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ARC Represents Members Before Surface Transportation Board

One of the key benefits of ARC membership is representation on major issues before the Surface Transportation Board. This high level representation can be equated into thousands of dollars of savings for each ARC member every year. Additionally, ARC representation serves to allow companies, through their membership, to participate in important industry shaping rule making which potentially affects each company's financial stability.

The table below provides a list of major proceedings in which the Alliance for Rail Competition has participated on behalf of its members during the past two years. Enclosed are the testimony filed with the STB for the Rail Infrastructure and Capacity hearing to be held on April 12, 2007.

Case	Issue	ARC Activity	Result
Ex Parte No. 575	Paper Barriers	ARC filed comments	Awaiting STB ruling
Ex Parte No. 646	Small Rate Case Rules issued by STB in 2006	ARC filed multiple comments jointly with 27 shippers	Awaiting STB ruling
Ex Parte No. 657	Rail Rate Challenges under Stand-Alone Costing	ARC led captive shipper comments working with 20 other parties	Awaiting STB ruling
Ex Parte No. 658	The 25th Anniversary of STB	ARC filed an extensive Opening and Reply Statements critiquing ICC/STB performance vs. the Staggers Rail Act	N/A
Ex Parte No. 661	Fuel Surcharges	ARC filed Open and Reply Statements and participated in oral hearing	STB rejected RR's arguments in the proceeding and ruled in favor of shippers by outlawing rate based fuel surcharges and 'double dipping' by rail carriers.
Ex Parte No. 665	Grain Rail Transportation	ARC filed comments	Awaiting STB ruling
Ex Parte No. 671	Rail Infrastructure and Capacity	Filing this week with ARC and Wheat & Barley Commission	Hearing to be held April 12, 2007; ARC to participate in oral hearing

BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 671

RAIL CAPACITY AND INFRASTRUCTURE REQUIREMENTS

COMMENTS OF
ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO WHEAT COMMISSION
IDAHO GRAIN PRODUCERS ASSOCIATION
MONTANA GRAIN GROWERS ASSOCIATION
NEBRASKA WHEAT BOARD
NEBRASKA WHEAT GROWERS ASSOCIATION
OKLAHOMA WHEAT COMMISSION
SOUTH DAKOTA WHEAT COMMISSION
SOUTH DAKOTA WHEAT INC.
TEXAS WHEAT PRODUCERS BOARD
TEXAS WHEAT PRODUCERS ASSOCIATION
WASHINGTON WHEAT COMMISSION
NATIONAL ASSOCIATION OF WHEAT GROWERS
NATIONAL BARLEY GROWERS ASSOCIATION
AND
THE HONORABLE BRIAN SCHWEITZER, GOVERNOR, STATE OF MONTANA

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Dated: April 4, 2007

I. INTRODUCTION

These comments are being filed on behalf of the Alliance for Rail Competition ("ARC"), sixteen groups of shippers of agricultural commodities (collectively, "Wheat and Barley Commissions"), and the Honorable Brian Schweitzer, Governor of Montana. ARC, et al. agree with the Board that the ability of the railroad industry to increase capacity to meet increasing freight volume is an important issue, and we welcome the opportunity to provide our views.

II. INTEREST OF ARC, ET AL.

ARC has been active for many years, before the STB and before Congress, in pursuing regulatory and legislative changes needed to foster conditions under which major railroads are more responsive to their customers' needs for dependable service without excessive rates or charges or unreasonable rules or operating practices. As the Board is aware, ARC does not view the regulatory status quo as acceptable. In ARC's judgment, STB regulation has served railroad industry revenue needs well, but has not properly implemented statutory protections for captive shippers. ARC's members include major shippers of agricultural commodities, chemicals, coal and other bulk products.

The Wheat and Barley Commissions share these concerns, and have also participated in STB proceedings, including proceedings addressing paper barriers, simplified standards for rail rate cases, rail fuel surcharges, the 25th Anniversary of the Staggers Rail Act, arbitration, rail mergers, and others. In Ex Parte No. 665, Rail Transportation of Grain, the Wheat and Barley Commissions filed opening comments, participated in the hearing and filed supplemental comments on January 12, 2007 documenting adverse impacts on the highway infrastructure of Montana caused by BNSF's efforts to discourage grain shippers' use of smaller local grain elevators.

Governor Brian Schweitzer has participated in comments filed by shippers, including ARC and the Wheat and Barley Commissions. The Governor testified at the Board's hearing in Ex Parte No. 661, Rail Fuel Surcharges, in order to call attention to rate and service issues associated with the state-wide dominance by BNSF of wheat transportation in Montana, which is the nation's third largest producer of wheat. In recent years, several members of the STB have visited Montana and heard from agricultural shippers about their rail transportation concerns, and the need for more effective competitive and regulatory responses to BNSF's exercise and abuse of its overwhelming market power (with control of over 90% of rail freight in the State).

ARC, et al. recognize the need for a strong national rail system. However, the STB would err as a matter of fact and as a matter of law to the extent that it equated the financial interest of the railroad industry with the public interest.

III. THE NEED FOR GROWTH OF THE NATION'S RAIL INFRASTRUCTURE

Despite the expansion of the service sector, much of the nation's economic strength depends on the movement of goods, and much of the nation's economic growth will depend on growth in the ability of the nation's carriers of all modes to transport goods.

Studies of freight growth over the next 10-20 years may vary in their details, and "offshoring," which is partly the result of high rail rates and poor rail service, may offset some growth in domestic freight volumes. There is nevertheless a clear consensus that the volume of freight moving in the U.S. is growing faster than the nation's investment in road, rail, water and air carrier infrastructure and capacity to handle that growth.

Most studies project greater growth in demand for trucking services than for rail services, consistent with the needs of integrated supply chains, just-in-time delivery schedules, and the reduced inventories that modern businesses strive to achieve. Motor carriers handle some 70% of domestic freight shipments, and the preference of most shippers for truck transportation is likely to continue.

However, the investment in highway construction and maintenance reflected in the most recent highway bill, SAFETEA-LU, which was enacted in 2005, fell far short of the amount needed. It was the judgment of key members of Congress that $375 billion over six years was needed merely to maintain current capacity. Unfortunately, Congress appropriated almost $100 billion less than that amount, and some 10% of the amount appropriated was "earmarked" to fund performing arts centers, bike trails and "bridges to nowhere."

In addition, there is resistance to increasing highway fuel taxes, and federal and state governmental authorities are looking increasingly to public private partnerships, tolling, privatization and similar unconventional financing arrangements for highways, despite their unpopularity with carriers, shippers and motorists. The ability of these approaches to meet the need for growth in the highway infrastructure is unclear.

To the extent that highway, air and water carriers fall short of meeting growing demand, rail carriers are likely to see increases in demand, over and above growth in the demand for transportation of high volume bulk commodities such as coal, grain, chemicals, etc., that have always been the railroads' specialty.

Though ARC, et al. have sometimes been characterized erroneously as adversaries of the railroads, most of the shipper interests represented by ARC, et al. are shippers of such large volume bulk commodities. As rail dependent shippers and as representatives of rail dependent shippers, ARC, et al. have a direct interest in seeing the rail infrastructure expand in ways that will ensure continued and improved service for their shipments.

It was partly for this reason that S. 919, the Railroad Competition Act of 2005, which ARC strongly supported in the 109th Congress (and which the railroads opposed), included provisions for over $35 billion in new rail infrastructure funding.[1] ARC continues to support public funding of expanded rail infrastructure.

However, as with any public policy initiative, there are better ways and worse ways to achieve even desirable goals. ARC, et al. anticipate that the major railroads and their supporters will call on the Board to promote rail infrastructure growth. While ARC, et al. generally support that goal, the Board must recognize that railroads enjoy significant monopoly power as to many shippers, receivers, commodities and regions.

Rail pricing, service and operations are frequently <u>not</u> constrained by market forces or competition, and tight capacity for alternative modes of transportation may serve to increase the railroads' market power. Accordingly, the Board must be careful to strike an appropriate balance between the railroads' desire to control existing capacity and add new capacity, and captive shippers' need for protection against abuses of rail market power.

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[1] The counterpart of that bill in the 110th Congress, S. 953, excludes infrastructure funding only because its sponsors expect stand-alone legislation to be introduced on an Investment Tax Credit for railroads.

In this proceeding, the Board is likely to confront three fundamental questions of railroad regulation. First, what is the true extent of current and projected shortages in rail capacity? Second, in allocating existing capacity, should railroads have a free hand to provide or maximize service to some shippers, and deny or minimize service to others, as they see fit, or should certain service obligations be imposed on the railroads? Third, in adding new capacity, should railroads have a free hand to decide where and now to invest, and also how to fund their investments, or should their ability to invest and their ability to raise rates and charges to fund investments be supervised? ARC, et al. will address these questions in turn.

IV. <u>THE BOARD SHOULD MONITOR RAIL CAPACITY AND INFRASTRUCTURE INVESTMENT</u>

Because rail captive shippers have already borne a disproportionate share of the cost of restoring railroads to financial strength, ARC, et al. do not want capacity concerns to become a rationale for further and worse differential pricing of captive traffic, or for further reductions in the frequency and quality of rail service.

For reasons set forth below, even genuine capacity shortages do not, in our view, justify such measures. It would be even worse if captive shippers were to be hit with new increases in rates and charges and new service cuts based on mere allegations of or worries about a capacity "crisis."

Accordingly, ARC, et al. believe the Board should monitor existing demand and capacity, as well as projections of future growth in freight volume and projected capacity investments and additions by railroads.

No one wants to return to the service problems experienced in the wake of the UP/SP merger or the acquisition of Conrail by NS and CSX. Major railroads were unable to meet service needs for weeks, even though they had assured the Board and their customers that the transitions would be smooth. In recent years, the Board has called on the major railroads to provide information about their ability to meet peak fall shipping requirements. ARC, et al. commend the Board for such initiatives, and for instituting this proceeding, which will provide additional information.

Further measures along these lines are warranted. For example, to the extent that isolated capacity shortages occur, the Board must promptly use its investigatory powers to determine why they occurred, what short-term relief is available, and what steps can be taken to prevent a recurrence.

The Board must also investigate ways in which efficiency gains can contribute to the railroads' ability to handle more freight with existing infrastructure and equipment. For example, increases in average train speeds translate into additional system capacity. Better coordination among railroads, to minimize circuitous routings, could have similar benefits.

The Board should also consider returning to this issue periodically, through further hearings like the one scheduled for April 11, 2007, as a means of tracking capacity needs and railroad responses to shipper demand. In the course of its analyses the Board should also monitor and compare increases in capacity and efficiency by the motor, water and air carrier industries. These improvements could set a benchmark for railroads.

V. THE RAILROADS' DECISIONS IN ALLOCATING SCARCE CAPACITY MUST ACKNOWLEDGE THE COMMON CARRIER OBLIGATION AND THE PUBLIC INTEREST

ARC, et al. will not be surprised if the railroads argue that they are in the best position to determine the optimal allocation of scarce capacity, where capacity is scarce.

The railroads may also be expected to argue that any allocation that is consistent with economic considerations, i.e., that favors the most profitable service, should not be subject to regulatory second-guessing.

ARC, et al. do not believe that major railroads are indifferent to the reliance interests of their long-term customers, or to the disruption and economic dislocation that could result from arbitrary service curtailments. However, economic forces and pressure from Wall Street, neither of which is a negligible consideration, create incentives for railroads to manage shortages in ways that elevate the interests of railroad stockholders above all other interests. As publicly-held corporations, railroads must be responsive to shareholder interests and to economic considerations. However, the law has, for over 100 years, recognized that there is also a public interest dimension to railroads. This is reflected in the Rail Transportation Policy of 49 U.S.C. § 10101, and in the common carrier obligation set forth in 49 U.S.C. § 11101:

> (a) A rail carrier providing transportation or service subject to the jurisdiction of the Board under this part shall provide the transportation or service on reasonable request. A rail carrier shall not be found to have violated this section because it fulfills its reasonable commitments under contracts authorized under section 10709 of this title before responding to reasonable requests for service. Commitments which deprive a carrier of its ability to respond to reasonable requests for common carrier service are not reasonable.

The Act thus mandates service where the shipper's request for service is reasonable. Unlike unregulated companies, monopoly railroads are not free to decide for themselves, based on their own self interest, what service to provide and what service to decline to provide. And where disputes arise, the STB has a role to play in resolving the disputes consistent with the law and with sound policy.

As excess rail capacity gives way to constrained rail capacity, the Board faces new challenges in applying the Act and national policy. On the short notice available for these Comments, a comprehensive analysis of these issues by ARC, et al. has not been possible. However, we offer the following as considerations the Board should evaluate as alternatives to simply rationing available rail capacity on the basis of the highest bidder.

- Some shippers are more rail-dependent than others.
- Some regions of the country are more rail-dependent than others.
- Some shippers have "paid their dues" through years, or decades, of differentially higher prices than other shippers have paid.
- Some commodities, because of their importance for the health, welfare and security of the nation, should be recognized as necessities, and given priority when rail service is scarce.
- Some commodities can be diverted to other modes easily; others cannot.
- Some commodities would benefit more from small efficiency improvements in rail operation than others.

ARC, et al. note that the Board has offered no proposals in connection with this proceeding. We therefore regard the April 11 hearing as an opportunity for the Board to begin to identify relevant issues and to consider potential remedies. In that process, the railroads' common carrier obligation must not be ignored or weakened.

VI. RAILROAD INFRASTRUCTURE INVESTMENT NEEDS MUST NOT TRUMP THE BOARD'S REVENUE ADEQUACY CONSTRAINT

Turning to issues raised by railroad investment in new capacity, ARC, et al. and other captive shippers are concerned that the Board not weaken or abandon the revenue adequacy constraint of Constrained Market Pricing in promoting railroad industry infrastructure investment.[2]

The Board has limited authority to tell railroads where to build new lines or extend existing lines. However, the Board has exclusive jurisdiction over rail rates and charges (except where freight moves under contracts). Accordingly, there may be STB personnel who see a green light for rail rate increases as the best way the Board can assist railroads to increase capacity. Such reasoning is flawed.

In the first place, rail rate regulation by the STB is already virtually nonexistent. Recent decisions under the stand-alone cost test have almost all been favorable to defendant railroads. In addition, while the Board recently modified the SAC test in its decision served October 30, 2006 in Ex Parte No. 657 (Sub-No. 1), Major Issues in Rail Rate Cases, most shippers who have analyzed that decision believe it will make large rate cases more expensive to litigate and harder to win. In addition, many large shippers will have no hope of even testing their rates in a SAC case due to the segment cross-subsidy test adopted in PPL Montana and expanded in Otter Tail.

Only two smaller rate cases have even been commenced under the simplified standards adopted in Rate Guidelines – Non-Coal Proceedings, 1 S.T.B. 1004 (1996). One of those cases was promptly settled, and the other was filed only recently. Moreover, in its pending proceeding in Ex Parte No. 646 (Sub-No. 1), Simplified Standards for Rail Rate Cases, the Board has proposed to require a version of the SAC test for virtually all rate cases not litigated under full-SAC, and such cases would again be subject to dismissal based on the segment cross-subsidy threshold test.

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[2] See Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520 (1985), aff'd., Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987).

The comments filed in that proceeding make it plain that captive shippers do not regard the Board's proposed Simplified SAC approach as an effective remedy for excessive differential pricing and unlawfully high rates imposed by market dominant railroads.

The absence of effective rate case methodologies creates the danger that railroads interested in expanding capacity will simply fund their infrastructure investments through more differential pricing of captive traffic. Comments filed by railroads in Simplified Standards for Rail Rate Cases suggest that this may be their intent. Not only might captive shippers face rate increases that are far out of proportion to any service improvements offered to such shippers, but there could be few remedies for captive shipper rate increases by railroads that provide no benefit at all to such shippers, or that result in worse service for such shippers.

Consider a simplified hypothetical example. BNSF controls over 90% of grain shipments from Montana to customers and to Pacific Northwest ports from which the grain is exported. Accordingly, BNSF has little reason to fear loss of such captive shippers' business. BNSF could increase such shippers' rates not because Montana grain shippers are paying too little for the service they receive,[3] but because BNSF wants to invest in additional capacity to haul international container traffic from the Ports of Los Angeles and Long Beach to "big box" stores near major population centers. Assuming additional capacity for such merchandise traffic is desirable, why should Montana grain shippers be exposed to higher rates (and possibly worse service) to help BNSF achieve that goal? Why shouldn't such investments be funded primarily or entirely by their beneficiaries?

[3] As detailed in the January 12, 2007 filing by the Wheat & Barley Commissions and by Governor Schweitzer in Rail Transportation of Grain, BNSF rates on Montana grain are already higher than rates paid by competitors in neighboring states, and service quality leaves much to be desired.

Absent new regulatory remedies, the main protection against such cross-subsidies for most captive shippers is likely to be the Board's revenue adequacy constraint. As explained in Coal Rate Guidelines, the revenue adequacy constraint is firmly grounded in the statute, which requires the agency to "make an adequate and continuing effort to assist" the railroads in earning adequate revenues. See 1 I.C.C. 2d at 535 and 49 U.S.C. Section 10704(a)(2).

The explanation in Coal Rate Guidelines goes on to say that revenues are adequate when they equal the current cost of capital, and that this is a reasonable level of profitability for a healthy carrier. (Id.) As relevant here, once revenue adequacy is achieved, the statutory command to assist carriers has been met:

> 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.

1 I.C.C. 2d at 535-6.

It is important to understand that the attainment of revenue adequacy does not mean railroads cannot raise their rates. The need to keep up with inflation means that railroads may fall back below revenue adequacy if they do not raise rates enough to cover cost increases they experience (assuming "honest, economical and efficient" management as required by 49 U.S.C. § 10704(a)(2)). However a railroad should "not use differential pricing to consistently earn, over time, a return on investment above the cost of capital." Moreover, a "railroad seeking to earn revenues that would provide it, over the long term, a return on investment above the cost of capital would have to demonstrate with particularity (1) a need for higher revenues; (2) the harm it would suffer if it could not collect them; and (3) why the captive shippers should provide them." Coal Rate Guidelines, 1 I.C.C. 2d at 536.

This does not mean that infrastructure investment must be underfunded. Investment tax credits aside, companies earning their cost of capital are, by definition, able to obtain financing in capital markets, as the major railroads have done for years. Evidence filed recently by the Western Coal Traffic League in Ex Parte No. 664, Methodology to Be Employed in Determining the Railroad Industry's Cost of Capital, adds to the growing weight of evidence that all of the nation's Class I railroads are currently earning their cost of capital.

In addition, there is no statutory limit on the railroads' ability to raise rates and charges paid by shippers who are not captive. With increasing demand for rail service and with tighter capacity, railroads have in recent years dramatically increased their revenues from transportation services over which they lack market dominance. This trend is certain to continue as freight volumes increase. In its October 30, 2006 Decision in Ex Parte No. 657, Major Issues in Rail Rate Cases, the Board recognized "the important principle that a railroad should recover as much of its costs as possible from each shipper served before charging differentially higher rates to its captive shippers." Decision at 12 and 16. This principle, and fundamental fairness, require that the costs of expanded infrastructure must not be shifted from direct beneficiaries to captive shippers whose benefits are indirect or nonexistent.

The revenue adequacy constraint is only intended to constrain differential pricing. It is not a constraint on railroad revenues. As such, it is a critical tool preventing infrastructure investment through the abuse of market power, while not preventing railroads from expanding capacity.

VII. CONCLUSION

As the railroads confront capacity shortages of varying scope on their systems, and consider investment in infrastructure and capacity to meet future demand, two very different scenarios are possible.

In one scenario, railroads cite or engineer artificial shortages in order to justify increased rates and charges and further transfers of operating costs to captive shippers. Infrastructure investment is deliberately underfunded in order to avoid surplus, railroads auction off new and existing capacity to the highest bidders, and captive shippers experience rate increases and service cuts in order to permit railroads to expand capacity and improve service for non-captive customers.

In the other scenario, railroads allocate limited capacity fairly, minimizing service disruptions and maintaining reasonable service levels for existing customers. Capacity shortages are not exaggerated as a scare tactic, and railroads pursue efficiency gains. Railroads invest in new capacity with a view to avoiding service curtailments, but strive to recover the costs of such investments through rate increases that fall mainly or entirely on the shippers who benefit. Differential pricing of captive traffic is phased out as adequate revenues are earned from all rail customers, captive and non-captive.

There can be no doubt that the second of these scenarios is preferable as a matter of sound public policy, and this should be the scenario the Board encourages and requires. It is also the only scenario that comports with fundamental STB ratemaking principles. As the Board summarized these principles in Major Issues in Rail Rate Cases:

> A captive shipper should not be required to pay more than is necessary for the carrier involved to earn adequate revenues. Nor should it pay more than is necessary for efficient service. And a captive shipper should not bear the cost of any facilities or services from which it derives no benefit.

October 30, 2006 Decision at 7.

ARC, et al. urge the Board to adhere to these principles as it monitors and guides efforts by railroads to deal with, and mitigate, capacity shortages.

Respectfully submitted,

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