September 20, 2007

MEMORANDUM:

TO: Members, Committee on Transportation & Infrastructure

FROM: Ranking Republican Member John Mica

Subject: **SUMMARY OF SUBJECT MATTER:**
Hearing on the Status of Railroad Competition
10:00 a.m. September 25, 2007 Room 2167 RHOB

PURPOSE

This hearing will examine the status of railroad competition, standards for the economic regulation of rail carriers, and HR 2125 which would re-regulate railroad shipping rates and service. The Surface Transportation Board (STB) currently has regulatory jurisdiction over freight rail service.

BACKGROUND

State regulation of rail carriers was common at the dawn of the rail era, beginning in the 1830s. Federal economic regulation of rail carriers began with creation of the Interstate Commerce Commission (ICC) under the Interstate Commerce Act of 1887. The ICC was the first independent federal regulatory agency.

The scope of rail regulation ultimately grew to include railroad line construction, mergers, acquisitions, carrier practices and abandonment. The ICC administered all federal rail safety requirements until the Department of Transportation was created in 1966. Safety matters now fall within the jurisdiction of the Federal Railroad Administration.

In 1935, the ICC was given responsibility for economic and safety regulation of motor carriers (trucks and buses). These responsibilities were substantially reduced by deregulation in 1980 and virtually eliminated in the 1990s.

The pre-1980 rail regulatory regime prevented the railroads from responding to the marketplace in an efficient manner. Infrastructure deteriorated as the railroads were forced to maintain uneconomic lines and services. At the same time, competition from trucks took a significant portion of the railroads' share of the freight market, while air carriers and increased use of private automobiles reduced intercity passenger rail demand.

The net result was the economic destruction of the railroad industry. Between 1955 and the early 1980s, a number of major railroads went bankrupt while track, equipment and major infrastructure decayed. Derailments became an everyday occurrence. By 1976, more than 47,000 route-miles — about 25 percent of the nation's total — had to be operated at reduced speeds because of dangerous conditions. Parked railcars sometimes fell off deteriorated tracks. More miles of railroad were bankrupt in the 1970s than in the Great Depression of the 1930s.

Major Railroad Bankruptcies 1960-80

- **New York, New Haven and Hartford Railroad**
- **Boston Terminal Corporation (South Station)**
- **Central Railroad of New Jersey**
- **Boston and Maine Corporation**
- **Lehigh Valley Railroad**
- **Reading Company**
- **Lehigh and Hudson River Railway**
- **Erie Lackawanna Railway**
- **Ann Arbor Railroad**
- **Rock Island Railroad**
- **Penn Central Transportation**
- **Penn Central subsidiaries--**
- **United New Jersey Railroad and Canal Company**
- **Beech Creek Railroad**
- **Cleveland, Cincinnati, Chicago and St. Louis Railway**
- **Delaware Railroad; Erie and Pittsburgh Railroad**
- **Michigan Central Railroad**
- **Northern Central Railway**
- **Penndel Company**
- **Philadelphia and Trenton Railroad**
- **Philadelphia, Baltimore and Washington Railroad**
- **Pittsburgh, Fort Wayne and Chicago Railway**
- **Pittsburgh, Youngstown and Ashtabula Railway**
- **Union Railroad of Baltimore**

> ***"In recent decades the problems of the railroad industry have become severe. Its 1979 rate of return on net investment was 2.7 percent, as compared to over 10 percent for comparable industries. We have seen a number of major railroad bankruptcies and the continuing expenditure of billions of Federal dollars to keep railroads running. Service and equipment have deteriorated. A key reason for this state of affairs has been overregulation by the Federal Government."***
>
> **-Statement of President Jimmy Carter**
> **on signing the Staggers Act**

The principal legislative response to this situation was deregulation under the Staggers Rail Act of 1980 which produced a major turnaround in the financial condition of the industry. Staggers, which is discussed in more detail below, finally allowed the railroads to set competitive rates, negotiate contracts with shippers and abandon unprofitable lines. No major rail carrier has failed since the early 1980s.

THE SURFACE TRANSPORTATION BOARD

In 1995, Congress passed the ICC Termination Act (ICCTA), which replaced the old 5-member ICC Commission with a smaller 3-member Surface Transportation Board (STB). Members of the STB are appointed by the President and confirmed by the Senate. Currently, the STB is chaired by Charles Nottingham, a Republican appointed by President Bush, with a term expiring December 31, 2010. The other board members are Douglas Buttrey, a Republican whose term expires December 31, 2008 and Francis Mulvey, a Democrat whose term expires December 31, 2007.

REGULATION OF RATES AND ACCESS

The STB has jurisdiction over freight railroad rates, including both common carrier and contract rates. Common carrier rates are essentially rates available to any customer requesting rail service, while contract rates are the subject of confidential negotiations between the railroad and a particular customer.

The STB may permit one rail carrier to operate trains across or over the tracks of another carrier, both along main lines and in terminal areas. The STB also has the administrative power to "exempt" most rail regulatory matters (other than labor protection requirements) from the full bureaucratic process, provided certain conditions are met [49 U.S.C. 10502]. Regarding rates and track access, the exemption power has been applied most frequently to exempt certain classes of rail traffic (usually those with strong competition, such as intermodal traffic).

HR 2125 proposes to make significant changes in the regulation of rates and access, as discussed below.

RATES

Common Carrier Rates and Contract Rates

Prior to the Staggers Act, railroads were not permitted to negotiate rates with individual shippers. Staggers changed this by permitting the use of "contract rates"— individual rates and service agreements negotiated with customers. In general, such contracts are confidential and beyond the regulatory jurisdiction of the STB [49 U.S.C. 10709].

Common carrier rates are generally protected from antitrust challenge by the "filed rate doctrine." Rail transportation provided under contracts is subject to the antitrust laws, with disputes handled like any other private-sector commercial dispute. The shipper and carrier may establish liability arrangements that are not subject to the usual "Carmack Amendment" [49 U.S.C. 11706] standards for common-carrier liability. A majority of U.S. rail traffic now moves under contract rather than common-carrier rates.

Prior to ICCTA, common carrier rates had to be filed in tariff form with the ICC. Now rates may be published by other means, including electronic transmission [49 U.S.C. 11101(b)]. Shippers are generally entitled to 20 days notice of any proposed increase in previously quoted rates [49 U.S.C. 11101(c)].

Under current law, a railroad is not required to quote a rate to an intermediate point along its route, unless the shipper has a signed contract with another railroad which interchanges at that point.

HR 2125 proposes to require rate quotes to any point along a railroad's route where traffic "may be reasonably interchanged."

The phrase "may be reasonably interchanged" is vague and may be subject to much litigation. A larger concern is whether allowing shippers to determine interchange points could reduce existing efficiencies and "gum up the system." Railroad yards are already major chokepoints nationally, and the proposed legislation might make matters worse.

With regard to chemical shippers, TSA rules may impact where hazmat cars may be interchanged.

RATE-REASONABLENESS STANDARDS FOR COMMON-CARRIER RATES

a. "Market Dominance"

To help assure an adequate flow of revenue to rail carriers, the Staggers Act limited regulatory jurisdiction to evaluate whether rail rates are "reasonable" to rates collected in situations where the rail carrier is "*market dominant*" [49 U.S.C. 10701(d)]. This is defined by statute to mean situations where there is an "absence of effective competition from other rail carriers or modes of transportation" [49 U.S.C. 10707(a)]. Unless the STB finds that market dominance exists, a challenge to a rate as unreasonably high may not proceed.

By contrast, HR 2125 focuses on rail-to-rail competition, and discounts the fact that railroads face extensive competition from trucks and barges which operate on publicly funded infrastructure.

The 1980 Committee conference report for the original Staggers Act justified deregulation on the basis that, "Nearly two thirds of intercity freight is transported by modes of transportation other than railroads." By 2005, railroads still carried only 38% of freight ton/miles. Competing modes carried the remainder, including a majority of the highest-revenue cargo.

b. The 180% of Variable Cost "Floor"

Under Staggers, a rate that produces revenues of less than 180% of *variable* costs of the railroad is conclusively presumed to be non-market-dominant and therefore beyond the agency's rate-reasonableness jurisdiction.

Rates above 180% of variable cost may be subject to challenge.

(Railroads have very high *fixed* costs that do not vary with the level of service provided; therefore a rate that is 180% of variable costs usually does not cover the full cost of providing transportation.)

- **180% *is* an arbitrary number.**
- **180% *is not* based on any economic analysis of actual railroad costs.**
- **180% *was a political deal* negotiated between the House and Senate in 1980.**
- **180% *does not represent* an efficiency factor, a break-even point or profitability point for rail carriers.**
- **Railroads' break-even point is normally *much* higher than 180%.**
- **HR 2125 attempts to drive rates to 180% or below.**

The following table shows the percentages that Class I railroads would have to charge potentially captive shippers to earn a fair rate of return. (Actual average markup is only

217%.) The chart is based on information published annually by the STB and is calculated based on the agency's Revenue Allocation Shortfall Method (RSAM).

RSAM Mark-up Percentages 2001 - 2004
(Range Represents RSAM With & Without Efficiency Adjustment)

Railroad/ Region	4 - Yr Average	2004	2003	2002	2001
BNSF	245-315	215-266	234-275	273-366	258-354
CSXT	242-281	254-292	247-283	223-259	242-290
GTC		322-375	390-486	415-497	
KCS	268-315	241-298	263-289	266-310	302-364
NS	186-222	197-226	181-210	179-216	186-235
SOO	256-329	234-33 1	226-283	237-260	328-441

c. Evaluation of Rates

If a rate being challenged is within the STB's regulatory jurisdiction, STB currently evaluates the reasonableness of the rate. STB must consider whether the railroad is providing some service under rates so low as to not contribute to the carrier's going-concern value, whether the railroad is providing service under rates that only marginally contribute to fixed costs, and whether the carrier's mix of traffic is forcing one type of traffic to provide an unreasonable share of the carrier's revenues. STB also must determine whether the railroad is earning enough to be "revenue adequate." [49 U.S.C. 10701(d)(2)]. That policy is discussed below.

Administrative interpretations and rules of the ICC and STB have included the use of highly complex so-called "*constrained market pricing*" and "*stand-alone cost*" models for evaluating whether a specific rail rate is unreasonably high. The ICCTA of 1995 required the STB to complete a rulemaking by the end of 1997 to establish simplified rate-reasonableness standards for evaluating non-coal rate cases where a full stand-alone-cost presentation is too costly [49 U.S.C. 10701(d)(3)].

The STB's initial attempt to provide simplified rate reasonableness standards was a failure. STB litigation remained costly and complex. Small shippers, who comprise 73% of all rail traffic, were denied an effective remedy for excessive rates. The STB recently took steps to remedy this by adopting new Small Rate Case guidelines. [*Ex parte 646 (Sub No.1), Sept. 5, 2007*]

The new procedures attempt to shorten the litigation process to twenty days by requiring mandatory, nonbinding mediation. If mediation does not work, the parties proceed to a final board decision. The STB has set up an expedited case schedule, so cases will be resolved more quickly than in the past.

Small customers will be able to file a case for only $150. Proceedings will be based on a “Three-Benchmark” methodology (which is much simpler than previous methodologies.) If successful, the customer will be entitled to recover up to $1 million over a five year period.

Larger customers will be able to use “Simplified Stand-Alone Cost” methodology and recover up to $5 million over a 5-year period. The fee for these larger cases is $17,600.

It should be noted that HR 2125 proposes the use of final offer arbitration (also known as “baseball arbitration”) in resolving rate cases. The new STB Small Rate Case guidelines adopt a limited form of this approach regarding the selection of regulatory cost comparison groups. This limited use of baseball arbitration will greatly simplify STB proceedings, but general use of the procedure could be problematic, as discussed below.

d. Baseball Arbitration

HR 2125 provides for use of baseball arbitration in rate cases involving the transportation of any agricultural product, including timber, paper, and fertilizer. While baseball arbitration sounds good in theory, the Canadian version of this process has been subject to some criticism.

According to STB comments filed by Canadian National and Canadian Pacific in *Ex Parte No. 586*, baseball arbitration is inherently biased against railroads, for several reasons:

- The shipper has exclusive control over whether and when to file for arbitration. This chills the negotiating process for contract rates, because prior shipper-railroad negotiations will become the baseline for starting arbitration.

- Preliminary jurisdictional objections have tended to generate litigation.

- The shipper is not bound to accept the arbitrated rate. Only the railroad is bound.

- The proceedings occur in a short timeframe and require great expense on behalf of the railroads.

- The proceedings have been adversarial and disruptive of commercial relations between the shipper and carrier.

- The baseball arbitration process is not grounded on the overall economics of the entire rail system.

- Arbitrated rates do not serve as published precedents. This gives an advantage to the most litigious party, one who frequently files cases, versus the occasional filer.

e. Stand Alone Cost

Rate cases for the largest shippers are currently handled under "Stand-Alone Cost" methodology, which essentially requires the creation (on paper) of a hypothetical railroad to serve the complaining customer. This methodology is accurate, but cumbersome and expensive. HR 2125 would require STB to establish the reasonableness of rail rates based on the railroad's actual costs including a portion of fixed costs and an adequate return on debt and equity.

HR 2125 would require that rate reasonableness be determined for any of all portions of the rail movement. This might generate a new set of complexities, as railroad efficiencies do not vary in a linear fashion based solely on the length of haul.

f. HR 2125 Might Punish Good Deeds

In some circumstances, HR 2125 could actually penalize railroads who provide lower shipping rates.

Assume that in Year 1 a shipper is paying a rate of $20. The railroad's variable cost is $12. The R/VC ratio is 20/12 or 167%. Since the rate is less than 180%, it is "competitive" and not subject to STB challenge.

Then assume that the railroad reduces its variable costs by $2.00 (perhaps by saving fuel, reducing crew size or investing in a new signal system.)

Further assume that the railroad passes this $2.00 saving directly to the shipper.

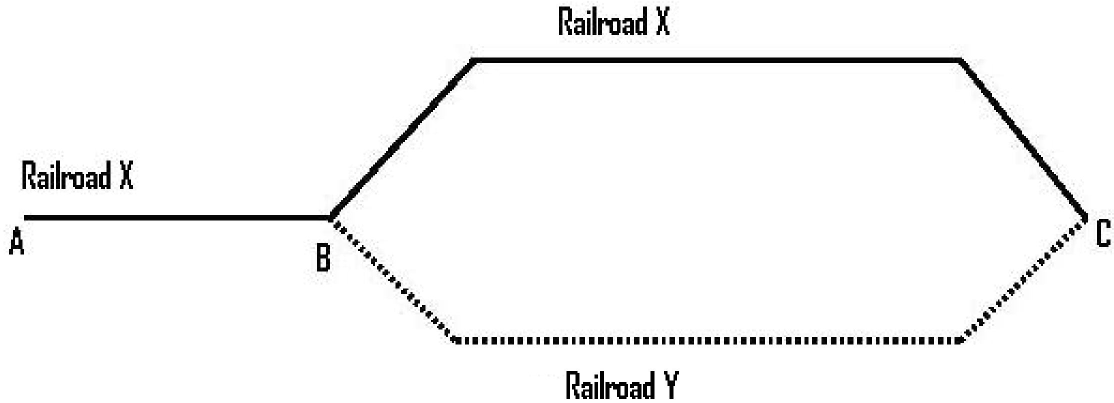
The R/VC is now 180%. Even though the rate is lower, it becomes "non-competitive" and subject to challenge.

Year	Revenue Collected (R)	Variable Costs (VC)	R/VC
Year 1	$20.00	$12.00	167%
Year 2	$18.00	$10.00	180%

Source: GAO.

BOTTLENECKS

A Bottleneck Situation



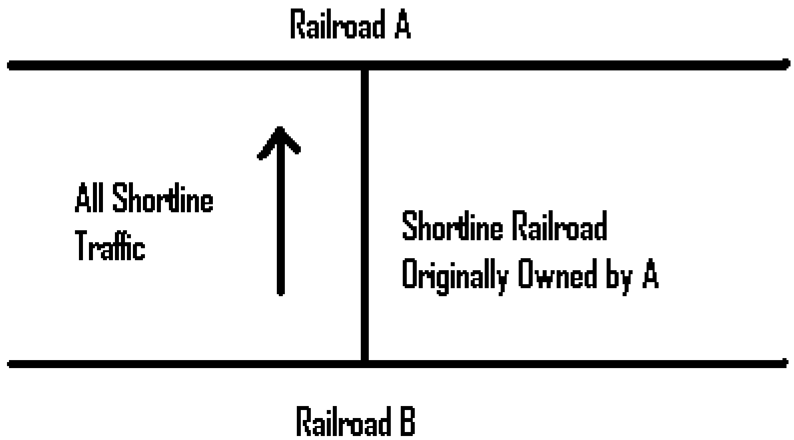
"In the diagram above, the bottleneck portion of the route between origin A and destination C is the rail segment from A to B because only one railroad, *Railroad X*, has track between these two points. The non-bottleneck portion of the route is from points B to C because two railroads have track between these two points. Under existing practice, *Railroad X*, the bottleneck carrier, can exclusively serve all traffic from origin A to destination C by insisting on only offering a through rate from A to C even though *Railroad X* could potentially interchange traffic with *Railroad Y* at point B. By only offering through rates, *Railroad X* prevents *Railroad Y* from competing for the through traffic between points A and C." (August 3, 2007 CRS Report, *Railroad Access and Competition Issues.*)

Current ICC/STB administrative decisions require that a challenge to the reasonableness of a common carrier rate be made to the entire rate, *i.e.*, the complaining shipper may not "segment" the rate into component parts for purposes of proving that a particular component exceeds a reasonable maximum. There have been some shipper complaints that this in practice allows a railroad to foreclose use of alternative rail routings, because the incumbent carrier can dramatically increase the part of the rate covering a "short haul" to a connection with a second railroad, and instead merely quote one through rate for the entire journey.

By administrative decision, the STB slightly expanded the rate-quoting obligation of a carrier that provides the single rail connection on the "bottleneck" segment of a through route that otherwise involves a choice of 2 rail carriers. The STB has ruled that the bottleneck-controlling carrier must in fact segment and separately quote a rate for the bottleneck (short-haul) segment alone, but *only if* the second railroad isolated from the shipper by the bottleneck segment has in fact already entered into a rate contract with the shipper for service on the non-bottleneck segment of the route. This compromise between the views of rail carrier and shippers is lifted almost entirely from a Canadian rail statute, and anomalously makes the scope of a bottleneck carrier's *common carrier* rate-quoting obligations depend entirely on what another carrier does regarding contract transportation. However, thus far, the STB's bottleneck position has survived judicial review.

HR 2125 would legislatively overrule the current STB decisions and require segmented quoting of common carrier rates on both the short-haul "bottleneck" portion and the long-haul portion of a route.

PAPER BARRIERS



In the above diagram, Railroad A originally owned a branch line with a number of rail customers. Railroad A historically sent this traffic over its own line. Railroad A later sold the branch to a Shortline Railroad, with the proviso that all traffic continue to travel over Railroad A. This proviso is an Interchange Commitment or "Paper Barrier." Note that traffic routing remains the same before and after the sale.

The issue of "Paper Barriers" first arose in the 1980s, as Class I railroads began to abandon or sell underperforming rail lines. Some of these lines were sold at a low cost to shortline operators. The deal sometimes included a provision that the selling railroad would be entitled to capture all the traffic, or a certain level of traffic, produced by the shortline. This traffic-capture provision, called a Paper Barrier or Interchange Commitment, permitted the Class I railroad to recover the value of the line over time rather than in a single up-front payment by the purchaser.

HR 2125 would essentially nullify most Paper Barriers.

The practical effect of the bill must be analyzed in light of a 1998 Railroad Industry Agreement between the Class I railroads and shortlines. Under this agreement, a "paper barrier" will be waived if it would help the short line and not harm the Class I railroad.

Several years ago, the Western Coal Traffic League asked that STB review the effectiveness of the 1998 agreement. STB has been less than expeditious in reviewing this issue, but is expected to issue new rules in coming weeks.

One question raised by HR 2125 and any new STB rules is whether removal of a Paper Barrier constitutes a "taking" of property rights by the government. If so, the Class I carrier could sue the government for fair market compensation.

A larger question is whether Paper Barriers actually benefit Class I railroads at a macro level. Entrepreneurial operators have in many cases turned dilapidated Class I branch lines into booming shortlines. Eliminating Paper Barriers might benefit the entire rail system, and therefore all carriers, by increasing total traffic inflow. This may be true even if originating traffic tended to shift between railroads at some locations.

"REVENUE ADEQUACY" OF RAIL CARRIERS

The Staggers Act required the ICC to establish standards and procedures to evaluate whether a specific rail carrier is earning revenues adequate to cover total operating costs plus a reasonable return or profit, and to attract sufficient capital to maintain a sound rail transportation system [49 U.S.C. 10704(a)(2)]. The STB conducts an annual evaluation of whether major (Class I) rail carriers are "revenue-adequate."

The STB has a pending rulemaking to change its method of calculating the cost-of-capital. This change will have the effect of making more rail carriers "revenue adequate" and therefore subject to further rate scrutiny.

Many industry analysts still consider the railroad industry's capital inflow insufficient for replacement of existing infrastructure and future expansion. Compounding this problem is the fact that many major carriers have shed underperforming lines—around one-half of the pre-1980 network. Many of these lines have become shortline railroads, most of which do not have the customer base to support major capital investments.

INVESTIGATING UNREASONABLE RATES

Under current law, the STB may not challenge a rail carrier's common-carrier rate on its own motion, but only on complaint from an outside party [49 U.S.C. 10704(b)].

If the agency determines, using the standards outlined above, that the rate in question is unreasonable, the agency may "prescribe" a reasonable rate, which the carrier may not exceed [49 U.S.C. 10704(a)]. If the shipper has already paid for transportation under the challenged rate, the shipper may recover "reparations" from the carrier for the overpayment.

HR 2125 would give the STB authority to act on its own initiative motion and enforce remedies. Rate reasonableness would be determined for each segment of the shipment, not merely from endpoint to endpoint as is currently done. This would limit a railroad's ability to generate revenue through free market pricing.

TERMINAL AREA ACCESS AND RECIPROCAL SWITCHING

The STB's existing authority includes the power to require one railroad to make its terminal facilities (including main-line track for a "reasonable distance" beyond the terminal area) available to another carrier, if such availability is "practicable," in the "public interest," and will not "substantially impair" the owning carrier's use of the facilities for its own traffic [49 U.S.C. 11102(a)]. The Board also may set compensation and other terms and conditions for such access. Although the ICCTA generally removed passenger rail operations from the STB's regulatory jurisdiction, it did preserve the power of publicly owned commuter authorities to utilize the compulsory terminal access remedies in Section 11102.

Reciprocal switching arrangements allow one railroad to provide service over another's tracks to reach a particular shipper location. The existing statute empowers the STB to require rail carriers to enter into such arrangements, either because they are "practicable" and in the "public interest," or because such action is "necessary to provide competitive rail service" [49 U.S.C. 11102(c)]. In the absence of mutual agreement between the carriers on compensation and conditions, the STB may determine those parameters itself. Administrative precedents of the ICC have largely limited use of this power to local situations, not long-haul traffic.

HR 2125 would in some cases *require* STB to establish Reciprocal Switching rights and provide open Terminal Access, provided it is practicable and in the public interest. There would not need to be any showing of anti-competitive conduct to establish Reciprocal Switching in an area.

This proposal would likely be uneconomic because terminal areas are frequently not self-supporting. A share of line-haul revenues is therefore often used to subsidize the terminal. Without this revenue stream, terminal facilities would likely begin to deteriorate.

A railroad seeking Reciprocal Switching and Terminal Access would likely be required to pay a cost far above incremental cost. Under SSW Compensation [1 I.C.C. 2d 776 (1984)], the tenant railroad would pay the variable costs of usage; a pro-rata apportionment based on total annual maintenance costs; and a return element on the value of the assets used. This latter calculation includes some estimate of indirect cost (opportunity cost) associated with traffic lost by the host railroad. SSW Compensation calculations are preferably based on capitalized earnings, but other methods such as comparable sales, an appraisal, or replacement cost less depreciation may be applicable

Unless a host railroad receives full compensation for use of its assets, forced access could be viewed as a "taking" of private property similar to the Kelo case [*KELO V. NEW LONDON* , 545 U.S. 469 (2005)], under which the government essentially mandated transfer of one owner's private property to a new owner favored by the government.

DIVESTITURE OF LINES

Current law allows the STB to mandate divestiture of particular rail lines for competitive reasons only in the context of "conditions" on approval of a merger or acquisition. [See 49 U.S.C. 11323(c).] In merger cases, the agency also retains continuing jurisdiction to modify any of the original conditions of the merger.

HR 2125 would not require divestiture of any rail lines.

EMERGENCY SERVICE ORDERS

Emergency Service power was employed by the STB to deal with the 1997 traffic congestion on the Union Pacific-Southern Pacific system; the STB required UP to grant access to Burlington Northern Santa Fe and other carriers pursuant to the emergency order, and ordered frequent reporting by UP of the degree of traffic congestion. The purpose of the statutory authority is to allow the agency to address emergencies caused by shortage of equipment, congestion of traffic, an unauthorized cessation of rail service, or other traffic movement failure [49 U.S.C. 11123]. The powers of the agency to require one railroad to operate on another's lines are limited to a maximum duration of 270 days. The STB may set compensation levels in the absence of voluntary agreement, but a carrier ordered to operate on another's lines must derive its compensation solely from revenues from those operations. (This power originated as a Congressional response—the Esch Car Service Act of 1917—to massive rail congestion on the east coast resulting from offshore U-boat attacks on coastal shipping.)

The STB's emergency powers under Section 11123 were expanded by the FY04 omnibus appropriations measure: the STB is now also empowered to maintain directed emergency service for freight and commuter transportation affected by any cessation of operations by Amtrak.

In addition to powers to deal with transportation emergencies as outlined above, the STB is also authorized to give traffic priority to troops, war material, and other essential government traffic in time of war or threatened war [49 U.S.C. 11124].

"AREAS OF INADEQUATE RAIL COMPETITION"

HR 2125 creates a new type of STB authority, more far-reaching than the existing emergency powers.

1. The legislation would require STB to designate an "Area of Inadequate Rail Competition" where—

   a) a state or substantial portion of a state served by only one Class I carrier, and

   b) shippers are being charged more than 180% of revenue-variable cost, or

   c) shippers "have experienced competitive disadvantage in the marketplace or other economic adversity because of high cost or poor quality of rail service."

d) “An area of inadequate rail competition may be composed of the facilities of a group of shippers or receivers of one or more specific commodities within a geographic area.”

An example of these “facilities” might be grain elevators, mines or chemical plants.

2. The Governor of a state may petition the STB to designate the state or a portion thereof an “area of inadequate rail competition.”

After designation of an area of inadequate rail competition, the STB is required to:

a) reduce rates, but not lower than 180% of revenue-variable cost. (Again, 180% is virtually assured to be a money-loser for the railroads.)

b) authorize reciprocal switching over large geographic areas.

c) authorize haulage rights, under which Railroad A is required to haul cars to and from its customers on behalf of Railroad B.

d) provide expedited final-offer (baseball) rate arbitration of rates on any line segment which is subject to congestion. (It is not clear how this rate review process could alleviate rail congestion, other than by driving traffic to trucks.)

e) determine if the rate is discriminatory.

STB will be allowed to compare the rates to other rail routes, something which is not currently permitted by law.

NOTE: No showing of anti-competitive conduct is required for STB to impose Reciprocal Switching or Terminal Access Rights under this section.

A carrier operating under Haulage Rights, Reciprocal Switching or Terminal Access would still be required to compensate the host railroad under <u>SSW Compensation</u> or similar standards. This means that cost savings will be less than might appear at first glance, even if the mandated access does not effect operational efficiency (which it likely will.)

CUSTOMER COMPLAINTS

The STB already has a number of customer service programs. In 2000 the STB established a rail Consumer Assistance Program to provide informal assistance with any type of rail service related transportation problem. In 2006, OCA received only 100 complaints nationally.

The STB also has implemented a Rail Shipper Transportation Advisory Council (RSTAC) established under the ICC Termination Act, Grain Car Council established by the ICC in 1994, and Rail Energy Transportation Advisory Committee established by STB in 2007.

HR 2125 would set up a new office of Rail Customer Advocacy staffed by a Rail Customer Advocate by the Secretary of Transportation in consultation with the Secretary of Agriculture. The Rail Customer Advocate's job would be to accept rail customer complaints, participate as a party in proceedings of the STB, and "collect, compile, and maintain information regarding the cost and efficiency of rail transportation."

RECENT & PENDING STB DECISIONS

In recent days, STB has made substantial changes in the complaint process for small rate cases under *Ex Parte No. 646 (Sub-No. 1)*. This new process will be highly beneficial to shippers. **A fact sheet is attached.**

STB has also announced that it will use a Capital Asset Pricing Model (CAPM), rather than the traditional Discounted Cash Flow method for calculating a railroad's cost of capital. Initial comments on this proposal were due on September 13, 2007. It is expected that using CAPM will reduce the cost of capital figure, which STB uses in evaluating the adequacy of rail revenues. The cost of capital is also used in determining the reasonableness of rates.

Both the Small Rate Case guidelines and switch to CAPM will benefit shippers and address many of the issues driving HR 2125. Rail rate cases will be easier to bring, simpler to litigate and produce fairer results. With the lower cost of capital calculation, rates will receive greater scrutiny and the playing field will be tilted more toward shippers.

Finally, as mentioned above, an STB ruling on Paper Barriers will be forthcoming soon. These new rules will likely render moot HR 2125's proposed provision on Paper Barriers.

CONCLUSION

According to STB Chairman Chip Nottingham, it will take one year to determine if the agency's new rulings and procedures are working as planned. By that time, the agency will also have completed a $1 million independent study of freight rail competition. This study, which was recommended by GAO, is being performed by Christensen Associates of Wisconsin with a due date of September 2008.

In light of the foregoing, it may be prudent to wait until the fall of 2008 before considering major legislative intervention.

Expected Witnesses

W. Douglas Buttrey
Vice Chairman
Surface Transportation Board

Susan M. Diehl
Senior Vice President, Logistics & Supply Chain Management
Holcim, Inc.

Glenn English
Chief Executive Officer
National Rural Electric Cooperative Association

Ronald R. Harper
Chief Executive Officer and General Manager
Basin Electric Power Cooperative

JayEtta Z. Hecker
Director, Physical Infrastructure Issues
Government Accountability Office

Wayne Hurst
Vice President
Idaho Grain Producers Association
On behalf of the National Association of Wheat Growers

Terry Huval
Director
Lafayette Utilities Service
(Lafayette, Louisiana)

Bruce I. Knight
Under Secretary of Agriculture, Marketing and Regulatory Programs
U.S. Department of Agriculture

Charlie N. Marshall
Senior Vice President of Industry Relations
Farmrail System, Inc.

Francis P. Mulvey
Board Member
Surface Transportation Board

Charles D. Nottingham
Chairman

Surface Transportation Board

William Rennicke
Director
Oliver Wyman, Inc.

Gary Spitzer
Vice President and General Manager
Chemical Solutions Enterprise
DuPont

Jim Young
Chairman, President, and Chief Executive Officer
Union Pacific Railroad

STB DECISION SIMPLIFYING THE PROCESS FOR RESOLVING SMALL AND MEDIUM-SIZE RAIL RATE DISPUTES

STB Ex Parte No. 646 (Sub-No. 1)

FACT SHEET

- Provides access to the rate reasonableness process for all sizes of rail rate disputes, and in particular, to the estimated 73% of challengeable rail traffic for which the large rate case process would be financially impracticable.
- Requires, for all rail rate disputes, mandatory, nonbinding mediation—a mechanism that has been used successfully in previous cases to arrive at negotiated settlements.
- Allows rail customers to choose the methodology that is most appropriate for consideration of their complaints:
    - A rail customer choosing the simplest approach, the "Three-Benchmark" methodology, will be eligible to recover up to $1 million over a 5-year period.
    - A rail customer choosing the "Simplified Stand-Alone Cost" methodology will be eligible to recover up to $5 million over a 5-year period.
- Requires the use of the Board's Uniform Rail Costing System (URCS), without any movement-specific adjustments, to determine the variable cost of the challenged movement. URCS is the general purpose costing model used to determine if a rate is subject to the Board's jurisdiction (i.e., whether the rate is above 180% of the carrier's variable cost of proving the service). Calculating variable costs based on URCS is a quick and administratively simple process; the advance work is performed by the Board annually, and the computer program is available to the public at a minimal cost.
- Clarifies and revises the Three-Benchmark methodology that evaluates a challenged rate in relation to three benchmark figures. Specifically, this revised methodology:
    - Allows shippers of any size (including small shippers) to use this most expedited dispute resolution process to obtain up to $1 million, with a filing fee of $150.
    - Establishes an expedited procedural schedule that calls for a Board decision within approximately eight months of filing a complaint
    - Changes previous Board policy by providing a complaining shipper access to the unmasked Waybill Sample. The Waybill Sample is a database of nationwide shipments by rail carriers. The unmasked version includes confidential contract revenue information.
    - Provides a more detailed explanation of how the comparison group should be developed. Comparability will be determined by reviewing a variety of factors, such as length of movement, commodity type, traffic densities of the likely routes involved, and demand elasticity (although the comparison group need not have movements with identical demand). Movements with different cost characteristics may be included in the comparison group. Only movements of the defendant carrier may be included in the comparison group and the movements must be drawn from the Waybill Sample provided to the parties by the Board at the outset of the case.
    - Establishes a "final offer" system for selecting the comparison group. The shipper and railroad will each simultaneously tender their evidence regarding an appropriate comparison group. The Board must select the comparison group that it concludes is most similar in the aggregate to the issue movements, without modification.

- Corrects the calculation of the Revenue Shortfall Allocation Method (RSAM) benchmark, to ensure that when a carrier is not "revenue adequate" under the Board's annual calculations, the carrier's RSAM benchmark will be greater than its $R/VC_{>180}$ benchmark.
- Uses a single formula for the RSAM benchmark figure, instead of the previous range of values.
- Creates rebuttal presumptions as to the reasonableness of the challenged rate based on the relationship between the R/VC_{COMP}, RSAM and $R/VC_{>180}$ benchmarks. Each movement in the selected comparison group will be adjusted by the ratio of RSAM ÷ $R/VC_{>180}$ to reflect the revenue needs of the defendant carrier. If the challenged rate is above the mean (with a confidence interval) of the adjusted comparison group, it will be presumed unreasonable.

* Creates a Simplified Stand-Alone Cost methodology for medium-sized rail rate disputes. Specifically, this methodology:
    - Allows any shipper to use this process to obtain up to $5 million in relief, with a filing fee of $10,600.
    - Establishes an expedited procedural schedule that calls for a Board decision within approximately 17 months of filing a complaint.
    - Focuses the analysis on whether the carrier is abusing its market power by charging more than it needs to earn a reasonable return on the replacement cost of the infrastructure used to serve that shipper.
    - Simplifies and standardizes the route selection, traffic group selection, configuration, road property investment calculation, operating plan determination and operating expenses calculation, greatly reducing the cost of bringing a case before the Board.