton-miles have not quite kept pace with U.S. industrial production over the period from 1994 to 2003. "AAR Railroad Ten-Year Trends 1994-2003, p. 44.

Modal Revenue Growth – 1993-2001 (\$000,000)



Source: Association of American Railroads, "Railroad Ten-Year Trends 1994-2003," p. 26 [data for 2002 and 2003 not available at time of printing]

C. Public Policymakers Need to Address How to Grow Capacity in the Railroad Industry and Across All Transportation Modes

The railroad industry is the victim of trends that have been moving at this point in the opposite direction: strong growth in the amount of transportation needed by the country to maintain its standard of living, and a long-term decline in the railroads' physical plant as they used existing plant more and more efficiently. But from a mindset of cost-control and downsizing, the railroad industry has to shift radically and rapidly to a mindset of capacity expansion.

Demand is very likely to outstrip capacity growth in the current model. The railroad industry is capital-intensive, and railroad investment is expensive. With the reduction in the number of carriers through mergers, it is questionable whether rail carriers on their own have the ability to expand capacity at the rate that it needs to grow. Indeed, in the current concentrated market, there is a question as to whether the industry even desires to grow at a pace that, in the

short term, would increase the supply of railroad transportation services and therefore decrease price.

The fact of the matter is that the country does not need railroad capacity to grow at the same pace as the growth of the economy or transportation generally: it needs to grow faster. For reasons of energy independence and environmental concerns, and because it will be even more difficult to expand the nation's road system easily in the face of increasing public opposition to new roads through densely-settled existing communities, the railroads' share of intercity freight has to grow. The growth in freight generally will tax every mode, and there will be increased freight for all modes. The question is not whether one mode will be "disadvantaged" vis-à-vis another mode in this growth: it is whether all modes, together, can handle the job.

Public policymakers need to confront this issue, and quickly. Public policymakers need to address how to grow capacity in the railroad industry, and to integrate that growth in capacity with the trucking industry, which will in many cases be required to bring the freight "the last mile." Modal collaboration will be essential. The Staggers Act did not really address this matter: it didn't have to, given the substantial overcapacity in the railroad industry in 1980. The League understands that this will require new resources, and that the Board, as a regulatory agency, will have only a marginal part to play in the development of new resources. But the Board, as the overseer of the industry, should strongly communicate this need to the Congress, and recommend that the Congress should more strongly address the problem.

D. The Board Needs to Become More Sensitive to Service Issues, and Its Regulatory Protections Must Be Better Designed to Address Service Problems

In a just-in-time business environment spanning the globe, inventory is "warehoused" in large part on the nation's transportation providers. The League has been a leader in identifying

service as one of the key issues: for example, it was very active at the time of the UP/SP service crisis, and it organized two service forums in 2004 regarding the UP and CSXT service problems in that year, in cooperation with the Board and the railroads. The League is well aware from its members that service reliability has become a larger and larger part of the shipper's concern. Moreover, as noted above, the League believes that there has been a decline in contracts containing significant service guarantees and an increase in the incidence of public pricing whose service requirements fall within the Board's statutory authority. Thus, the quality of rail service should become a larger part of the Board's focus.

There are several things that the Board can do in the service arena.

First, the Board should develop and require much better data on rail service, to enable cross-carrier comparison and comparison of service trends over time. After the UP/SP merger debacle in the mid-1990s, the Board required the UP to publish a few broad service measurements. Over time, these service measurements: average train speed, terminal dwell, cars on line, and few other service metrics, were published by the AAR. But there are numerous weaknesses in this data: it is too general; it is published by the AAR only for the recent past and thus it is difficult to make comparisons over time; and it is subject to changing and sometimes inconsistent definitions by the rail carriers themselves, which limits the usefulness of the data.¹⁹

The agency clearly has the authority to compel carriers to submit data in a format selected by the STB and to make that data public if it is not competitively sensitive. The agency should do so. In addition to the data being published by the AAR, the agency should require

¹⁹ The BNSF, for example, has changed the way that it measures terminal dwell. For a while, both "old" and "new" methods were published, so that a continuity of comparison could be made. The League understands that this is no longer done, so it is impossible to compare dwell over time. Moreover, it does not appear that the BNSF's definition is the same as the definition used by other rail carriers. The BNSF's change has also affected its calculation of average train speed.

railroads to publish metrics for key lanes, and average dock-to-dock rail performance should be measured and published. The League believes that railroad have moved to create increasing amounts of data as they have begun to move toward a more scheduled railroad system.

Railroads have complained in the past that it is difficult to make cross-carrier comparisons, and have used that assertion to argue against more detailed reporting of data. The kernel of truth in this statement should not be taken too far. It is inconceivable that, for example, BNSF does not have a very good idea of UP service metrics in key corridors, and does not evaluate the efficiency of its own system at least partly in relationship to service provided by its competitor. The same is likely true of the NS and CSX. Somewhat inconsistently, railroads have argued that data should not be made public because it is competitively sensitive. At the level of data that the League is talking about, it is extremely difficult to credit such an argument. Moreover, even if, for example, transit times in key corridors are a point of comparison between carriers, wouldn't the competitive market work better if this information were known by the shipping public?

Second, the Board should make an attempt to better define its authority over rail service. The Board's statutory authority in service matters is subject to very general standards (service on "reasonable request"; service with "reasonable dispatch"). Obviously, the Board needs to be extremely careful in service matters, to avoid adverse impacts on one shipper as it tries to cure the service problems of another shipper. Moreover, the legal standards governing the Board's authority are fact-specific. Yet, these standards cannot be meaningless, and both the courts and the agency in the past have made attempts to define what service on "reasonable request" means. See, *Alstom Power v. Norfolk Southern Railway Company*, Civil No. L-01-622, U.S. District Court, District of Maryland, July 12, 2004; *Minneapolis & St. Louis Ry. Co. v. Pac. Gamble*

Robinson Co, 215 F.2d 126, 134 (1954) (the law requires “of every carrier the utmost fairness and good faith on its part in dealing with the shipper and in the discharge of its duties to him.”). The Board needs to have the means to hold carriers accountable for reasonable service.

Finally, the League is concerned about the increasingly onerous conditions being imposed by rail carriers on loss and damage claims. Section 11706 requires that carriers limit their liability only in accordance with that section, and courts have ruled that this exception to the public policy in favor of full liability is to be construed narrowly. See, *Rohner Gehrig Co. v. Tri-State Motor Transit*, 950 F.2d 1079, 1083 (5th Cir. 1992). Courts have also held that, before a liability limitation may become effective, the railroad has to provide the shipper with a reasonable or fair opportunity to choose between two or more levels of liability. *Hughes v. United Van Lines, Inc.*, 829 F.2d 1407, 1419-1420 (7th Cir. 1987).

There are real questions as to whether all of the carriers’ liability rules comport with these requirements. While some carriers appear to offer both full and limited value rates in their public prices, other railroads do not do so. But even railroads that do offer a choice of full versus limited liability rates, full liability rates are at two or three times limited value rates, making the “choice” essentially meaningless. Carriers’ liability rules sometimes require the burden of proof to be on the claimant; establish no presumption of carrier fault, and impose other limitations that might be in direct contradiction to the requirements of the Carmack Amendment.²⁰ Reasonable rules on loss and damage are an important element of good service.

²⁰ See, for example, BNSF Rules Book 6100-A

E. The Board Must Revise Its Approach to Rail-to-Rail Competition in Light of Changes in the Industry

For many, many years, the League has argued that the Board should change its extremely restrictive policies on rail-to-rail competition. The increased market power of rail carriers vis-à-vis shippers and increasing capacity constraints in the rail industry makes this more urgent now than at anytime in the past, and at the same time, insures that such a change would not, as the railroad industry has argued for many years, result in crippling economic losses.

Competition is at the heart of this Nation's economic system. Competition creates a sense of urgency that enables companies to thrive. It spurs efficiency. Competition allocates scarce resources in the most efficient way possible, according to their economic value. In the railroad industry, effective rail-to-rail competition is only present if there is a choice of rail carriers both at origin and at destination.

Increased railroad competition would be particularly valuable in a capacity-constrained environment. Reasonable economic access, such as through a reversal of the agency's "bottleneck" decisions and a lowering of the extremely high barriers for reciprocal switching, would permit shippers to access rail carriers that they cannot currently access, who may have under-utilized capacity. In a capacity-constrained environment, it simply makes no sense to keep shippers captive to one railroad when other carriers might be able to move goods more efficiently.²¹

Moreover, greater reliance on the competitive market would be economically efficient, since capital for capacity expansion would naturally flow to the most economically beneficial

²¹ Railroads have claimed that, if a competitive route is really more efficient, then the railroads themselves will decide to utilize that route. But railroads have a number of reasons not to share traffic when that traffic can be carried on their system, foremost being a desire not to share profits with a competing carrier. Moreover, the competitive market, and not one of the carriers, should make this decision.

projects for the transportation system, without uneconomic barriers being thrown up by one rail carrier.

Finally, given the capacity constraints in the rail system, a move to a more competitive railroad marketplace would not lead to economic ruin, as the industry has asserted in the past. As Mr. Valentine noted, rail carriers have, in the current environment, moved from a system based on incremental pricing to a system based on full cost recovery pricing, including recovery of the cost of capital. Valentine Railroad Report, p. 8. If the Board would increase rail-to-rail competition in the current capacity-constrained environment, even in the short term the overall level of revenue to the industry would not decline drastically, but would be allocated more efficiently among rail carriers. In the longer term, individual rail carriers and the railroad system as a whole would be spurred to greater efficiencies through the competitive process.

In short, the League urges the Board to revisit and revise both its bottleneck decisions and the standards imposed by its interpretation of its Ex Parte 445 rules in *Midtec* and other cases. The League would note that neither of these changes would result in one carrier operating over the lines of another, but would simply provide a shipper with economic access to the lines of a nearby, potentially competing carrier.

F. The Board Needs to Revise and Better Define Its Standards and Speed Up Its Processes

The twenty-fifth anniversary of the Staggers Act is an appropriate time for the Board itself to revisit its standards and procedures. Indeed, in a capacity-constrained environment, the Board should analyze and re-think the role of differential pricing as the industry moves, as Mr. Valentine noted, from an era of incremental pricing to an era of full-cost recovery pricing.

1. The Board should develop standards and procedures for adjudicating small rate cases

On July 16, 2004 in Ex Parte 646, *Rail Rate Challenges in Small Cases*, the League joined with many other organizations in calling for the Board to establish a “bright line” test for qualifying for small rate cases; to facilitate the processing of small rate cases; and to better define its standards for adjudicating small rate cases. The League still strongly believes that the Board should make the changes recommended in that submission.

On June 6, 2005, the Board issued an important decision in the case of *BP Amoco v. Norfolk Southern*, the very first case filed under the Board’s “small case” guidelines. That decision, which was explicitly limited to the circumstances of that case, did a number of specific things: (a) it set a 200-day schedule for adjudicating the case; (b) it set a three-phased procedure for determining eligibility, winnowing certain evidence, and issuing a decision; (c) it established procedures for expediting discovery; (d) it ruled that parties were to use URCS Phase III costing, and that no movement-specific adjustments would be permitted; (e) it would utilize only the RSAM unadjusted for efficiency; and, (f) it would choose either the complainant’s or defendant’s comparison group for calculating the R/VCcomp factor, and would not select its own comparison group.

Assuming that the *BP Amoco* procedures foreshadow similar procedures in future cases, the League applauds the Board’s determination not to permit small cases to take years and millions of dollars to litigate. The decision to utilize Phase III costing and forbid movement-specific adjustments appears reasonable, although there are still a number of questions as to what is meant by “movement-specific adjustments” and whether there should be any exceptions to that rule.

However, the League strongly disagrees with the Board's decision to utilize the RSAM unadjusted for efficiency, and believes that it is legally unsupportable and economically irrational. In a capacity-constrained environment, there is no reason for any traffic to be carried at below variable cost, and indeed the burden should be on the rail carrier to show why traffic is not recovering at least its long-run variable costs.

2. The Board should attempt to simplify its large-case standards and procedures

Few if any League members are able to utilize the Board's large-case standards, which take millions of dollars and three to four years to litigate. Given the experience that the Board has had in adjudicating large cases, the Board should investigate whether, on a case-by-case basis as it did in the *BP Amoco Chemical* case, it can develop procedures that would substantially speed and simplify the processing of large rate cases. Otherwise, the most accurate and economically-supported rate standard will be unavailable to the very large majority of rail shippers.

3. The Board should analyze the role that differential pricing should play in the regulatory scheme in a capacity-constrained environment

One of the cornerstones of the ICC's and the Board's regulatory scheme since the Staggers Act has been the concept of differential pricing, the notion that rail carriers should price inversely to demand, that demand-inelastic customers should pay more for rail carriage than demand-elastic customers, and that the Board should recognize this principle in its regulatory review of the reasonableness of a rate to a captive shipper. However, under the statute, the Board is also bound by the notion of revenue adequacy, which is not only a goal, but as the agency has recognized in a regulated setting, also over time a limit. As the agency noted in its decision in *Coal Rate Guidelines – Nationwide*, 1 I.C.C.2d 520, 535 (1985):

Our revenue adequacy standard represents a reasonable level of profitability for a healthy carrier. It fairly rewards the rail company's investors and assures shippers that the carrier will be able to meet their service needs for the long term. Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues. Therefore, the logical first constraint on a carrier's pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this "revenue adequacy" level. In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs [footnote omitted]."

In a capacity-constrained environment, carriers can price non-captive traffic at levels that more closely approximate full cost pricing, including the cost of capital. Indeed, Valentine Railroad Report makes clear that railroads are already doing this to an extent not seen in several generations.

But the necessary extension of this development is that differential pricing should have less of a part to play in the pricing of regulated, captive traffic, in order for a railroad to achieve revenue adequacy. As more and more railroads are likely to approach or even exceed the rate of return necessary for revenue adequacy, the Board itself needs to re-think the extent of differential pricing necessary for captive traffic and the role that differential pricing should play in the Board's evaluation of reasonable rates for captive shippers. Indeed, given the changes in the transportation marketplace, the Board may need to re-think just how "competitive" traffic that was formerly considered "truck-competitive" now really is. It is clear that the business landscape within which the regulatory authority of the Board must operate is very different now than it was when the Staggers Act was passed. These are difficult issues, and the League is willing to work with the Board and the railroads to explore potential solutions.

4. The Board should investigate and create standards for rail surcharges and accessorials

Rail shippers have become concerned about carriers' increasing use of accessorials and surcharges as a means to raise revenue rather than cost-recovery. League members increasingly report that these charges are multiplying rapidly, without checks and balances. The League has also heard numerous expressions from its members that many railroads' fuel surcharge programs appear to permit an over-recovery of increased fuel costs. The League has met with a number of carriers over the past several months to voice these concerns about some of these fuel surcharge program. Recently, BNSF has announced a significant change in its fuel surcharge program to attempt make it fairer and more reflective of the actual increase in the cost of fuel, and while the League is still waiting to see the final results of this revision, it warmly applauds BNSF's efforts in this area. The CN has also made positive changes in its fuel surcharge program.

The League believes that surcharges and accessorials should be cost-based. However, the reasonableness of the surcharges or accessorials does not fit easily into either the Board's large case procedures or its small case guidelines, and, depending on the circumstances, it is often not clear whether these should be considered under the Board's reasonable rate or reasonable practice authority, or both. The Board should analyze this matter, and clarify how it would adjudicate challenges to such charges.

V. CONCLUSION

The substantial changes experienced by the railroad industry in the twenty-five years since the Staggers Act make this a particularly appropriate time for a review of the effects of this landmark legislation and a look ahead to the challenges of the future. The Staggers Act was clearly a substantial factor in the financial revitalization of the rail industry, by freeing the

industry from outmoded regulation and by permitting rail carriers to rationalize their systems. The Staggers Act also contributed to that financial revitalization by permitting the shedding of uneconomic assets through abandonments and by encouraging the growth of lower-cost short line carriers.

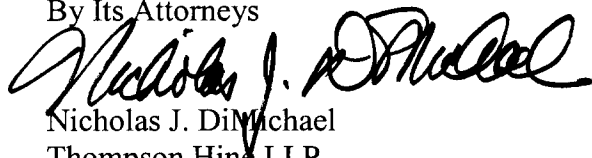
But there have been many changes that make today's railroad industry very different from the one faced by the drafters of the Staggers Act. In particular, the industry faces growing capacity constraints, the opposite situation confronting the Congress in 1980. The industry is now highly concentrated; motor carriers face increasing difficulties in competing in many markets; and shippers have invested heavily in instrumentalities of rail transportation. These changes, as well as regulatory decisions that have limited rail-to-rail competition, have increased rail carriers' market power vis-à-vis shippers. These new realities require new responses by policymakers over the next quarter century.

The nation requires a strong and viable rail industry to meet the challenges of the future, as shippers and carriers confront the need to move increasing quantities of goods in a global marketplace over a domestic transportation system that is increasingly capacity-constrained. The needs of all of the stakeholders in the industry – rail management and employees, rail customers, and rail stockholders – must be taken into account, and rail carriers and their customers must work together within the structure of a competitive transportation market to build a rail system to meet the needs of the 21st Century. The League stands ready to work with the nation's rail carriers, the Board, and the Congress in developing that system.

Respectfully submitted,

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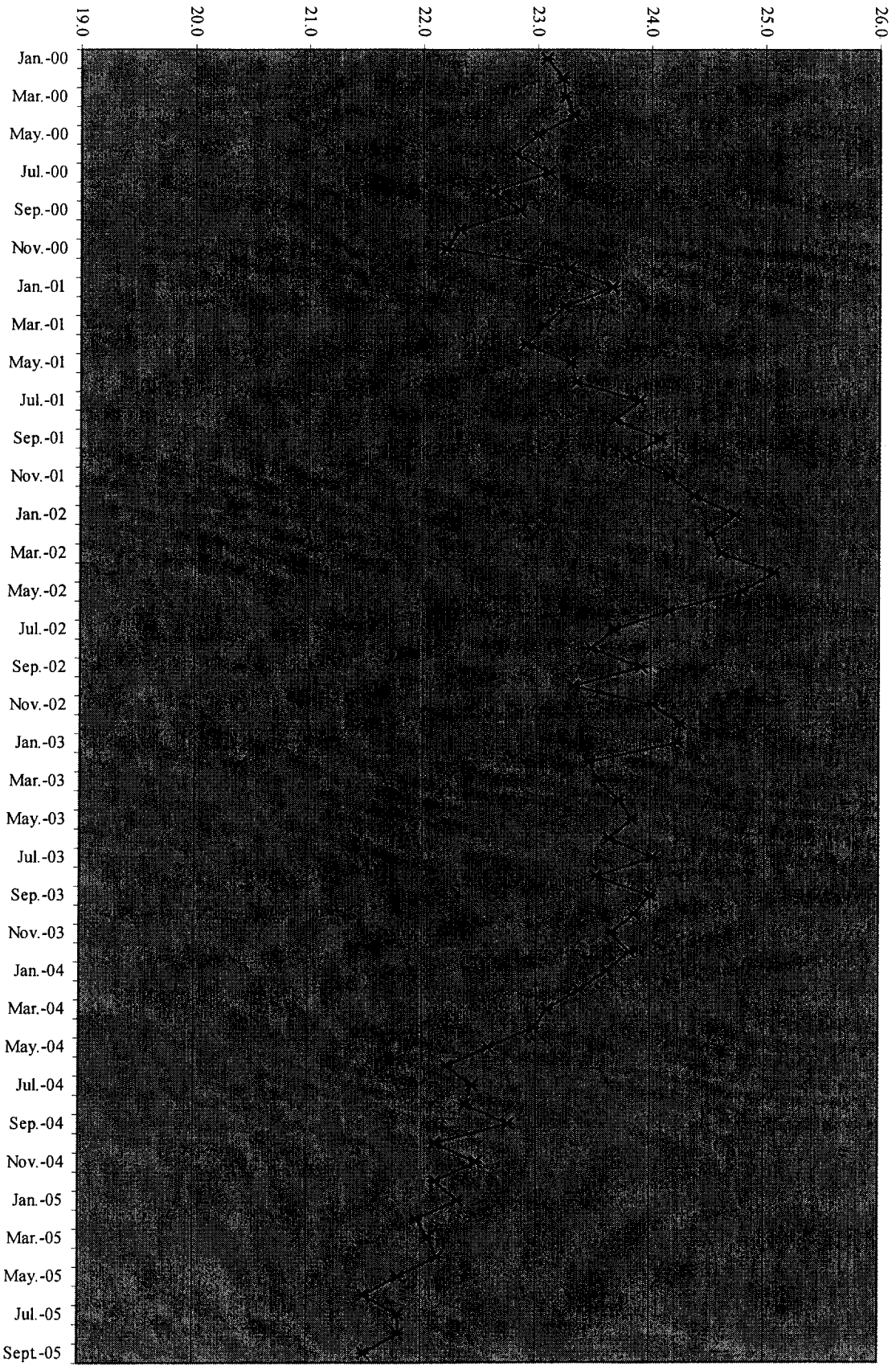
By Its Attorneys

A handwritten signature in black ink, appearing to read "Nicholas J. DiMichael". The signature is stylized with a large, looping "N" and "J".

Nicholas J. DiMichael
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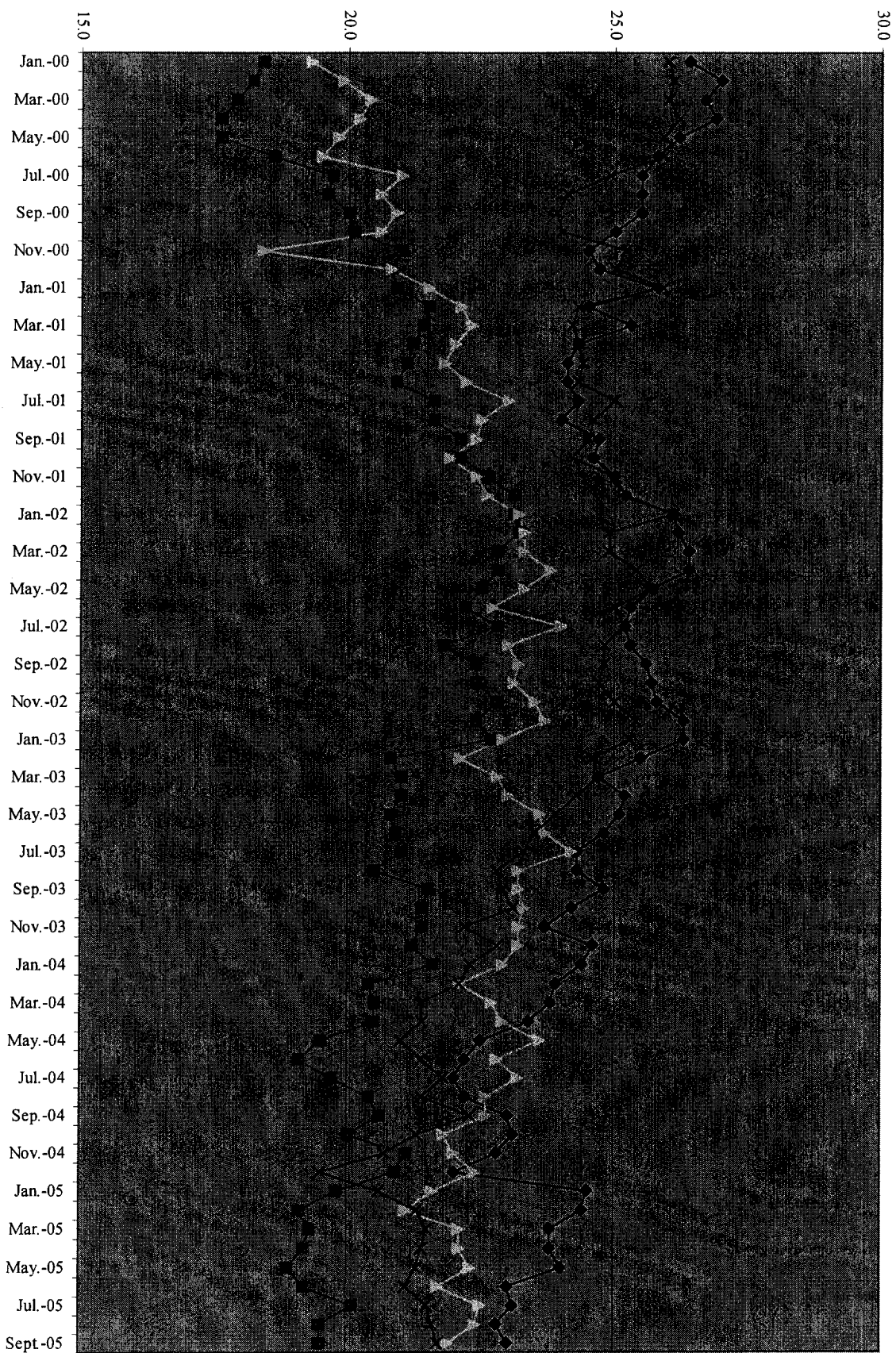
Train Speed - Total U.S.



* TOTAL US

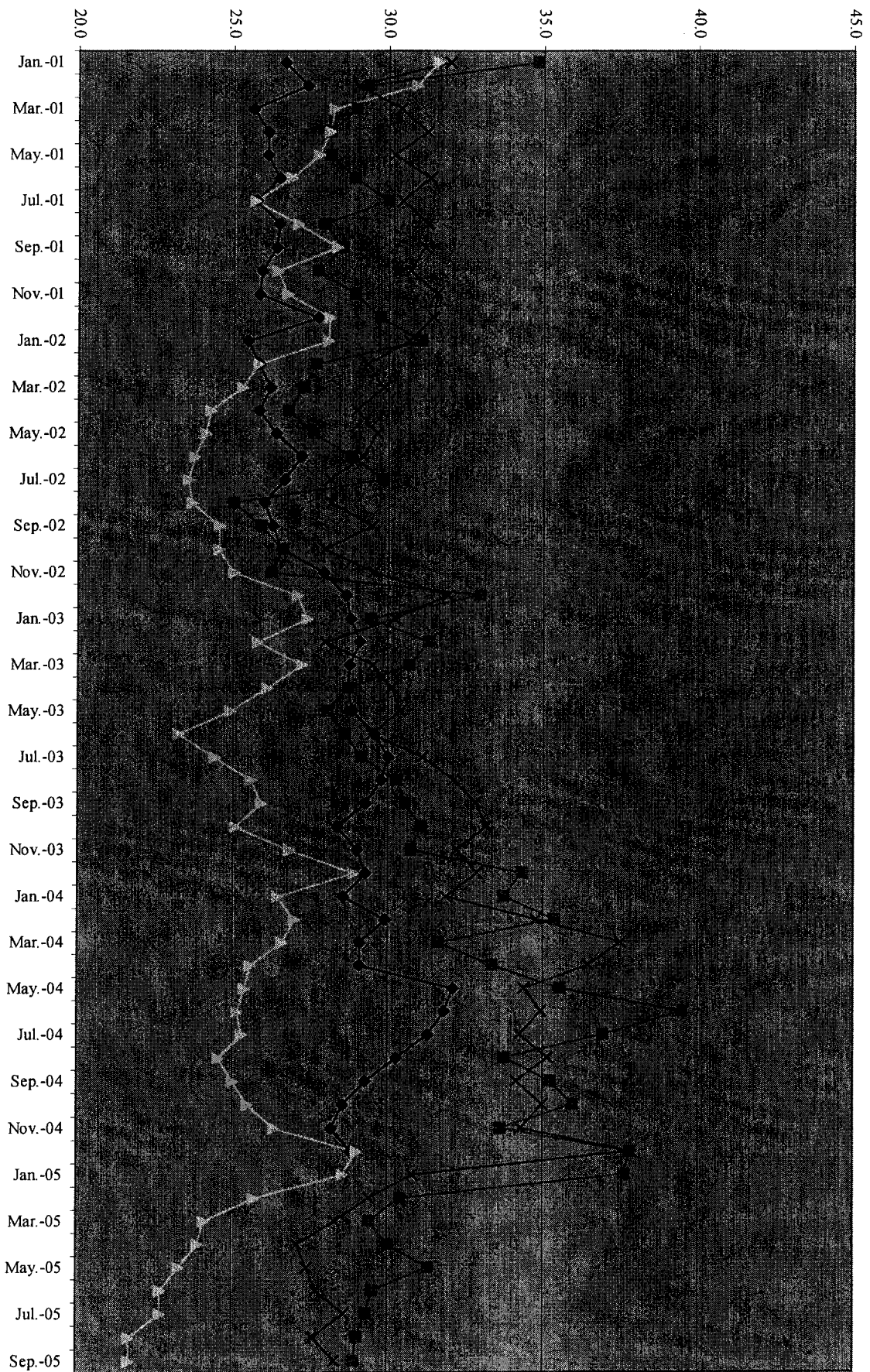
Source: AAR Website

Train Speed



Source: AAR Website

Terminal Dwell



Source: AAR Website

Exhibit C



COMMITTEE ON COMMERCE,
SCIENCE, AND TRANSPORTATION

OFFICE OF OVERSIGHT AND INVESTIGATIONS
MAJORITY STAFF

**Update on the Financial State
of the Class I
Freight Rail Industry**

STAFF REPORT FOR CHAIRMAN ROCKEFELLER
NOVEMBER 21, 2013

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EXECUTIVE SUMMARY

In September 2010, Chairman Rockefeller issued a Senate Commerce Committee Majority Staff Report on the financial condition of the freight railroad industry. Relying on financial information that the dominant Class I freight railroads regularly report to their investors, the Staff Report concluded that the freight railroad industry had recovered from the serious financial problems that prompted Congress to pass the Staggers Rail Act of 1980. The report found that, three decades after the Staggers Act, the Class I freight railroads were financially sustainable and highly profitable companies.

Understanding the financial condition of the railroads is integral to assessing whether the current regulatory system effectively balances the interests of railroads, shippers, and consumers. Because railroads were struggling financially when the Staggers Act was enacted, the regulatory system that was built on that law places heavy focus on helping railroads earn higher revenues. For example, under the Staggers Act, shippers that do not have access to other transportation modes (“captive shippers”) subsidize the freight railroads’ revenues by paying transportation rates that far exceed the railroads’ costs. If the railroad industry is now proving to be financially viable for the near and long term, policymakers will need to consider whether regulatory changes are in order to make sure the industry does not enjoy unfair advantages.

Because the debate over freight railroad policy continues both in Congress and at the Surface Transportation Board (STB), Commerce Committee staff recently reviewed the railroad industry’s latest financial reports to update the findings of the September 2010 Staff Report. These financial reports, as well as the public statements the companies’ executives have recently made to their investors and Wall Street analysts, show that the financial performance of these companies is at its strongest since the passage of the Staggers Act. The positive financial trends identified in the 2010 Staff Report have continued in the most recent years, and the railroads appear confident they will continue for the foreseeable future.

Specifically, this Committee staff report finds:

- In every reporting period since the last quarter of 2009, at least one of the three largest publicly traded Class I freight railroads set an all-time company quarterly record for operating ratio, operating income, or earnings per stockholder share (EPS);
- In the past four years, these companies broke records for operating ratios in 29 of the 48 quarters, with Union Pacific having a streak of 8 consecutive quarters in the most recent reporting periods. A decrease in operating ratio means a company is keeping more income after operating expenses are removed from revenue;
- In 30 of the past 48 quarters, the companies set new records for operating income – or the amount of income left over after subtracting a company’s operating expenses from its gross profit. It is a measure of the profitability of a company’s basic business activities;

- The railroads have also achieved record results in earnings per share (EPS) for stockholders, with Union Pacific breaking its EPS record in 15 of the last 16 quarters, and Norfolk Southern setting records for 6 straight quarters in 2011 and 2012;
- In the last few years the STB routinely has been finding these companies to be “revenue adequate” under an analysis that examines a company’s return on investment in relation to the industry’s cost of capital. This trend stands in stark contrast to the decades following enactment of the Staggers Act, where railroads in the vast majority of years were found not to be “revenue adequate;”
- The companies’ publicly traded stock shares have performed significantly better in recent years than the Standard and Poors stock market index; and
- Increasing free cash flow of the companies in the past few years has enabled them to increase capital expenditures at the same time they boost dividend payments and stock buyback programs. For example, between 2006 and 2010, CSX increased its dividend per share payments by 445% and the cumulative value of its share buyback grew from \$500 million in 2006 to \$5.6 billion in 2010.

While much of the rest of the American economy has been struggling to recover from a deep recession, the freight railroads have been achieving new financial performance milestones. These financial results are especially remarkable as they were accomplished even while overall rail volumes were still below prerecession levels, and while the two dominant railroads operating east of the Mississippi River, CSX and Norfolk Southern, experienced significant drops in the volume of their coal shipments. Each new quarter brings further evidence that the large freight railroad companies are highly profitable enterprises that have confidence that their financial success will continue.

I. Background on Freight Railroad Financial Performance

In September 2010, the Senate Commerce Committee Majority Staff issued a report examining the financial state of the Class I freight railroad industry.¹ This report presented evidence showing that, 30 years after the passage of the Staggers Rail Act of 1980, the freight rail industry had reached the law’s goal of financial stability and profitability. It found that the large U.S.-based Class I railroads that dominate the industry today were generating significant profits for their owners, investing substantial capital in their networks, and competing successfully against other transportation modes.

The current financial condition of the freight railroads is an important issue for policymakers because the laws regulating the railroad industry were written at a time when the industry was experiencing serious financial problems. Two of the important goals of the Staggers Act were “to assist the rail system to remain viable in the private sector of the economy” and “to assist in the rehabilitation and financing of the rail system.”² If these goals have been achieved, policymakers should take a fresh look at whether the current U.S. freight rail system is meeting another important goal of the Staggers Act, “to provide a regulatory process that balances the needs of carriers, shippers, and the public.”³

In early 2011, recognizing the changing landscape of the freight railroad industry, the Surface Transportation Board (STB) initiated a new public hearing process to examine competition issues. Among the factors the Board cited as its reasons for opening the proceeding were, “the improving economic health of the railroad industry” and “increased consolidation in the Class I railroad sector.”⁴ In this proceeding, *Ex Parte 705*, the STB heard from a variety of interested parties on competitive access issues including whether to mandate “reciprocal switching” and “terminal use” policies that require railroads to carry cars of a competitor or allow a competitor access to terminals for a fee.⁵ The proceeding also reviewed policy options

¹ Senate Committee on Commerce, Science, and Transportation, *Majority Staff Report on the Current Financial State of the Class I Freight Rail Industry* (hereinafter “September 2010 Staff Report”) (Sept. 15, 2010) (online at http://commerce.senate.gov/public/?a=Files.Serve&File_id=76823478-a901-4b4d-869b-9301bb43343b).

² The Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (1980). In order to increase the railroads’ ability to earn “adequate revenues,” the Staggers Act allowed railroads to charge higher rates to shippers over which they had “market dominance.” U.S. House of Representatives, *Staggers Rail Act of 1980 Conference Report*, 96th Cong. (H.R. Rep. No. 96-1430), at 90-91; 49 U.S.C. § 10707. According to the Staggers Act conference report, regulators would have greater authority to review this so-called “differential pricing” when the railroads were once again financially stable businesses. *Staggers Rail Act of 1980 Conference Report*, at 91 (“The Conferees have adopted the concept of a jurisdictional level that varies according to the performance of the railroad industry. When the industry is earning revenues which are adequate, it is appropriate for the Commission to have the authority to review rate increases more carefully”).

³ *Id.*

⁴ *Competition in the Rail Industry*, S.T.B. Ex Parte No. 705, 2011 WL 93782, *3 (Jan. 11, 2011).

⁵ *Competition in the Rail Industry*, S.T.B. Ex Parte No. 705, 2011 WL 93782, *1-4 (Jan. 11, 2011).

concerning “rail bottlenecks,” where the origin or destination of an otherwise competitive route is served by only one carrier, and contractual provisions known as “interchange commitments” that limit the incentive or ability of a rail line purchaser or tenant carrier to interchange traffic with competitors of the seller or lessor railroad.⁶

Following the July 2011 closure of the record on *Ex Parte 705*,⁷ the STB initiated a proceeding regarding certain rules on rail rate cases and ultimately adopted a number of rule modifications.⁸ In a separate ongoing proceeding, *Ex Parte 711*, the STB is considering a petition for a rule to modify reciprocal switching and terminal use policies.⁹

II. Railroads Have Been Setting New Financial Performance Records

A. Overview

A detailed review of the freight railroads’ financial results over the past four years shows that the companies have been establishing record-low operating ratios, experiencing record growth in operating income, and posting record earnings-per-share figures.¹⁰ As detailed in this report, 35 of the past 48 individual quarters of publicly available financial information were described by the three largest publicly traded Class I railroads as “record” or “record-breaking” quarters.¹¹ In each of the most recent 16 quarters, at least one freight railroad set new records for operating ratio, operating income, or earnings per share.

⁶ *Competition in the Rail Industry*, S.T.B. Ex Parte No. 705, 2011 WL 93782, *2-4 (Jan. 11, 2011).

⁷ See *Petition for Rulemaking to Adopt Revised Competitive Switching Rule*, S.T.B. Ex Parte No. 711, 2011 WL 5257467, *1 (Nov. 3, 2011); see also *Competition in the Railroad Industry*, S.T.B. Ex Parte No. 705, 2011 WL 2596922, *1-2 (June 30, 2011).

⁸ Association of Corporate Counsel, *Ex Parte No. 715, Rate Regulations Reforms* (July 19, 2013) (online at <http://www.lexology.com/library/detail.aspx?g=9ef9f5b5-b8e7-4ec8-997d-ba4bc395a6b9>). For example, STB removed the \$5 million relief cap previously imposed on pursuit of certain simplified relief cases. *Id.* It is unclear at this point whether these reforms will have a significant impact on rate regulation cases.

⁹ *Petition For Rulemaking to Adopt Revised Competitive Switching Rules*, S.T.B. Ex Parte No. 711, 2012 WL 3059230, *1-2 (July 25, 2012). The rule would allow shippers located in terminal areas without competitive alternative carriers to be granted access to a competing carrier if there was an interchange within a reasonable distance. *Id.*

¹⁰ To conduct this update, Committee staff reviewed the last sixteen quarters of financial information reported by CSX, Norfolk Southern, and Union Pacific. Committee Staff reviewed 10-Q Financial Reports filed by the companies with the Securities and Exchange Commission (SEC), company earnings press releases, transcripts of the companies’ quarterly earnings calls, as well as transcripts of rail industry investor conferences. Any subsequent revisions companies may have made to these reports were not part of this review. The September 2010 Staff Report included BNSF quarterly financial results, while this update does not. Since Berkshire Hathaway acquired BNSF in early 2010, the company ceased conducting quarterly earnings calls, and it no longer reports earnings in the same manner as when it was a standalone company.

¹¹ For the purposes of this report, a “record quarter” occurs when the management of the railroad described its quarterly performance as a new quarterly or all-time financial record with respect to any of

These impressive operating and earnings accomplishments occurred at a time when overall rail volumes were below their record 2006 peaks. Importantly for the purposes of this report, the freight railroads were able to continue improving their operating and earnings results even as the shipment of coal, which makes up a significant share of rail volume, decreased significantly as the U.S. utilities began a transition to natural gas as primary fuel for electrical generation.¹²

The companies' public statements about their financial performance have been replete with superlatives, highlighting the companies' record-shattering results.¹³ For example, at an investor conference in June 2011, Union Pacific's CFO, Rob Knight, summarized his company's record-breaking 2010 performance:

A little more than a year ago, we started to see a rebound from the severe economic downturn of 2009. As 2010 progressed, we continued to gain momentum, and ended up recording the most profitable year in the history of our Company. Topline growth and efficiency gains in 2010 resulted in an all-time record operating ratio of 70.6. We achieved best-ever earnings per share, free cash flow, and return on invested capital.

the following financial metrics: operating ratio, operating income, or earnings per share. In determining a quarterly record, the point of comparison is the same quarter in the previous year; e.g. first quarters are compared to first quarters in previous years, not to the immediately preceding or succeeding quarter.

¹² Between 2008 and 2013, the price of natural gas in the United States fell from \$13 to less than \$4 per British thermal unit. This decline in the price of natural gas contributed to a drop in coal consumption by the nation's electrical power plants from 264.3 million to 212.4 million short tons of coal between Q1 2008 and Q1 2013. This five-year drop was part of a larger trend of power plants in the United States turning to alternative energy sources. While in 1990, American power plants generated 53% of their electric power from coal, by 2015, power plants are estimated to generate an estimated 39% of their electric power from coal. *Railroads Struggle at the Coal Face*, The Wall Street Journal (Mar. 16, 2012); *A Declining Source of Energy*, The New York Times (May 29, 2012); Investment Mine, *5 Year Natural Gas Prices and Natural Gas Price Charts* (Nov. 13, 2013) (online at <http://www.infomine.com/investment/metal-prices/natural-gas/5-year/>); U.S. Energy Information Administration, *Quarterly Coal Report* (Oct. 2, 2013) (online at <http://www.eia.gov/coal/production/quarterly/>); U.S. Energy Information Administration, *Electricity Net Generation: Total (All Sectors)* (Oct. 2013) (online at http://www.eia.gov/totalenergy/data/monthly/pdf/sec7_5.pdf).

¹³ When the Committee in 2010 issued its initial staff report on the financial state of the railroad industry, the Association of American Railroads (AAR) took issue with the report's use of "accounting measures" such as operating revenue and operating ratio, arguing for a focus on the railroads' return on investment instead. See Joint Verified Statement of Robert S. Hamada and Rajiv B. Gokhale, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (May 27, 2011) (report commissioned by AAR discussing the 2010 Committee Staff Report). This criticism ignores the fact that when top rail industry executives themselves describe their companies' financial performance to investors and analysts, they repeatedly focus on the very same "accounting" metrics used in the Committee staff report.

These were impressive results, considering our volume levels were still 10% below peak levels of 2006.¹⁴

Since that conference, Union Pacific's operating results continued to follow a record-breaking course. On the company's most recent quarterly investor teleconference, Mr. Knight asserted:

Let's start with a recap of our third-quarter results. Operating revenue grew 4% to an all-time quarterly record of nearly \$5.6 billion, driven mainly by solid core pricing gains. Operating expense totaled \$3.6 billion, increasing 1.5%. Operating income grew 10% to \$1.96 billion, also hitting a best-ever quarterly mark. ... These results combined to produce a best-ever quarterly earnings of \$2.48 per share, up 13% versus 2012.¹⁵

In CSX's investor teleconference call announcing the company's results for the second quarter of 2011, CEO Michael Ward commented:

Last evening CSX was pleased to report another record quarter of financial results. ... From a financial perspective, it was an excellent quarter. Operating income was up 21% to a record \$926 million, and the operating ratio improved 190 basis points to 69.3%. That represents real progress against our target of achieving a high 60s operating ratio for the year and a 65% operating ratio by no later than 2015. Looking at the full year, we expect the upward trends in markets we serve to continue going forward and for CSX to produce another record year in 2011 for our shareholders.¹⁶

CSX went on to have a record year in 2011 regarding performance in operating income, operating ratio, and earnings per share. Describing CSX's overall 2012 results, Mr. Ward predicted that even with a drop in its coal shipping volumes it was well positioned to reward shareholders:

At this time last year, we had just completed eight straight years of operating ratio improvement with earnings growth in seven of those years. Both occurred in a period that included one of the most severe economic periods in our nation's history. In 2012, we again grew earnings while facing a major drop in a key market, one of the slowest economic recoveries on record and a political environment that has added even more uncertainty to the mix. Through all of this we have remained a vibrant, healthy company with a compelling long-term value proposition for investors.¹⁷

On January 24, 2012, Norfolk Southern CFO Jim Squires announced to Wall Street analysts that his company had set new records concerning several key financial metrics for 2011:

¹⁴ Union Pacific Presentation at Deutsche Bank Securities, Inc. Global Industrials and Basic Materials Conference (June 15, 2011).

¹⁵ Union Pacific 3rd Quarter 2013 Earnings Conference Call (Oct. 17, 2013).

¹⁶ CSX 2nd Quarter 2011 Earnings Conference Call (July 20, 2011).

¹⁷ CSX 4th Quarter 2012 Earnings Conference Call (Jan. 23, 2013).

Record revenues of \$11.2 billion, up 17% versus 2010, contributed to record income from railway operations of \$3.2 billion, up 20% compared to \$2.7 billion in 2010. These results generated a 70 basis point improvement in our operating ratio, which was 71.2% for the year, a close second to our 71.1% post Conrail records set in 2008. Net income for the year reached \$1.9 billion compared to \$1.5 billion in 2010 and diluted earnings per share increased from \$4 to \$5.45 per share. These results reflect a 28% increase in net income and a 36% increase in diluted earnings per share. Both measures set new records.¹⁸

A drop in its coal volumes would also impact Norfolk Southern in 2012. However, when discussing the company's second quarter of 2013 financial results, Norfolk's Chief Marketing Officer Don Seale argued that with potential decreasing coal shipments, the company remained well-positioned for continued growth:

Wrapping up in summary, we expect that our diverse market base will generate volume growth ahead, despite continuing challenges in the coal market and a slow growth economy. We also remain committed to market based pricing at levels that equal or exceed the rate of rail inflation. Obviously, with current conditions in our coal business, this is a short-term challenge. But that doesn't alter the value of our strong service product across a very diverse set of markets, where our pricing remains solid.¹⁹

B. Freight Railroads' Operating Ratios Continue to Improve

One of the financial indicators that reflect the railroad industry's strong financial performance is its steadily improving operating ratio. This metric expresses as a percentage the relationship between operating expenses and revenues. A company that lowers its operating ratio is improving the productivity of its operations by keeping more income after operating expenses have been removed from revenues. As Union Pacific CFO Rob Knight explained to investors, the operating ratio measures "UP's progress on improving total returns and profitability."²⁰

As the September 2010 Staff Report documented, between 2000 and 2009, the largest U.S. Class I freight railroads lowered their operating ratios by approximately nine percentage points, from ratios in the mid-80s to ratios in the mid-70s.²¹ The data the companies have reported during the last 16 quarters shows that they are continuing to drive their operating ratios even lower. While operating ratios vary from quarter to quarter for various reasons, Table I

¹⁸ Norfolk Southern 4th Quarter 2011 Earnings Conference Call (Jan. 24, 2012).

¹⁹ Norfolk Southern 2nd Quarter 2013 Earnings Conference Call (July 23, 2013).

²⁰ Union Pacific 4th Quarter 2009 Earnings Conference Call (Jan. 21, 2010).

²¹ September 2010 Staff Report, at 6. See note 10 *supra* for a discussion of why BNSF financial results were used in the September 2010 Staff Report, but were not available for this report.

shows that the companies have regularly achieved quarterly operating ratios in the low 70s to high 60s, occasionally dropping into the mid-60s, over the past four years.²²

TABLE I - Operating Ratios Reported by the Three Largest Publicly Reported Class I Freight Railroads (green highlight = company record)²³

Year	2009	2010					2011				2012				2013		
Operating Ratio	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	
CSX	74.9	74.5	71.2	69.1	70.0	72.5	69.3	70.4	71.5	71.1	68.7	70.5	72.1	70.4	68.6	71.5	
NSC	73.9	75.2	69.8	69.6	73.2	77.1	69.5	67.5	71.4	73.3	67.5	72.9	73.4	74.8	70.2	69.9	
UNP	73.3	75.1	69.4	68.2	70.2	74.7	71.3	69.1	68.3	70.5	67.0	66.6	67.1	69.1	65.7	64.8	

As the green highlighting in Table I²⁴ indicates, the three largest publicly traded Class I railroads broke quarterly operating ratio records in 29 of the 48 quarters Committee staff reviewed. CSX and Union Pacific set new operating ratio records for six straight quarters in 2010 and 2011. Union Pacific exceeded this streak recently with its eight most recent record-breaking quarters.

C. Operating Income Continues to Grow

Another investment measure the railroads tout in their quarterly earnings calls and press releases is their growing operating income. Operating income is the amount of income left over after subtracting a company's operating expenses from its gross profit. It is a measure of the profitability of a company's basic business activities.²⁵ The railroads have set new operating income records in 30 of the 48 quarters Committee Staff reviewed, as shown in Table II.

TABLE II - Operating Income (\$ Millions) Reported by the Three Largest Publicly Reported Class I Freight Railroads (green highlight = company record)

Year	2009		2010				2011				2012				2013		
Operating Income	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	
CSX	583	634	768	825	846	773	926	878	841	856	943	854	804	875	963	854	
NSC	549	555	733	746	642	600	875	938	800	745	934	731	714	691	836	849	
UNP	1,002	988	1,279	1,401	1,313	1,137	1,392	1,578	1,617	1,510	1,724	1,786	1,725	1,633	1,878	1,962	

²² See also the CSX Power Point slide included at Appendix XI. Presented as part of CSX's fourth quarter 2010 earnings call, this chart shows the dramatic improvements the company made in operating ratios over the previous several years, dropping from 78.6% in the fourth quarter of 2006 to 70% in the comparable 2010 quarter. CSX 4th Quarter 2010 Earnings Presentation, at 22 (Jan. 25, 2011) (online at <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Nzg0Mzd8Q2hpbGRJRDR0tMXxUeXB1PTM=&t=1>). CSX continued to set new operating ratio records in 2013, posting a first quarter record of 70.4% and a second quarter record of 68.6%.

²³ See note 11 *supra* for a discussion of the use of the term "record quarter" in this report.

²⁴ All tables and figures depicted in this report are included in the appendices section in the order in which they appear in the text.

²⁵ Jan R. Williams, Susan F. Haka, Mark S. Bettner, and Joseph V. Carcello, *Financial & Managerial Accounting The Basis for Business Decisions*, at 622 (2008).

D. Freight Railroads Are Breaking Earnings Per Share Records

The healthy financial performance of the companies is also driving record results in earnings per share (EPS) for shareholders, a metric that the financial markets monitor closely. Comparing a company's EPS to a previous period's EPS (adjusted for any stock splits) is one of the most common ways for investors to see how fast a company's profits are growing.²⁶ As shown in Table III, Union Pacific has broken its EPS record for 15 of the last 16 quarters. Norfolk Southern set new record EPS marks for six straight quarters in 2011 and 2012. And CSX broke its quarterly EPS records in two of the last three quarters before its 3:1 stock split in May of 2011, as well as in two quarters in 2011 and one of the last three quarters in 2013.²⁷

TABLE III - Earnings per Share Reported by the Three Largest Publicly-Reported Class I Freight Railroads (green highlight = company record)

Year	2009	2010				2011				2012				2013		
Earning Per Share	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	0.77	0.78	1.07	1.08	1.14	1.06	0.46	0.43	0.43	0.43	0.49	0.44	0.43	0.45	0.52	0.46
NSC	0.82	0.68	1.04	1.19	1.09	0.90	1.56	1.59	1.42	1.23	1.60	1.24	1.30	1.41	1.46	1.53
UNP	1.08	1.01	1.40	1.56	1.56	1.29	1.59	1.85	1.99	1.79	2.10	2.19	2.19	2.03	2.37	2.48

E. STB Now Is Routinely Finding Class I Freight Railroads “Revenue Adequate”

As the top Class I freight railroads report quarter-after-quarter of record results with respect to operating ratios and revenues, they also have been performing well in the “revenue adequacy” evaluation of rail companies that the Surface Transportation Board is required to conduct annually under the 1980 Staggers Act. “Revenue adequacy” is defined under law as revenues sufficient to cover “total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business.”²⁸ While for many years following enactment of the Staggers Act, the top Class I freight railroads were found to be “revenue inadequate,” that trend has been changing in recent years.

²⁶ Morningstar, *Morningstar Investing Glossary* (Nov. 16, 2013) (online at http://www.morningstar.com/InvGlossary/earnings_per_share.aspx).

²⁷ On May 4, 2011, CSX announced that its board of directors approved a 3-1 stock split, meaning that all shareholders of record would receive three shares for every one share owned at the close of business on May 31, 2011. CSX Corporation, *CSX Announces Stock Split, Dividend Increase, Share Buyback* (May 4, 2011) (online at <http://www.csx.com/index.cfm/media/press-releases/csx-announces-stock-split-dividend-increase-share-buyback/>). CSX appears to have set an EPS record in an additional recent quarter, Q2 of 2013, as the company press release on this quarter said that CSX saw “record results” in “all key financial measures.” Because the company statement did not specifically address whether EPS was one of these measures, however, the Committee staff report does not count the CSX EPS results in that quarter as a “record.”

²⁸ 49 U.S.C. § 10704(a)(2).

The 1976 Railroad Revitalization and Regulatory Reform Act (known as the “4R Act”) instructed the then-Interstate Commerce Commission (ICC) to help freight railroads regain their ability to earn “adequate” revenues.²⁹ Four years later, the 1980 Staggers Rail Act ordered the ICC to begin calculating annually “which rail carriers are earning adequate revenues.”³⁰ When it implemented this annual reporting requirement in 1981, the ICC decided that to be revenue adequate, a railroad must be “earning a rate of return equal to the current cost of capital.”³¹

The theory behind this formula was that freight railroads could not be financially viable over the long term if their operating revenues were not strong enough to attract investors, either through selling equity shares or issuing debt. A railroad producing a return on investment high enough to attract investment (i.e., at the cost of capital level):

[S]hould be able to generate sufficient revenue to cover all of its operating expenses, including depreciation and taxes; generate sufficient cash flow to fund needed capital expenditures; retire maturing debt; pay interest on existing and new debt; and earn for the shareholders a fair and reasonable return on their investment commensurate with the risk involved.³²

In its 1986 *Coal Rate Guidelines* decision, the ICC offered more helpful guidance about the regulatory significance of the revenue adequacy evaluation. “Adequate” revenue meant the level “necessary for a railroad to compete equally with other firms for available financing in order to maintain, replace, modernize, and, where appropriate, expand its facilities and services.”³³ The revenue adequacy standard represented “a reasonable level of profitability for a healthy carrier” that “assures shippers that the carrier will be able to meet their service needs for the long term.” But once the freight railroads reach the revenue adequacy standard, the decision explained, shippers should no longer be asked to subsidize carrier operations:

Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues. Therefore, the logical first constraint on a carrier’s pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this “revenue adequacy” level. In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.³⁴

²⁹ Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (1976) § 205. The STB’s current statutory authority continues to recognize the broad policy goal that “rail carriers shall earn adequate revenues.” 49 U.S.C. § 10701(d)(2).

³⁰ Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895, § 205.

³¹ Interstate Commerce Commission, *Standards for Revenue Adequacy*, Ex Parte No. 393, 364 I.C.C. 803, 807 (1981).

³² Interstate Commerce Commission, *Standards for Railroad Revenue Adequacy*, Ex Parte No. 393, 3 I.C.C. 2d 261, 268 (1986).

³³ Interstate Commerce Commission, *Coal Rate Guidelines, Nationwide*, Ex Parte No. 347, 1 I.C.C. 2d 520, 535 (1985).

³⁴ *Id.*, at 535-36.

Since the original 1981 ruling, the ICC, and from 1996 onwards, the STB, have made a number of adjustments to the formulas used to calculate each freight railroad's return on investment (ROI) and the cost of capital (COC) against which it is annually compared. Many of these changes have been responses to concerns raised by freight railroads, shippers, or other interested parties about elements of the STB's methodology for calculating revenue adequacy.³⁵

While the freight rail community continues to debate whether the STB is properly calculating revenue adequacy,³⁶ in recent annual evaluations the agency has routinely found that the large Class I freight railroads have been earning rates of return that meet or surpass their cost of capital.

As Table IV below shows:

- With the exception of 2009, Norfolk Southern's ROI has either exceeded, met, or come close to meeting the cost of capital in every year for the last decade.
- While CSX was reporting ROIs in the 4-6% range in the 2003-05 period, the company has come within a few basis points of meeting, or has exceeded, COC in the 2010-12 time frame.
- In 2012, UP's ROI surged to 14.69%, exceeding the COC by more than three full percentage points.

³⁵ For example, in 2008, in response to concerns raised by the shipper community, the STB replaced the "Single-Stage Discount Cash Flow" model for estimating the rate of return investors require to buy shares of freight railroads, with a different accounting method known as the "Capital Asset Pricing Model." A year later, the STB modified its method for determining this so-called "cost of equity" by adding the Morningstar/Ibbotson "Multi-Stage Discount Cash Flow" method to the calculation. Surface Transportation Board, *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*, S.T.B. Ex Parte No. 664, 2009 WL 197991, *11 (Jan. 23, 2009).

³⁶ See, e.g., *Statement of Professor Alfred E. Kahn and Report of Professor Jerome E. Hass on Revenue Adequacy Standards* (Feb. 1997) ("The STB's measure of return on investment for each Class I railroad is fraught with short-comings and severely short-sighted; and the cost of capital estimate it uses as a benchmark against which to judge adequacy is severely flawed as well. Simple measures, such as market-to-book ratios, retention rates and debt ratings indicate that the railroads have a high degree of financial integrity and are expected to earn returns on the book value of equity well in excess of their cost of capital. They clearly have no difficulty in raising capital without causing any dilution for existing shareholders").

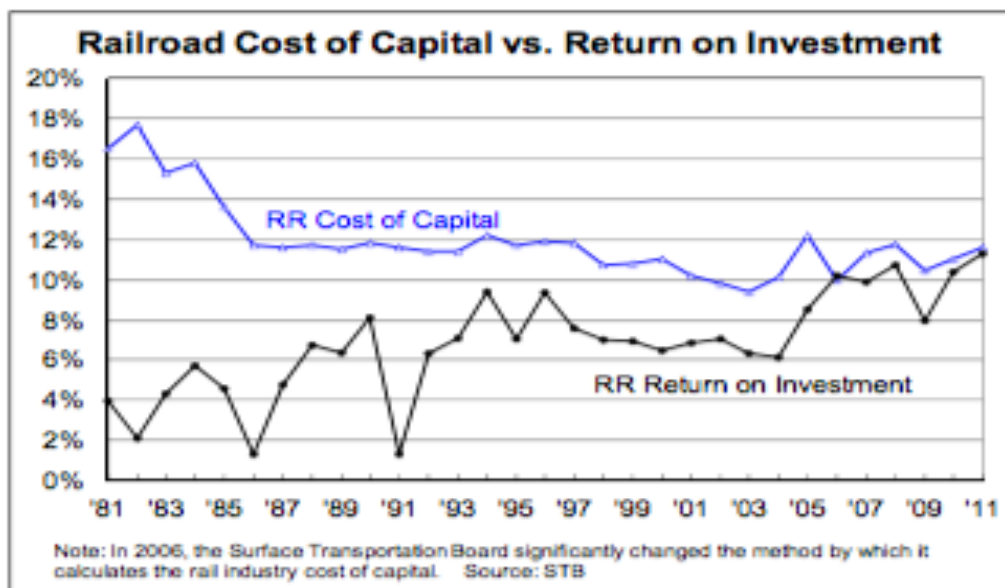
**TABLE IV – STB’s Railroad Cost of Capital and Revenue Adequacy Determinations
(* Indicates Pending STB Review)**

Year	Cost of Capital	BNSF	CSX	NSC	UNP
2003	9.40%	6.20%	4.00%	9.10%	7.30%
2004	10.10%	5.84%	4.43%	11.64%	4.54%
2005	12.20%	10.32%	6.23%	13.21%	6.34%
2006	9.94%	11.43%	8.15%	14.36%	8.21%
2007	11.33%	9.97%	7.61%	13.55%	8.90%
2008	11.75%	10.51%	9.34%	13.75%	10.46%
2009	10.43%	8.67%	7.30%	7.69%	8.62%
2010	11.03%	*	10.85%	10.96%	11.54%
2011	11.57%	*	11.54%	12.87%	13.11%
2012	11.12%	*	10.81%	11.48%	14.69%

Source: STB Revenue Adequacy Filings

This pattern contrasts starkly with the two decades following the passage of the Staggers Act, during which the STB determined that most railroads in most years were not revenue adequate.³⁷ As the graph below prepared by the Association of American Railroads (AAR) shows, in the most recent years, the freight railroads’ ROI has been converging with the STB-calculated COC.

**Figure I – Railroad Cost of Capital vs. Return on Investment
Since the Passage of the Staggers Act**



Source: Association of American Railroads

³⁷ Between 1980 and 2005, the ICC and STB made 445 individual determinations of revenue adequacy for railroad companies. It found railroads to be revenue adequate in just 32 instances. Congressional Research Service, *Rail Transportation of Coal to Power Plants: Reliability Issues*, at 78 (Sept. 26, 2007).

Furthermore, while the ROI numbers reported by BNSF in the years following its 2010 purchase by Berkshire Hathaway were below the cost of capital, the recalculation of BNSF ROIs required by a recent STB ruling is expected to boost the revenue adequacy results for BNSF for the years 2010, 2011, and 2012.³⁸

These recent revenue adequacy findings suggest that the long-term policy goals of the Staggers Act have been reached with respect to the major Class I freight railroads. These companies are now reliably producing enough income to fund their operations, make appropriate capital expenditures, and attract and reward their investors. If the companies are now profitable and, as a regulatory matter, revenue adequate, policymakers need to take a new look at the competitive advantages Congress gave the railroads 30 years ago.

III. Companies Project Continuing Financial Improvement

In their conversations with Wall Street analysts, railroad executives have repeatedly stated that they expect to continue delivering strong financial performance by “pricing above inflation” in future quarters and by continuing to drive operating ratios lower. These projections reflect a business environment starkly different from the one that existed at the time of the passage of the Staggers Act of 1980.

A. Freight Railroads Continue to Enjoy Strong Pricing Power

One of the key drivers behind the railroads’ improving financial performance is their ability to charge their customers increasingly higher rates to move their goods. The September 2010 Staff Report reviewed the growing evidence that after many years of declines in the rates they could charge their non-captive shippers, the freight railroads started raising their prices beginning in about 2004 and 2005.

According to outside experts and the railroads themselves, this “pricing renaissance” occurred because the railroads had steadily improved their productivity and were reaching the end of long-term “legacy” contracts they had entered when they had less pricing power.³⁹ In testimony before the STB on June 22, 2011, J.P. Morgan transportation analyst Tom Wadewitz commented: “Since 2004 we believe that a favorable pricing trend has been an important factor that has attracted investors to the railroads.”⁴⁰

³⁸ In July 2013, the STB ruled that BNSF needed to calculate its ROIs for 2010, 2011, and 2012, to exclude the \$8.1 billion “acquisition premium” it had previously included when calculating its investment base. *Western Coal Traffic League – Petition for Declaratory Order*, S.T.B. FD 35506, 2013 WL 3834052, *25-26 (July 24, 2013). Because the investment base represents the denominator of the ROI ratio, the \$8.1 billion acquisition premium makes the company’s net operating income look smaller in comparison and reduces the return on investment percentage.

³⁹ September 2010 Staff Report, at 8-10.

⁴⁰ Testimony of Tom Wadewitz, J.P. Morgan, *Competition in the Railroad Industry*, Surface Transportation Board, Ex Parte No. 705 (June 22, 2011).

A review of the company's recent filings and investor calls shows that the railroad companies continue to expect they will be able to raise rates faster than the rate of rail inflation for the foreseeable future. For example, on a third quarter 2012 earnings call, Don Seale, Norfolk Southern's Chief Marketing Officer, stated:

With respect to pricing, our commitment remains to price at levels above the rate of rail inflation over the long run. Export coal markets made this a difficult task in the third quarter, and we expect those same headwinds over the next few quarters. But based on our internal analysis, and excluding that negative effect of export coal, we met our objective of pricing above rail inflation in the third quarter, and we expect that positive trend to continue as we provide excellent service and value to our customers across our network.⁴¹

Similarly, CSX CEO Clarence Gooden highlighted the company's expectations to price above rail inflation, in the following exchange with an analyst:

Analyst: It doesn't seem, at least from your results, that there is any aggressive pricing between you and the NS going on right now. I just wanted to make sure that that is the case.

Gooden: What do you mean by aggressive pricing between us and the NS?

Analyst: I'm saying aggressive – are you guys getting more aggressive with trying to steal freight from one another? I think that was the crux of Bill's question.

Gooden: Absolutely not. As we've told you earlier, we are going to price to above rail inflation. We're going to price above it because, one, we think we've got a product that offers a significant value. And, secondly, because it's necessary for us to invest in our infrastructure. We've had a solid plan over the last 10 years now, nearly, in which we've wanted to work on our pricing. And that's what we're going to continue to do.⁴²

B. Projected Improvements in Operating Ratios and Operating Income

Executives from CSX have told investors and Wall Street analysts that the company's operating ratios will continue to improve, publicly announcing the company's goal of a 65% operating ratio by 2015. In the company's third Quarter 2011 earnings call, CEO Michael Ward told analysts, "We remain highly committed to a 65% operating ratio by no later than 2015, and we fully expect that this will be achieved."⁴³ CSX CFO Fredrick Eliasson, in a recent conference call with investors, noted that, even considering the "coal headwinds" that impacted CSX's financial results throughout 2012 and 2013, the company "remains on track to sustain a high-60s operating ratio by 2015, and a mid-60s operating ratio longer term."⁴⁴

⁴¹ Norfolk Southern 3rd Quarter 2012 Earnings Conference Call (Oct. 23, 2012).

⁴² CSX 1st Quarter 2013 Earnings Conference Call (Apr. 17, 2013).

⁴³ CSX 3rd Quarter 2011 Earnings Conference Call (Oct. 19, 2011).

⁴⁴ CSX 2nd Quarter 2013 Earnings Conference Call (July 17, 2013).

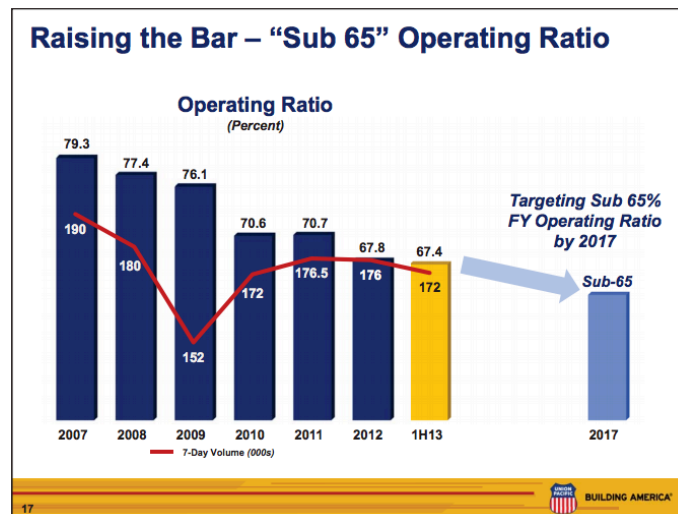
Union Pacific has set a similarly ambitious operating ratio goal. In 2007, the company initiated “Project Operating Ratio” with a goal of achieving a “low 70’s operating ratio by 2012.”⁴⁵ Union Pacific CFO Rob Knight recently explained that his company had already achieved the goals of “Project Operating Ratio,” and had set a new, even lower goal:

While it’s evident that the math of today’s higher fuel prices can inflate the operating ratio, as we just saw in the fourth quarter, we are focused on achieving our new target of 65% to 67% full-year operating ratio by 2015.⁴⁶

According to Committee staff’s analysis, Union Pacific has set a new, lower operating ratio record for 14 of the last 16 quarters including the last eight consecutive quarters.

Union Pacific has used the slide below at investor conferences over the past year to discuss progress made since initiating Project Operating Ratio and targets going forward:

Figure II – Union Pacific Analysis of Improvements to its Operating Ratio Since the Beginning of Project Operating Ratio



Source: Union Pacific Investor Presentation

On the company’s most recent conference call, Mr. Knight updated investors and Wall Street analysts on Union Pacific’s record-breaking operating ratio of 64.8%, noting “We are not going to stop. So the sub-65% is not an end game, it’s just the next rung on the ladder.”⁴⁷

In this same call, Union Pacific CEO Jack Koraleski reaffirmed his confidence in the company’s future financial performance in the following exchange with an analyst:

⁴⁵ Union Pacific, Project Operating Ratio Presentation (May 2008) (online at http://www.up.com/investors/attachments/presentations/2008/analyst_conf/rmk_slides.pdf).

⁴⁶ Union Pacific 4th Quarter 2010 Earnings Conference Call (Jan. 20, 2011).

⁴⁷ Union Pacific 3rd Quarter 2013 Earnings Conference Call (Oct. 17, 2013).

Analyst: When you look at the Union Pacific network and you see what you have been able to achieve over the last five to seven years, which in margin terms are kind of breathtaking, is there anything about the network that makes you say, yes, it is going to be hard for us to ever achieve record profitability relative to our peers in the industry? Is there anything about your network structure that limits how good you can be?

Koraleski: Man, I can't think of anything.⁴⁸

IV. The Railroads' Strong Financial Performance is Benefiting Shareholders

The publicly traded shares of the freight railroads have performed significantly better in recent years than the widely followed stock market indexes. This strong performance is tied to the companies' excellent financial results. In June 2011 testimony before the STB, J.P. Morgan analyst Tom Wadewitz explained that "[f]avorable EPS [earnings per share] growth performance and a broader trend of improving financial returns have been key factors that have attracted equity investors to the railroad stocks over the past seven years."⁴⁹

In testimony delivered during the same hearing, Scott Group from the Wolfe Trahan transportation industry analysis firm presented a graph showing that "Rail Stocks Have Materially Outperformed Other Transports and the S&P Since 2005." According to this graph, "Large-Cap Rails" have provided investors annualized returns of 15% since 2000, and trucking stocks had returns of 6.1%, while at the same time the S&P index return was -1.2%.⁵⁰

The September 2010 Staff Report presented a graph showing that the performance of freight rail stocks between 1999 and 2009 – the first decade after the rail industry had consolidated into four dominant U.S. based carriers – far exceeded the performance of companies that are part of the S&P 500 Index.⁵¹ A *Fortune* magazine story on the freight railroad industry showed the same graph updated through July 29, 2011. This graph was captioned, "The total return of the Big Four railroads' stocks has left the S&P 500 far behind."⁵²

⁴⁸ Union Pacific 3rd Quarter 2013 Earnings Conference Call (Oct. 17, 2013).

⁴⁹ Testimony of Tom Wadewitz, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (June 22, 2011).

⁵⁰ Testimony of Scott Group, Wolfe Trahan & Co., *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (June 22-23, 2011).

⁵¹ September 2010 Staff Report, at 6-7.

⁵² *Showdown on the Railroad*, *Fortune* (Sept. 26, 2011) (online at <http://features.blogs.fortune.cnn.com/2011/09/13/showdown-on-the-railroad/>).

While AAR critiqued the September 2010 Staff Report’s analysis of stock performance,⁵³ the railroads themselves have presented similar information to their investors to illustrate the strong recent performance of their shares.

For example, during an investor conference in 2011, a Norfolk Southern executive presented the graph below showing that over the past five and a half years, her company’s stock “has returned a compound annual growth of 11.4% versus 2.4% for the S&P 500.”⁵⁴ It is worth noting that, as of mid-November 2013, Norfolk Southern shares were trading at or near their 52-week highs.⁵⁵

Figure III – Norfolk Southern Shareholder Return



Source: Norfolk Southern Investor Presentation

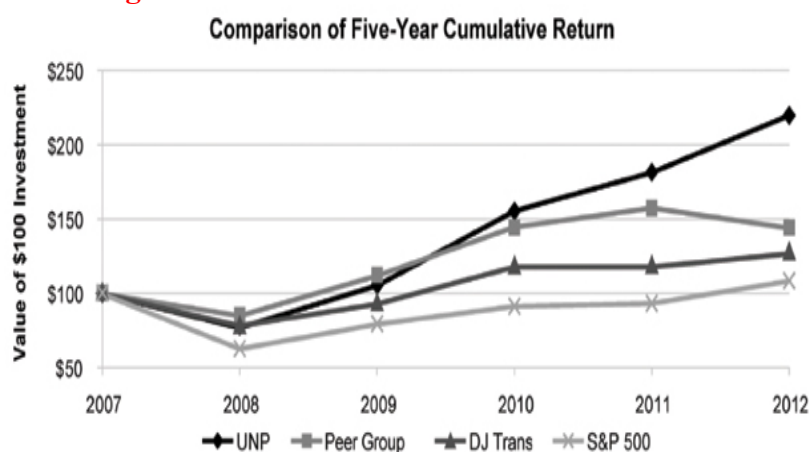
⁵³ Joint Verified Statement of Robert S. Hamada and Rajiv B. Gokhale, at 4-6, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (May 27, 2011) (statement commissioned by AAR). AAR takes the position that there is “nothing extraordinary about railroad stock performance,” arguing that the appropriate point of comparison is industries with similar capital intensities. See Reply Comments of the Association of American Railroads, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705, at 15 (May 27, 2011).

⁵⁴ Norfolk Southern Presentation at Morgan Keenan Industrial/Transportation Conference (Sept. 14, 2011).

⁵⁵ Stock price graph for NSC, January 6, 2006 to November 19, 2013, via Google Finance (accessed Nov. 19, 2013).

Similarly, as part of its 2012 10-K financial filing to the Securities and Exchange Commission, Union Pacific (UNP) published the graph below showing that the company and its peers have substantially outperformed stocks in the Dow Jones and S&P indexes over the past five years. According to this graph, a \$100 investment in UNP stock on December 31, 2007, with subsequent dividends reinvested, was worth approximately \$230 at the end of 2012, while \$100 invested in the major stock indexes would have only been worth marginally more at \$110.⁵⁶

Figure IV – Union Pacific Shareholder Return



Source: Union Pacific SEC Filings

The owners of freight railroad stocks are not just benefiting from the increasing value of their shares. They are also benefiting from the railroads' aggressive use of their free cash flows to expand their dividends and buy back outstanding shares. As noted in the September 2010 Staff Report, the freight railroads have been using the growing income left over from operations to increase their capital expenditures.⁵⁷ At the same time, they were also using significant portions of their free cash flows to boost the short-term value of their shares through stock buyback programs.

The CSX Power Point slide below illustrates what the company calls its “balanced approach” to managing its growing free cash flows. Free cash flows represent the cash a company has remaining after investing for the growth of its business operations.⁵⁸ These funds can be used to pursue opportunities to enhance shareholder value. As depicted in the chart, at the same time the company continued its strong commitment to capital expenditures between 2006

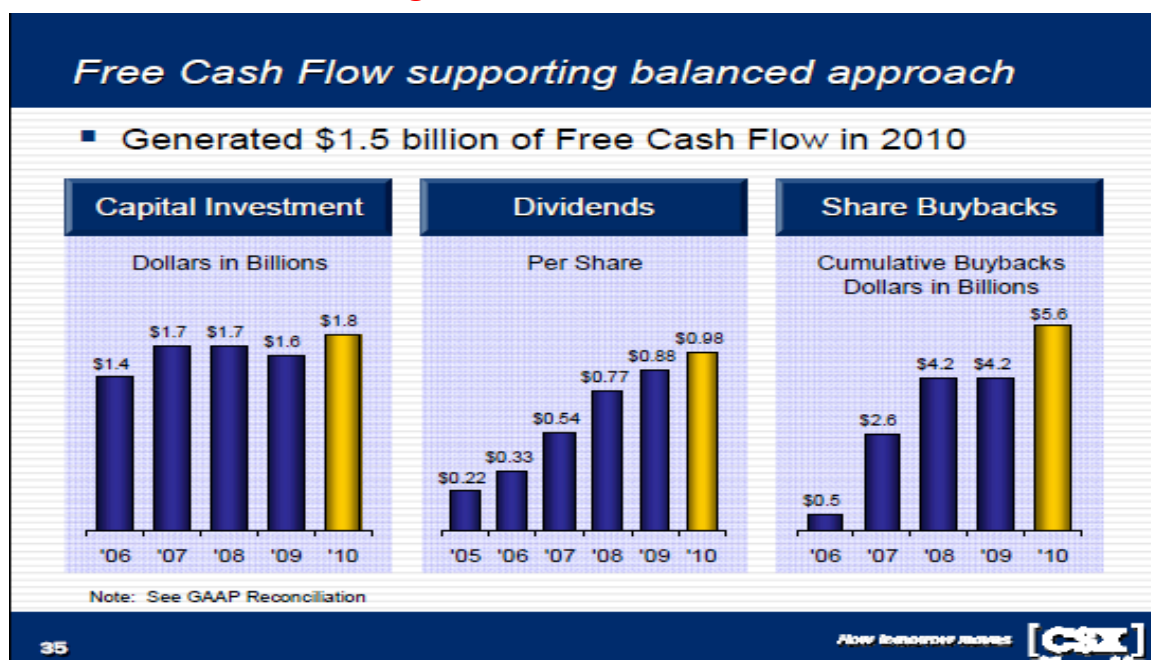
⁵⁶ Union Pacific 2012 Form 10-K Securities and Exchange Commission Financial Filing, at 20 (Feb. 8, 2013). With respect to this chart, Union Pacific in its 10-K filing defines “peer group” as CSX and Norfolk Southern, and “DJ Trans” as the Dow Jones Transportation Index.

⁵⁷ While the dollar value of the freight railroads' capital expenditures has generally been growing in recent years, the portion of operating revenues they dedicate to capital expenditures has remained at a steady 16-18%. Testimony of Scott Group, Wolfe Trahan & Co., *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (June 22-23, 2011).

⁵⁸ Morningstar, *Morningstar Investing Glossary* (Nov. 16, 2013) (online at http://www.morningstar.com/InvGlossary/free_cash_flow_definition_what_is.aspx).

and 2010, it also increased its dividend per share payments by 445% between 2005 and 2010, and the cumulative value of its share buyback grew from \$500 million in 2006 to \$5.6 billion in 2010.⁵⁹

Figure V – CSX Free Cash Flow



Source: CSX Investor Presentation

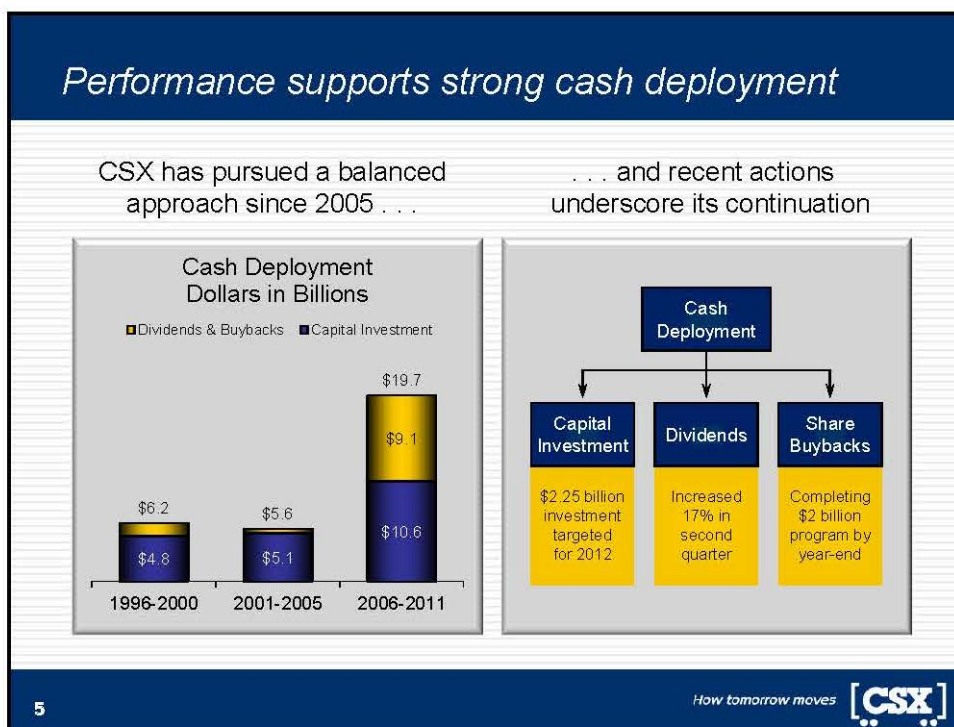
At a 2012 investor conference, CSX CFO Frederick Eliasson also highlighted CSX's ability to support a balanced approach to its cash deployment. Presenting the slide below, he commented:

Our cash deployment, really since 2005, has been very, very balanced, both between reinvesting in our business, but also in regards to returning cash to our shareholders. Prior to 2006, we weren't really in the position to either fully reinvest in our business, nor to return significant amounts of cash to our shareholders because of where we were in regards to our margins in our business. But since then, we have improved that significantly, and also as a result of that, been able to reinvest and return cash to our shareholders in a way we hadn't done previously.⁶⁰

⁵⁹ CSX 4th Quarter 2010 Earnings Presentation, at 35 (Jan. 25, 2011) (online at <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Nzg0Mzd8Q2hpbGRJRD0tMXxUeXBIPtM=&t=1>).

⁶⁰ CSX Presentation at UBS Best of Americas Health Care Conference, at 5 (Sept. 6, 2012).

Figure VI – CSX Strong Cash Deployment

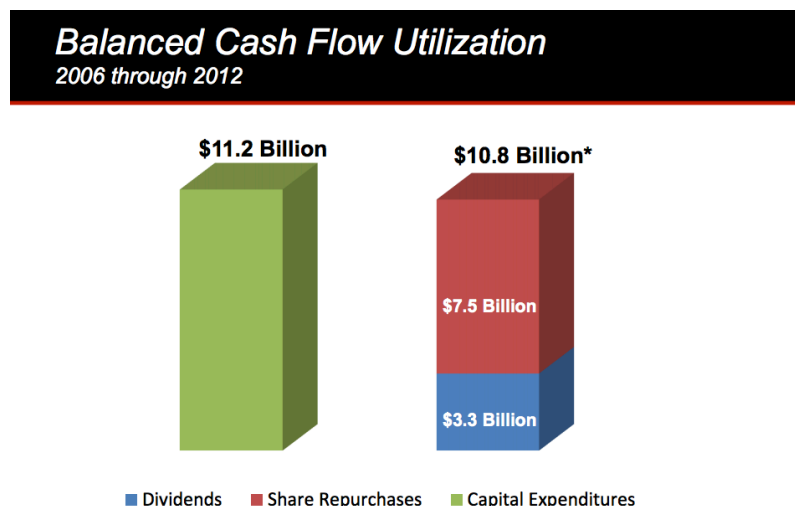


Source: CSX Investor Presentation

Norfolk Southern also has deployed its increasing cash flows to both increase capital investments in their networks and deliver short-term rewards to company shareholders. The slide below, recently presented by Norfolk Southern at an investor conference hosted by Citi, shows the scale and split of the cash distribution the company has managed since 2006 through the end of 2012. Norfolk Southern split its \$22 billion in cash flow roughly evenly between long-term capital investment and shorter-term shareholder gains. The company spent 34% of cash flow on share repurchases, 15% on dividends to shareholders, and 51% on capital expenditures.⁶¹

⁶¹ Norfolk Southern, Cowen Securities Global Transportation Conference, at 24 (June 11, 2013). (online at http://www.nscorp.com/content/dam/nscorp/get-to-know-ns/investor-relations/Slides/cowen_presentation_2013.pdf).

Figure VII – Norfolk Southern Balanced Cash Flow Utilization



* See reconciliation of Total Shareholder Distributions to GAAP posted on our website, www.nscorp.com.

Source: Norfolk Southern Investor Presentation

Union Pacific as well has been using cash flows to pay dividends as well as buy back shares. In comments to investors and analysts in 2011, Union Pacific CFO Rob Knight asserted that since 2007, his company had “distributed more than \$6.3 billion to shareholders through a combination of dividends and share repurchase,” and that the company anticipated even larger shareholder payments in the future.⁶² At another investment conference in 2011, he explained:

In 2010, we achieved a record return on invested capital of 10.8% and free cash flow of \$1.4 billion. Looking ahead, we are confident our returns and cash flows will be even higher, as we stay dedicated to growing our business, improving pricing, and driving efficiency gains. Beyond investing back into the business, we will reward our shareholders directly through both dividends and share repurchases. And as our cash grows, so does our ability to return even more to the shareholders through these programs.⁶³

More recently, at an investor conference earlier this year, Mr. Knight discussed how Union Pacific was “delivering value to shareholders.” Referencing the slide below, he explained:

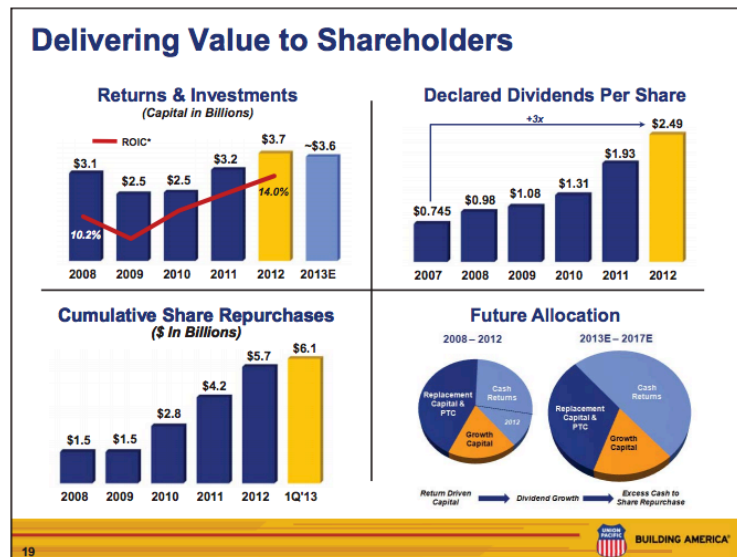
Beyond funding our capital programs, our record profitability has enabled us to grow shareholder returns. In the past five years we have increased our declared dividend per share over three-fold and bought back almost \$6 billion worth of stock. Cash returns in 2012 alone totaled over \$2.6 billion, driven by a 30% dividend payout ratio and opportunistic share repurchases. Looking ahead, we expect to generate even more cash

⁶² Union Pacific, J.P. Morgan Aviation, Transportation & Defense Conference (Mar. 24, 2011).

⁶³ Union Pacific Presentation at Deutsche Bank Securities, Inc. Global Industrials and Basic Materials Conference (June 15, 2011).

to allocate over the next five years. Even with a larger capital budget, we expect shareholders will receive a bigger piece of the cash pie going forward.⁶⁴

Figure VIII – Union Pacific Analysis of Benefits to Shareholders Since 2007



Source: Union Pacific Investor Presentation

Conclusion

In 1980, at the signing ceremony for the Staggers Act, President Jimmy Carter heralded the Act's regulatory reforms with the following description:

[S]tripping away needless and costly regulation in favor of marketplace forces wherever possible, this act will help assure a strong and healthy future for our Nation's railroads and the men and women who work for them. It will benefit shippers throughout the country by encouraging railroads to improve their equipment and better tailor their service to shipper needs. America's consumers will benefit, for rather than face the prospect of continuing deterioration of rail freight service, consumers can be assured of improved railroads delivering their goods with dispatch.⁶⁵

There is a broad consensus that the Staggers Act enabled the successful restructuring of the American freight rail industry. Three decades after President Carter signed the Staggers Act into law, the large U.S. Class I freight railroads in the United States see a "strong and healthy future" for their businesses. In recent public statements, the railroads have confidently predicted that their record-setting financial performance will continue for the foreseeable future.

⁶⁴ Union Pacific Presentation at Cowen Global Transportation Conference (June 11, 2013).

⁶⁵ Statement on Signing S.1946 into Law, 3 Published Papers of the President, Jimmy Carter 1980-1981 1949, at 2229 (Oct. 14, 1980).

While the railroads are prospering under the regulatory system established by the Staggers Act, it is less clear that today's shippers and consumers are enjoying the benefits President Carter envisioned in his 1980 statement. The goal of the Staggers Acts was not to enrich railroad companies, but to "provide a regulatory process that balances the needs of carriers, shippers, and the public." As policymakers continue to discuss the future of America's rail transportation network, they will need to carefully consider whether changes are needed to reach this goal.

APPENDICES

The Largest Publicly Traded Class I Freight Railroads Are Breaking Records in Several Key Financial Measures

(Green Highlighting Indicates Record Breaking Quarter)

TABLE I - Operating Ratio

Year	2009	2010				2011				2012				2013		
Operating Ratio	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	74.9	74.5	71.2	69.1	70.0	72.5	69.3	70.4	71.5	71.1	68.7	70.5	72.1	70.4	68.6	71.5
NSC	73.9	75.2	69.8	69.6	73.2	77.1	69.5	67.5	71.4	73.3	67.5	72.9	73.4	74.8	70.2	69.9
UNP	73.3	75.1	69.4	68.2	70.2	74.7	71.3	69.1	68.3	70.5	67.0	66.6	67.1	69.1	65.7	64.8

TABLE II – Operating Income
(In Millions)

Year	2009	2010				2011				2012				2013		
Operating Income	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	583	634	768	825	846	773	926	878	841	856	943	854	804	875	963	854
NSC	549	555	733	746	642	600	875	938	800	745	934	731	714	691	836	849
UNP	1,002	988	1,279	1,401	1,313	1,137	1,392	1,578	1,617	1,510	1,724	1,786	1,725	1,633	1,878	1,962

TABLE III – Earnings Per a Share

Year	2009	2010				2011				2012				2013		
Earning Per Share	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	0.77	0.78	1.07	1.08	1.14	1.06	0.46	0.43	0.43	0.43	0.49	0.44	0.43	0.45	0.52	0.46
NSC	0.82	0.68	1.04	1.19	1.09	0.90	1.56	1.59	1.42	1.23	1.60	1.24	1.30	1.41	1.46	1.53
UNP	1.08	1.01	1.40	1.56	1.56	1.29	1.59	1.85	1.99	1.79	2.10	2.19	2.19	2.03	2.37	2.48

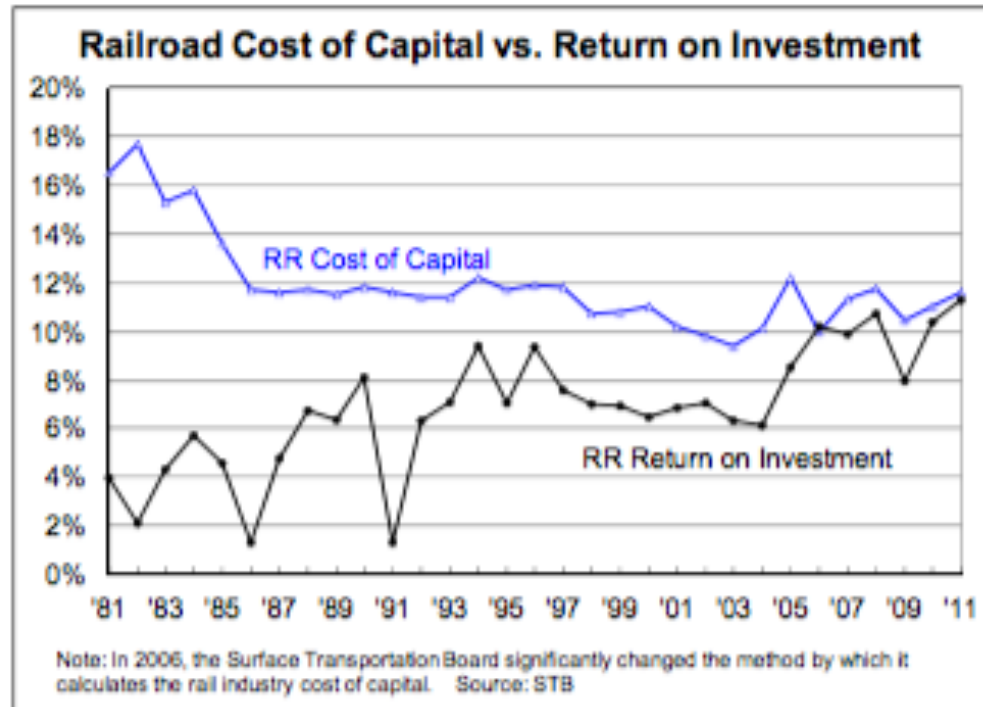
STB's Railroad Cost of Capital and Revenue Adequacy Determinations

(* Indicates Pending STB Review)

Year	Cost of Capital	BNSF	CSX	NSC	UNP
2003	9.40%	6.20%	4.00%	9.10%	7.30%
2004	10.10%	5.84%	4.43%	11.64%	4.54%
2005	12.20%	10.32%	6.23%	13.21%	6.34%
2006	9.94%	11.43%	8.15%	14.36%	8.21%
2007	11.33%	9.97%	7.61%	13.55%	8.90%
2008	11.75%	10.51%	9.34%	13.75%	10.46%
2009	10.43%	8.67%	7.30%	7.69%	8.62%
2010	11.03%	*	10.85%	10.96%	11.54%
2011	11.57%	*	11.54%	12.87%	13.11%
2012	11.12%	*	10.81%	11.48%	14.69%

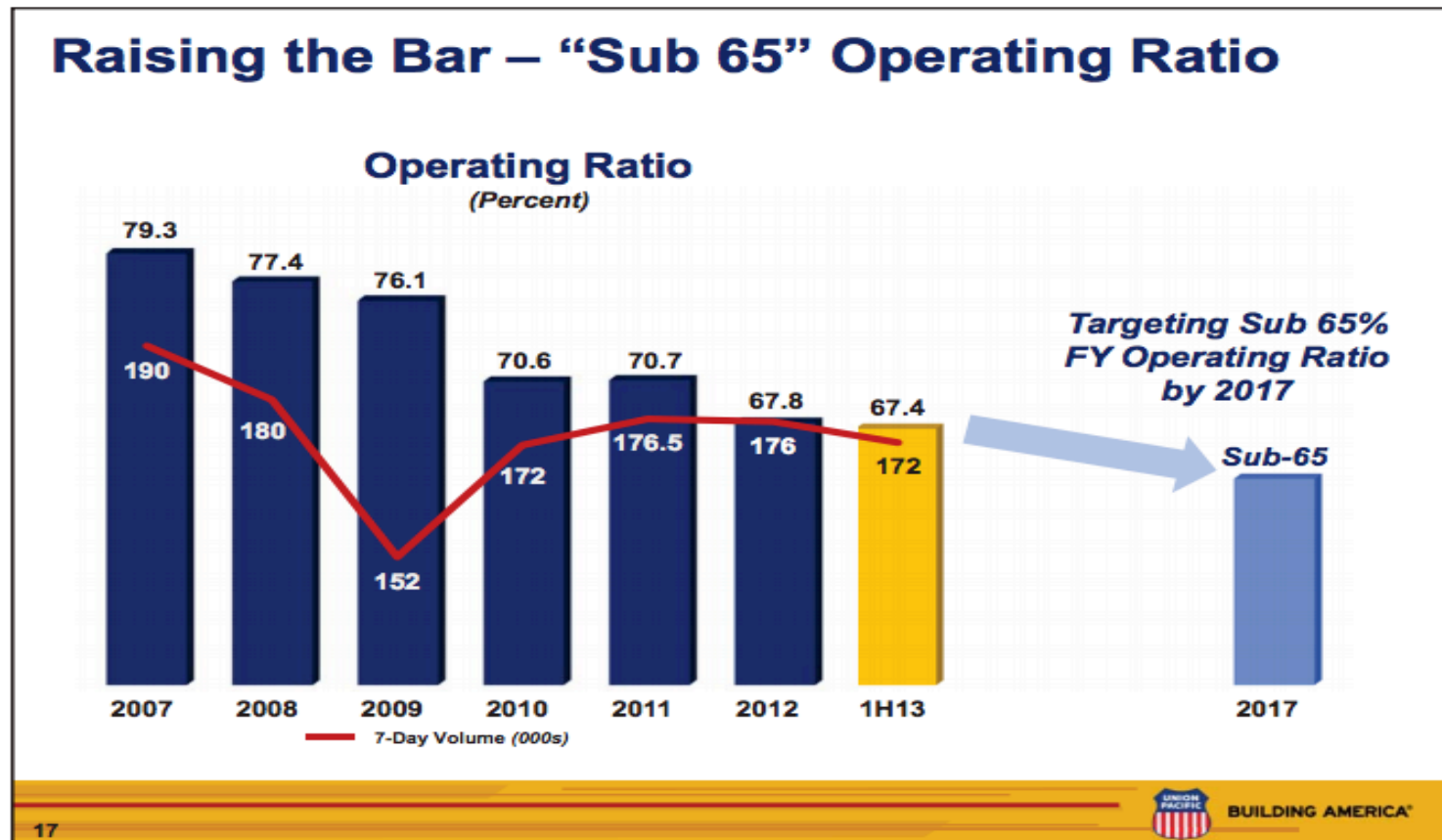
Source: STB Revenue Adequacy Filings

Railroad Cost of Capital vs. Return on Investment Since the Passage of the Staggers Act



Source: Association of American Railroads

Union Pacific Analysis of Improvements to its Operating Ratio Since the Beginning of “Project Operating Ratio”



Source: Union Pacific Investor Presentation

Norfolk Southern Shareholder Return 2006 – Q2 2011

Total Shareholder Return 2006 through Second Quarter 2011



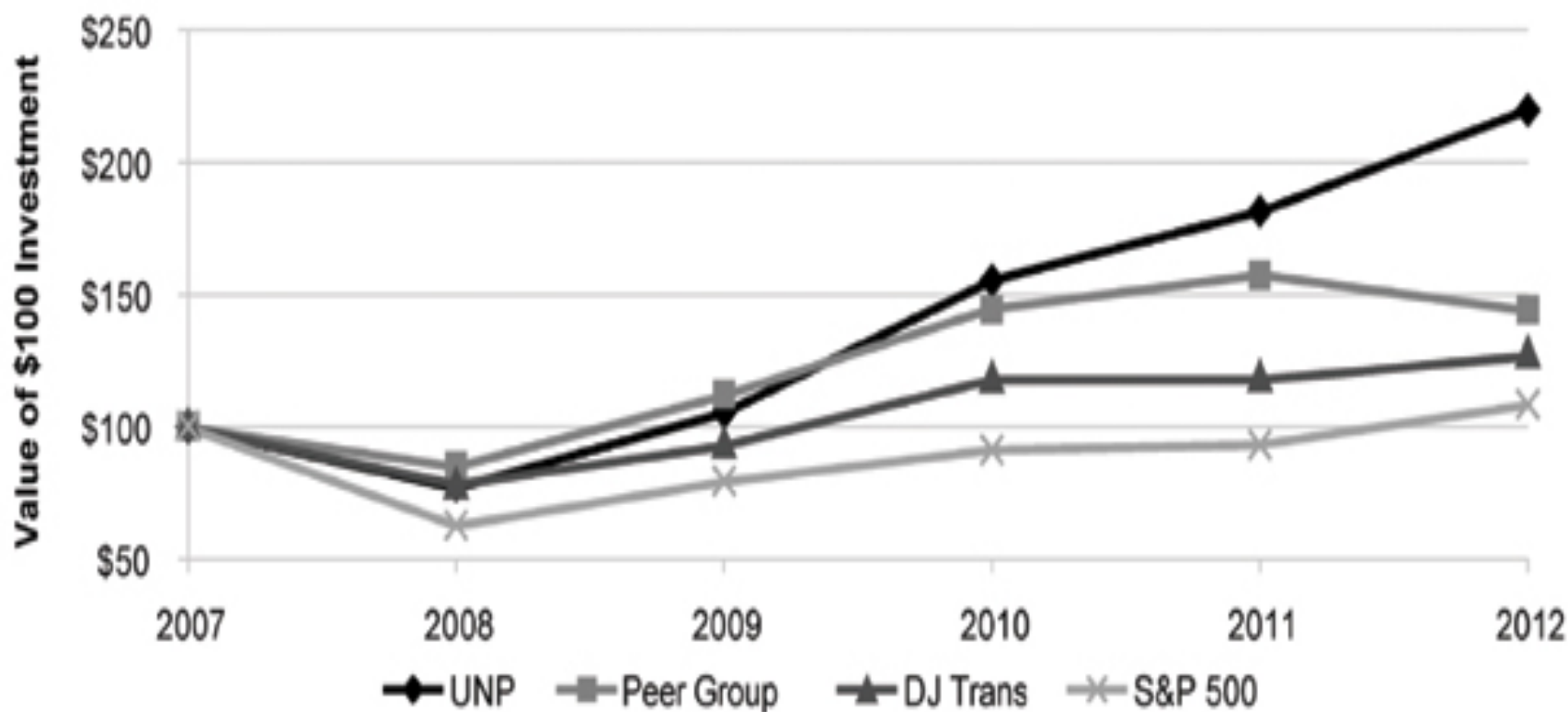
Source: Bloomberg



Source: Norfolk Southern Investor Presentation

Union Pacific Five Year Shareholder Return 2007 – 2012

Comparison of Five-Year Cumulative Return

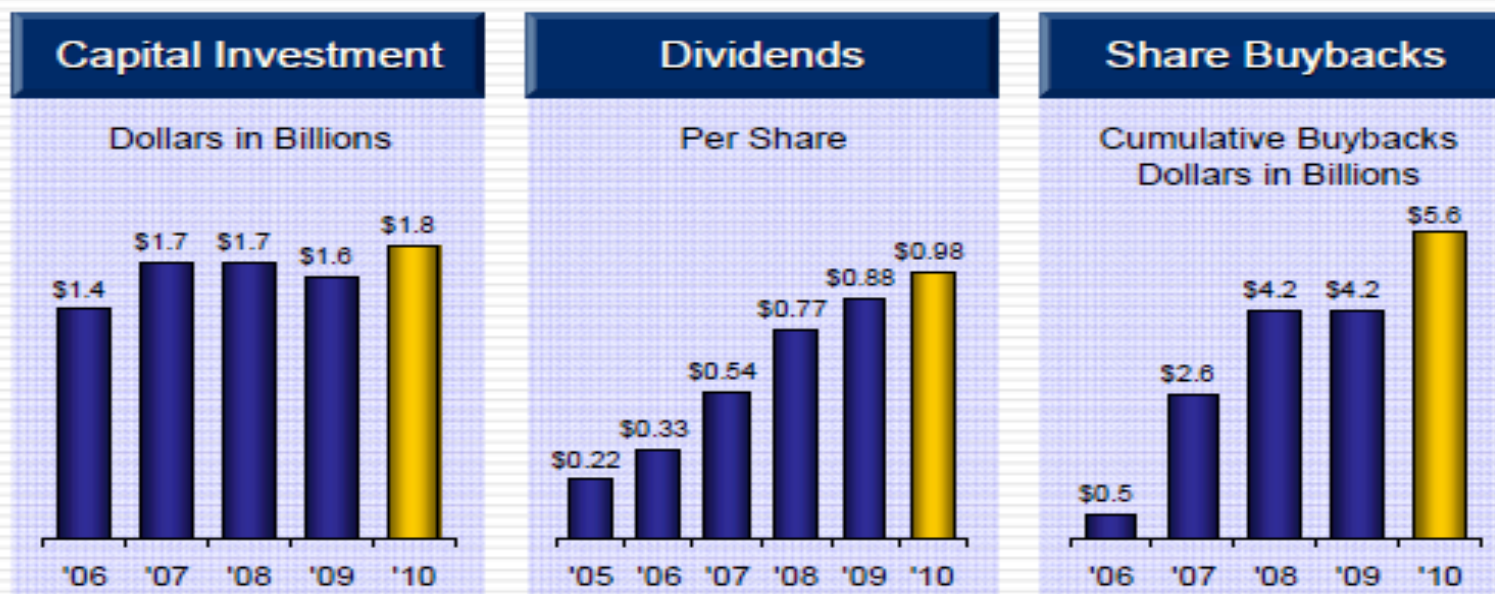


Source: Union Pacific Securities and Exchange Commission Filing

CSX Free Cash Flow 2006-2010

Free Cash Flow supporting balanced approach

- Generated \$1.5 billion of Free Cash Flow in 2010



Note: See GAAP Reconciliation

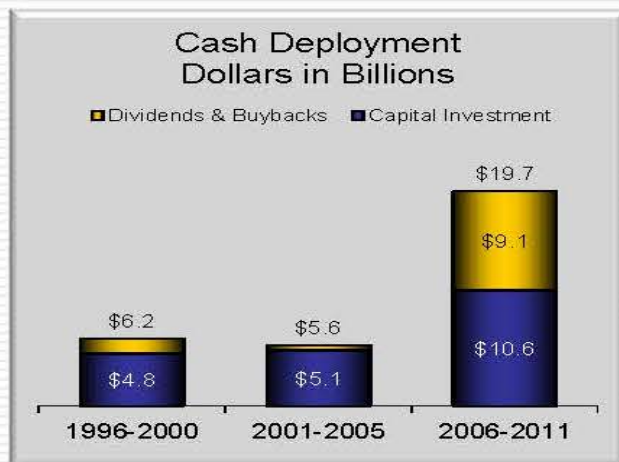
Source: CSX Investor Presentation

CSX Cash Deployment

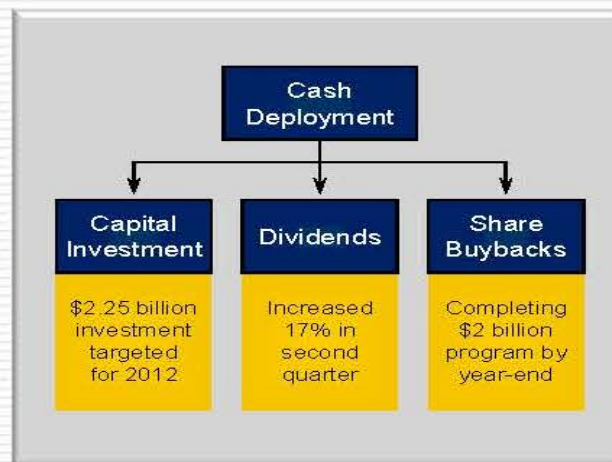
2006-2011 compared to 1996-2005

Performance supports strong cash deployment

CSX has pursued a balanced approach since 2005 . . .



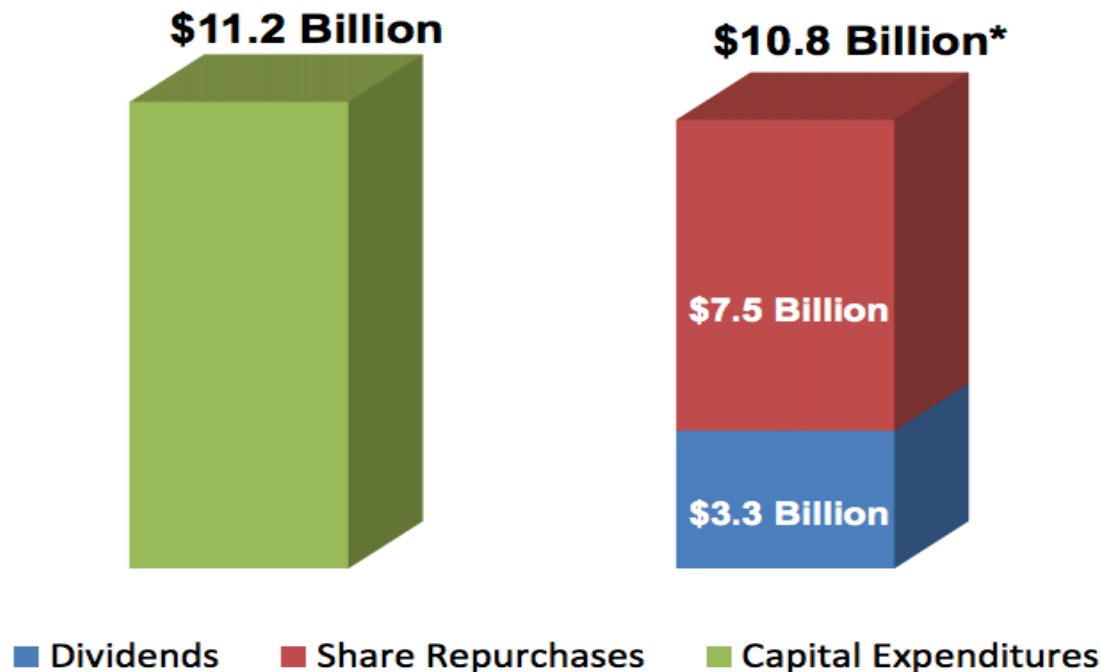
. . . and recent actions underscore its continuation



Source: CSX Investor Presentation

Norfolk Southern Balanced Cash Flow 2006-2012

Balanced Cash Flow Utilization *2006 through 2012*

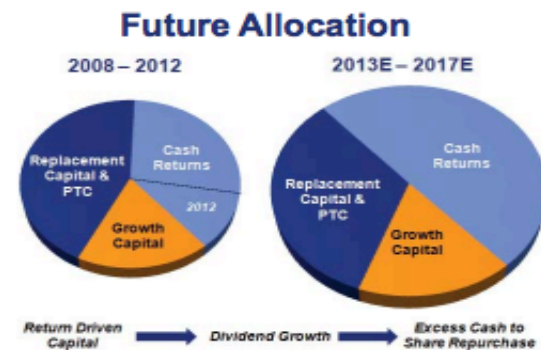
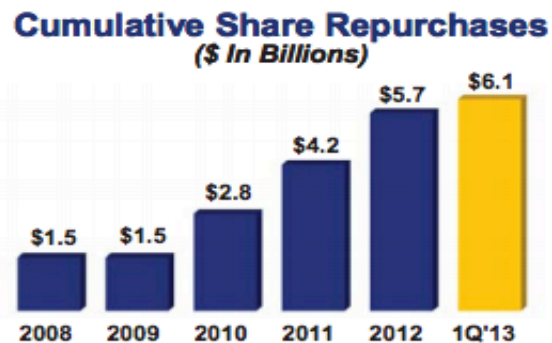
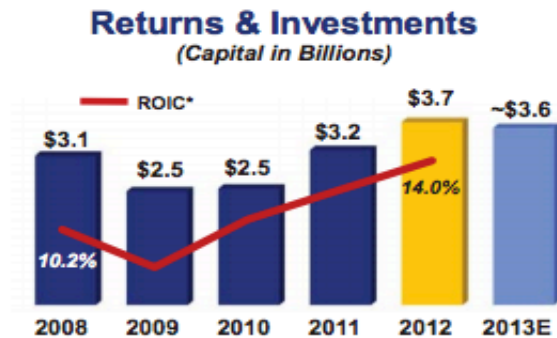


** See reconciliation of Total Shareholder Distributions to GAAP posted on our website, www.nscorp.com.*

Source: Norfolk Southern Investor Presentation

Union Pacific's Dividends and Share Repurchases 2008-2012

Delivering Value to Shareholders



Source: Union Pacific Investor Presentation

CSX Falling Operating Ratio Fourth Quarter 2006 - 2010



Source: CSX Investor Presentation