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TRANSPORTATION REPORT

From: Terry Whiteside

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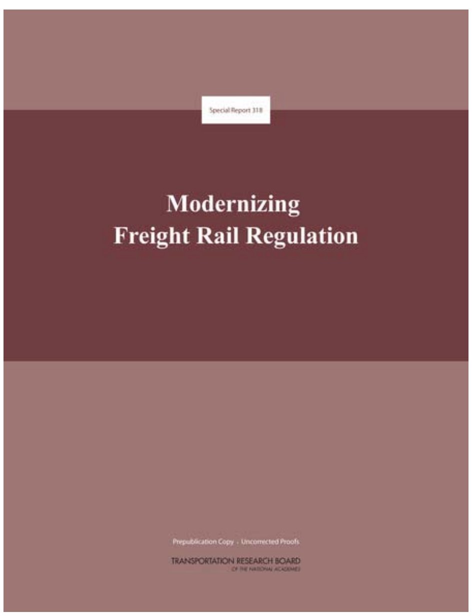
IMPORTANT NEW REPORT SAYS U.S. FREIGHT RAIL REGULATIONS OUTDATED, RECOMMENDS MODERNIZATION EFFORTS



The last major railroad reform law was the Staggers Rail Act passed in 1980 reform law which was designed to enable the modernization and stabilization of the U.S. freight railroad industry and stave off any future railroad bankruptcies. At the time of the passage of the Staggers Rail Act, the Penn Central, The

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Chicago and North Western, The Chicago, Milwaukee, St. Paul and Pacific Railroad (the Milwaukee Road), the Boston and Maine, and several others were in bankruptcy and the future of more bankruptcies were on the horizon. The effect of lightened regulatory oversight together with a host of railroad mergers that has massively concentrated railroad pricing power has brought the railroads to the enviable position of being ranked by Fortune magazine as the 5th most profitable industry in the U. S.

The Staggers Rail Act of 1980 eliminated or eased many regulations governing railroad pricing and operations and allowed railroads to redress decades-long declines in traffic, stagnant productivity, and oversized networks that had become chronically under-maintained and misaligned with demand. By the late 1990s, the Staggers Rail Act had succeeded in spurring the development of a financially stronger, more productive, and more innovative railroad industry that was better able to compete with trucks, invest in capacity, and respond to shippers' needs. The seven Class I railroads[1] left from the 41 that operated in 1979 had shed most of their legacy uneconomic capacity and become adept at operating and pricing in a deregulated environment

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[1] The seven Class I railroads in order of revenue are BNSF Railway Company, Union Pacific Railroad Company, CSX Transportation, Grand Trunk Corporation (Canadian National's U.S. operations), Kansas City Southern Railroad Company, Norfolk Southern Railway, and Soo Line Corporation (Canadian Pacific's U.S. operations). They accounted for 94 percent of railroad industry revenues in 2013.

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that favored tighter levels of capacity than the regulated railroads had long been required to maintain[2].

Approximately one-third of all freight traffic today is moved by rail, and shippers of bulk commodities such as grain, coal, and chemicals remain especially dependent on rail. Since 2000 their freight rates have been rising faster than inflation, and complaints about unreliable railroad service have been voiced by some shippers, the report says. Under the Staggers Rail Act, shippers have the ability to challenge some rates that seem unreasonable, but the formula used to identify unusually high rates that can be challenged is arbitrary and unreliable.

Since 1980, however, federal regulation has not kept pace with the industry's transformation. The National Acedemy of Sciences about 1 ½ years ago started and in-depth analysis of the industry, looking at the major components of the industry, the rail shipping community and concluded with a report issued on June 10th that the system of regulatory oversight should replaced with a system better-suited for today's freight rail system . This report by the Transportation Research Board of NAS outlines and lays out its case for

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[2] Two of the principles, the report writers sought out - Gallamore (1999) and Gaskins (2008) give firsthand accounts of the difficulties that some railroads had in adapting to the new environment at the outset of deregulation and of how the adaptations were eventually made.

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suggested change to Congress in the Congressional mandated report . The Report states that current policies designed to protect rail shippers who lack transportation options from excessive rates are not working for shippers of most commodities, including grain. The committee heard from Bruce Carlton, National Industrial Transportation League; Thomas Schick, American Chemistry Council; Paul Gutierrez and Brian Cavey, Consumers United for Rail Equity; Daniel Jaffe, Western Coal Traffic League; Thomas Canter, National Coal Transportation Association; Mark Fisher and Randy Gordon, National Grain and Feed Association; and Terry Whiteside, Alliance for Rail Competition. The Alliance for Rail Competition during the fact gathering period, appeared and testified before the TRB about grain and grain railroad transportation problems. The report focused on more appropriate, reliable, and usable procedures that are needed to resolve rate and service disputes between grain shippers and railroad without threatening the earnings railroads need to pay for their capital-intensive networks.

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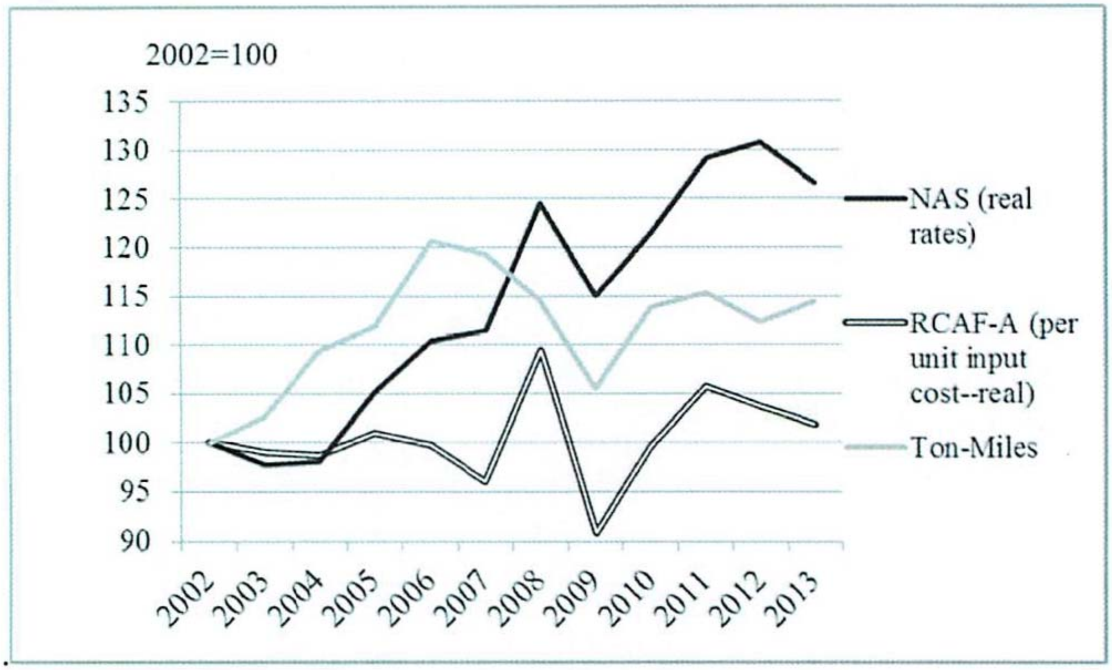

From TRB Special Report 318 – Modernizing Freight Rail Regulation, Page 51

The report was presented to the STB at its hearing on Ex Parte No. 665, Sub 1 RAIL TRANSPORTATION OF GRAIN, RATE REGULATION REVIEW on June 10th by Richard Schmalensee, Howard W. Johnson Professor of Management Emeritus and professor of economics emeritus at the Massachusetts Institute of Technology.

The committee that wrote the report recommended that the U.S. Department of Transportation develop, test, and refine a more reliable tool that compares disputed rates to those charged in competitive rail markets for comparable shipments. The goal appears to be to develop faster and less costly

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(economical methods) for judging the reasonableness of rates and service. Note: Repealing the current formula would require congressional action.

This replacement would, in turn, allow the Surface Transportation Board (STB), which regulates railroads, “to use faster and more economical methods for judging whether a shipper paying an unusually high rate is entitled to relief.” Customary STB adjudication methods can cost millions of dollars for litigation and some have taken years to resolve (McCarty Farms grain case – estimated cost $3M + and 18 years to a ultimate loss), deterring shippers with smaller claims from seeking rate relief. Simplified methods that are economically valid and useable have yet to be developed at the STB (one of the main purposes of Ex Parte 665 Sub 1 currently under review).

1. The committee recommended STB hearings that are used to rule on whether a challenged rate is reasonable be replaced with independent arbitration hearings that compel faster, more economical resolutions of rate cases.
2. The committee also recommended permitting parties in rate arbitrations to propose reciprocal switching – allowing shippers to transfer freight at the interchange of tracks owned by competing railroads – as a remedy for unreasonable shipping rates.

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The Staggers Rail Act mandates that regulators not grant rate relief so freely that railroads are denied the revenues they need to invest in their networks, and the committee recognized that railroads need to be able to charge rates that generally exceed their operating costs.

"The committee's two main recommendations go hand-in-hand," said committee chair Richard Schmalensee.

"Currently, burdensome STB rate hearings compensate for an unreliable initial process for identifying unusually high rates and in effect, they safeguard railroad revenues by making it too costly for most shippers to litigate a case. So, a more credible method for identifying unusually high rates would permit the use of less burdensome arbitration procedures, while not risking the adequacy of railroad revenue."

STB should, according to the study, discontinue issuing annual reports on the revenue adequacy of individual railroads, and its responsibility for reviewing railroad mergers should be transferred to the U.S. Department of Justice because these STB functions no longer serve their original purposes. There are several major shipper coalition that oppose the idea of doing away with

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Revenue Adequacy determinations based upon the idea that railroads operating above the revenue adequacy threshold are limited in their ability to price diffentially to captive shippers.

3. Finally, the committee recommended a thorough review of the data collection and dissemination practices of STB. Data that would permit systematic assessment of railroads' service quality would be especially valuable.

The study was sponsored by the U.S. Department of Transportation. The National Academy of Sciences, National Academy of Engineering, Institute of Medicine, and National Research Council make up the National Academies. They are private, independent nonprofit institutions that provide science, technology, and health policy advice under a congressional charter granted to NAS in 1863. The National Research Council is the principal operating arm of the National Academy of Sciences and the National Academy of Engineering. For more information, visit http://national-academies.org.

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