Railroad Access and Competition Issues

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Summary

Some bulk shippers, particularly those that are served by, or, in the view of some, "are captive to," one railroad, are extremely frustrated with what they perceive as poor rail service and exorbitant rail rates. "Captive shippers" claim that the railroad serving them acts like a monopoly—charging excessively high rates and providing less service than they require. Beginning in the late 1970s, Congress gave railroads flexibility to set rates and to enter into confidential contracts with their customers. Over the last decade, large railroads have consolidated and, particularly in the past two years, have achieved higher profitability. Some Members of Congress believe that the present, mostly deregulated, regime needs to be revised to provide more weight for the interests of "captive shippers." A major point of contention is whether current railroad industry practices should be changed to provide "captive shippers" with more railroad routing options.

Legislation has been introduced in the 110th Congress that would overrule regulatory decisions preventing shippers from gaining access to a second railroad—The Railroad Competition and Service Improvement Act of 2007 (S. 953, introduced by Senator John Rockefeller and H.R. 2125, introduced by Representative James Oberstar). This proposal would markedly change current railroad practices to allow "captive shippers" more access to competing railroads by addressing "bottlenecks," "paper barriers," and "terminal switching arrangements." A bottleneck refers to a situation in which only one railroad serves a particular origin or destination but a competing railroad provides parallel track over at least a portion of the route. Currently, the bottleneck carrier is not required to interchange traffic with the competing carrier but captive shippers seek legislative or regulatory change requiring the bottleneck carrier to do so. Paper barriers are contractual agreements between a large railroad selling or leasing a less profitable route segment to a smaller railroad. The agreement typically requires the smaller railroad to interchange all of its traffic with the large railroad, even if it has access to another railroad's network. These agreements are a means of reducing the up-front sale or lease price while enabling the selling railroad to still recover the full value of the route over time. Terminal switching refers to interchanging traffic between competing railroads wherever a terminal provides the possibility to do so. Currently, railroads interchange traffic at terminals only where they find it mutually beneficial to do so.

One issue for Congress is balancing the railroads' ability to earn revenue sufficient to reward shareholders, as well as maintain and improve its network, and the need of captive shippers for reasonable rates and adequate service. However, the captive shipper issue has wider economic implications than just the question of a division of revenue between railroads and their captive customers. Higher fuel prices, congestion on certain segments of the interstate highway system, and rising domestic and international trade volumes are driving shippers to demand more rail capacity. Freight revenues are a significant means of financing rail capacity because the railroads receive negligible public financing. Therefore, a larger policy question is how a legislated solution to the "captive shipper" problem would affect the development of a more robust and efficient railroad system.

Contents

Figures

Contacts

Introduction

Over the last decade, Class I railroads have consolidated and, particularly in the past two years, have achieved higher profitability.[1] The present, mostly deregulated, railway regime was designed during a period when railways were in financial peril. Beginning in the late 1970s, as part of a fundamental change in philosophy that affected the regulation of all modes of transportation, Congress gave railroads more flexibility to set rates and negotiate confidential contracts with their customers. Some Members of Congress believe that the present, mostly deregulated regime needs to be revised to provide more balance for the interests of those rail customers who are served by only one railroad. A major point of contention is whether current railroad industry practices should be changed to provide these customers (referred to as "captive shippers") with more routing options.

Captive rail shippers have been frustrated with what they perceive as poor rail service and exorbitant rail rates. These shippers often cannot ship their product economically by truck because of the bulk quantity or long distance of their shipments and do not have viable access to a navigable waterway to ship by barge. Captive shippers claim that the railroad serving them acts like a monopoly—charging excessively high rates and providing less service than they require.

Captive rail shippers are a minority of all rail customers (by one estimate, accounting for 15% to 20% of all rail movements[2]), and the argument between them and the railroads is long-standing. However, the captive shipper issue has wider economic implications than just the question of a division of revenue between captive shippers and the railroads. The captive shipper problem raises an important policy question for Congress: could more rail-to-rail competition lead to a more robust and efficient railroad system or could it undermine it by discouraging investment in rail infrastructure?

This report provides background on the current railroad regulatory regime. It then examines the three main points of contention between railroads and their captive customers: "bottlenecks," "paper barriers" (also known as "interchange commitments"), and "terminal switching arrangements." It discusses legislation addressing these issues as well as shipper and railroad points of view. The last section of the report discusses the implications of injecting more rail-to-rail competition into the industry.[3]

[1] The Association of American Railroads categorizes railroads based on annual revenues. Class I railroads had revenue of at least $289.4 million in 2004, regional railroads operate at least 350 route-miles and/or had revenues of at least $40 million but below the Class I threshold, and local railroads operate less than 350 route-miles and had revenues of less than $40 million per year. In this report, the terms Class I and main line railroad are used interchangeably while the term short-line railroad is used to mean both regional and local railroads.

[2] An estimate by the former chairman of the Surface Transportation Board (STB) is that about 80% of rail customers are served by only one railroad, but that because most of these customers can also ship by other modes, only about 15% to 20% of all rail movements would be judged captive by the STB. Oral testimony of STB Chairman Roger Nober, House Committee on Transportation and Infrastructure, Subcommittee on Railroads, *Status of Railroad Economic Regulation*, March 31, 2004, p. 10.

[3] Captive shippers also seek changes in the regulatory process for determining the reasonableness of rail rates but generally view greater rail-to-rail competition as a more effective means of addressing both rail rate and rail service issues.

Regulatory Background

The last major changes to U.S. law governing rail economic regulation were the Railroad Revitalization and Regulatory Reform Act of 1976 (the so-called "4R Act," P.L. 94-210; 90 Stat. 31) and the Staggers Rail Act of 1980 (P.L. 96-448; 94 Stat. 1898). At that time, there was a widely held view that the U.S. railroads were in a severe and prolonged period of financial decline, and that much of that decline was the result of strict federal regulation of railroad activities. Railroad deregulation was part of a larger movement toward deregulation of all modes of transportation in the late 1970s and early 1980s. Before 1976, the Interstate Commerce Commission (ICC) reviewed almost all rail rates to determine whether they were reasonable and rail shippers were given wide latitude in selecting the routes over which their shipments would travel and the railroad companies that would participate in their traffic. The 4R Act was mostly about restructuring the Northeast railroads and creating Conrail, as well as subsidizing branch lines, but one provision exempted, for the first time, railroad traffic from regulation if the regulation was deemed by the ICC to be an undue burden to commerce and served no useful purpose.[4] The 4R Act also introduced the concept of "market dominance," which the act describes as the "absence of effective competition from other carriers or modes of transportation, for the traffic or movement to which the rate applies." The act directed the ICC to establish standards and procedures for determining when a railroad possesses market dominance over a route.[5] The Staggers Act greatly advanced the movement toward railroad deregulation by granting railroads more freedom to set rates and enter into confidential contracts with their customers. Rates negotiated under contract are not subject to regulatory review on the assumption that a contract reflects shipper and railroad agreement.[6] However, rates published in tariffs and rates for captive traffic are still subject to regulatory oversight.

The Interstate Commerce Commission Termination Act of 1995 (P.L. 104-88; 109 Stat. 803) abolished the ICC and replaced it with the Surface Transportation Board (Board or STB). The ICC Termination Act eliminated many of the functions of the ICC but transferred its remaining functions to the STB. The STB is bipartisan and decisionally independent from, but organizationally housed within, the U.S. Department of Transportation (DOT).[7] The ICC Termination Act left largely intact the regulatory framework that governs captive rail shipper issues. Authorization of the STB expired September 30, 1998, but the agency continues to function through annual appropriations. The most notable issue associated with possible reauthorization of the Board, and the major reason for it not being reauthorized, is the captive rail shipper dispute.

Competition and railroad revenue adequacy figure prominently in national railroad policy. As stated in the Staggers Act and amended by the ICC Termination Act of 1995 (P.L. 104-88; 109 Stat. 803), in regulating the railroad industry, it is the policy of the United States Government "to allow, to the maximum extent possible, competition and the demand for service to establish reasonable rates..." and "to minimize the need for Federal regulatory control over the rail

[4] Section 207 of P.L. 94-210.

[5] Section 202 of P.L. 94-210.

[6] 49 USC 10709(c). (About 70% of rail tonnage moved under contract in 2004 according to the GAO report cited above, p. 24.)

[7] The three Board members are nominated by the President and confirmed by the Senate. The Chairman is appointed by the President.

transportation system and to require fair and expeditious regulatory decisions when regulation is required...."[8] The law also states a goal "to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Board" (the STB conducts an annual evaluation to determine railroad revenue adequacy based on established standards and procedures). The U.S. Department of Transportation (DOT), sharing the view of most observers, believes that the Staggers Act has been "profoundly successful," noting that today the railroads are financially healthy, productivity is high, the industry's infrastructure has been modernized, and shippers have benefitted from lower average rates.[9] A GAO study also notes that the rail industry's health has improved since Staggers but finds that while rates have declined, "they have not done so uniformly, and rates for some commodities are significantly higher than rates for others."[10] The GAO study notes that "the extent of captivity appears to be dropping, but the percentage of industry traffic traveling at rates substantially over the statutory threshold for rate relief has increased from about four percent of tonnage in 1985 to about six percent of tonnage in 2004."[11] The GAO states that "these findings may reflect reasonable economic practices by the railroads in an environment of excess demand, or they may indicate a possible abuse of market power."[12]

Competitive Access Issues and Legislation

The extent that a rail customer should have access to a second, potentially competing railroad is referred to as "competitive access" (shippers sometimes use the term "open access" and railroads use the term "forced access"). Unlike highways, waterways, and airways, which are publicly owned and over which carriers within these respective modes compete against each other for freight or passengers, railways are privately owned and each railroad has exclusive access to its rights-of-way. However, while railroads generally have exclusive access to their rights-of-way, they do share their rights-of-way with other railroads in circumstances where they find it is mutually beneficial to do so. For instance, if two railroads own parallel track in a relatively light traffic area, they may agree to abandon one track and share the other to reduce maintenance costs. Or, in a dense traffic lane, they may agree to designate each track for one direction (i.e., a west-bound track and an east-bound track) to increase train fluidity through the area. However, neither of these situations involves granting access to each other's customers.

In other situations, the STB has required railroads to share track, including access to potential customers on a route, as a condition for approving a merger. For instance, as a condition for approving the merger between Union Pacific (UP) and Southern Pacific (SP) in 1996, the STB granted the BNSF and other railroads trackage rights over about 4,000 miles of track because otherwise the merger would have reduced the number of railroads serving certain shippers from two to one.[13] In the case of the breakup of Conrail in 1997, the two acquiring railroads, Norfolk

[8] See 49 U.S.C. 10101.

[9] Written testimony of Jeffrey N. Shane, Under Secretary for Policy, U.S. DOT, STB hearing, *Rail Capacity and Infrastructure Improvements*, STB Ex Parte No. 671, April 11, 2007.

[10] GAO, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should be Addressed*, GAO-07-94, October 2006, p. 3.

[11] Ibid., p. 19.

[12] Ibid., p. 3.

[13] Trackage rights are the authority granted to one railroad to use the tracks of another railroad for a fee.

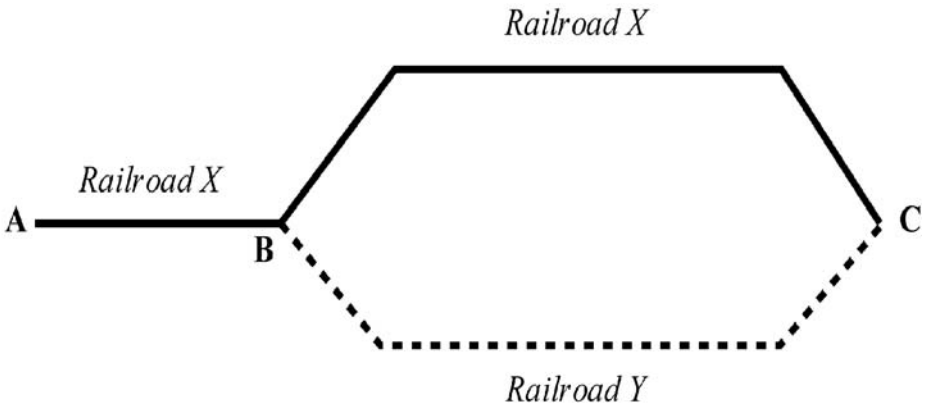
Southern (NS) and CSX, share some of the lines and terminals of the former railroad.[14] Other merger remedies include "switching arrangements" where one carrier transports the railcars of a competing carrier at origin or destination for a fee and "terminal access areas" where the terminal owning railroad allows trains from a competing railroad to use the terminal for a fee. While these track sharing circumstances are not uncommon, neither are they universal.

Legislation has been introduced in the 110th Congress that would allow shippers significantly more access to competing railroads—The Railroad Competition and Service Improvement Act of 2007 (S. 953, introduced by Senator John Rockefeller and H.R. 2125, introduced by Representative James Oberstar). Among other provisions, this legislation addresses three contentious issues between captive shippers and the railroads: "bottlenecks," "paper barriers," and "terminal switching arrangements."

Bottlenecks

A bottleneck refers to a situation where only one railroad has track serving a particular origin or destination but where another railroad also owns track that parallels at least a portion of the route between the same origin and destination. This situation is most easily explained with a diagram.

Figure 1. A Bottleneck Situation



Source: CRS.

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.

Bottleneck rate practices were affirmed by the STB in December 1996 in its ruling on three coal rate cases brought by several utilities.[15] The STB ruled that railroads did not have to "short-haul"

[14] For details of this arrangement, see http://www.conrail.com/Freight.htm.

[15] Central Power & Light Co. v. Southern Pacific Transp. Co., 1 STB 1059 (1996) ("Bottleneck I"), modified in part, 2 (continued...)

themselves by offering rates on only a portion of a route if they could serve the entire route. The Board cited the section of statute that states that a rail carrier may establish "any rate for transportation or service."[16] The Board decided that a railroad only has to offer a rate on the one route the railroad deems most efficient for handling the cargo. A railroad does not have to offer rates for any alternative routes that the shipper requests. The STB did establish an exception to this ruling. If a shipper has already entered into a contract with the non-bottleneck carrier for the non-bottleneck portion of the route (in other words, in the diagram above, a contract with *Railroad Y* for the movement between points B and C), then the bottleneck railroad (*Railroad X*) must in fact segment the route and offer a separate rate for the bottleneck (short-haul) portion of the shipment. In practice, however, the non-bottleneck railroad generally has not entered into a contract with a shipper under these circumstances.

H.R. 2125 and S. 953 would require railroads to provide a rate on any bottleneck segment of a route. Thus, in **Figure 1** above, a shipper located at origin A could require railroad X to quote rates from both A to B and from B to C. It could also seek a rate from railroad Y from point B to C. If the shipper chose railroad Y to carry its traffic from B to C, railroad X would be required to interchange the traffic at point B.

Bottlenecks and Railroad Mergers

In 1970, there were 71 Class I railroads in the United States. Today there are seven (two of which are Canadian railroads with U.S. subsidiaries). Captive shippers contend that the consolidation of the railroad industry has led to more bottleneck situations in the nation's rail network. Railroads contend that the number of captive shippers has remained about the same throughout the merger process. They assert that this is because the STB has required railroads to share access to track as a condition for approving a merger in those instances where the merger would otherwise result in captive traffic (as described above).

In addition to these merger remedies, railroads also contend that recent mergers have not resulted in more captive shippers because most mergers since 1980 have been "end-to-end" consolidations rather than mergers between neighboring railroads with parallel track. In an effort to exploit their comparative advantage (long-distance movement of freight), the Class I railroads have sought mergers with their interline partners, that is, with a railroad whose route network begins at the end point of their route network. By reducing the amount of interchanging between interline railroads, railroads believe that a merged railroad can better streamline its operations. In 1970, the average length of haul for a Class I rail shipment was 515 miles. Today it is more than 860 miles.[17] In addition to focusing on long-distance freight, the Class I carriers are deploying longer trains, utilizing bigger railcars, and trying to operate these trains, to the greatest extent possible, so that all the cars in the train have the same origin and destination ("through-blocking"). By reducing the amount of car switching that is required between a given origin and destination, the railroad can simplify its operation, reduce costs, and improve transit time reliability. The railroads argue that these benefits are passed on to shippers in the form of lower rates and improved service, and consequently, rail mergers benefit their customers also.

(...continued)

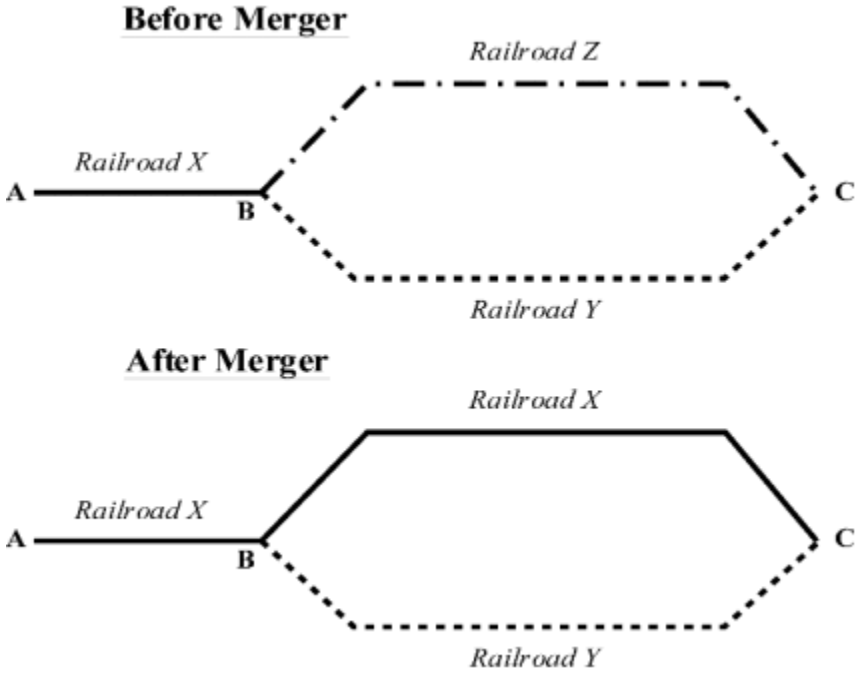
STB 235 (1997) ("Bottleneck II"), aff'd sub nom. MidAmerican Energy Co. v. STB, 169 F.3d 1099 (8th Cir. 1999), cert. denied, 528 U.S. 950 (1999).

[16] 49 USC 10701(c).

[17] AAR, *Railroad Facts*, 2004 edition, p. 36.

However, even end-to-end rail mergers can result in bottlenecks. The diagram below illustrates how a bottleneck situation might arise as the result of an end-to-end rail merger, in this case a merger between *Railroad X* and *Railroad Z*.

Figure 2. Bottlenecks and Railroad Mergers



Source: CRS.

Paper Barriers[18]

Beginning in the 1970s and accelerating during the 1980s, the Class I railroads consolidated their network by concentrating traffic over their trunk lines while abandoning their lighter-density, feeder lines. Since 1980, Class I railroads have shed about 66,000 route-miles. While some of these light-density lines have been abandoned, many of them have been sold (or more often leased) to short-line railroads. Today, 550 short line railroads operate 50,000 route-miles, which represent about 29% of the nation's rail network. It is estimated that short-line railroads originate or terminate about one in four carloads moved by Class I railroads. Especially in agricultural states, short-line railroads perform a gathering function, linking mostly rural shippers to high-volume Class I main lines.

Typically, when a Class I railroad sells or leases a track segment to a short-line railroad, the Class I railroad offers a much lower price (maybe lower rent or no rent) if the short-line agrees to interchange all of the existing traffic on the line with the selling railroad. These selling arrangements are referred to as "paper barriers." Under these arrangements, the main line railroad can ensure that it will maintain the traffic (and the freight revenues) that the feeder line generated on its main line network. It is also purportedly the case that potential short-line operators simply do not have the finances necessary to buy the line outright at fair market value, so the selling

[18] The railroad industry prefers the term "interchange commitments."

railroad uses an interchange commitment to recover the line's fair market value. New traffic that the short-line is able to generate after the sale, either by finding new customers or additional cargo from existing customers that previously moved by non-rail modes, may not be subject to this interline restriction.[19]

H.R. 2125 and S. 953 would disallow interchange commitments between a Class I railroad and a Class II or III railroad as part of a rail line sale and it would disallow charging higher per car interchange rates for Class II or III railroads to interchange traffic with a railroad other than the selling railroad. Captive shippers support eliminating paper barriers because they view it as a means for increasing rail-to-rail competition. They further argue that in an era of tight rail capacity, where certain segments are prone to delays, it is simply bad public policy to not allow shippers to utilize all potential routing options.

Short-line railroads contend that banning paper barriers would negatively affect their potential customers because it would discourage Class I railroads from selling the lines in question for fear of losing freight revenue to a competing main line railroad. Because Class I railroads typically view the line in question as less profitable, they are reluctant to reinvest in the line, leaving those customers located on the line with inferior rail service. Short-lines argue that these rail customers could receive much better service if the line was under their management. Most agree that short-line railroads have a good track record for improving service because their customers are central to the viability of their enterprise, rather than being marginal contributors.[20]

Terminal Switching Arrangements

Railroads often interchange traffic with one another at terminals located at the end points of their network, when a shipment's origin and destination traverses more than one railroad's network. This type of interchange can be viewed as an operating partnership among two or more railroads that is necessary to complete an interline movement. By statute, an origin railroad and a destination railroad are required to provide a physical connection with each other's network.[21]

Another kind of interchange is when a railroad interchanges cargo at terminals within its network with a competing railroad that offers an alternative route to the same destination. The interchange may also involve use of the owning railroad's tracks outside the terminal area for a reasonable distance. Under existing practice, this type of interchange generally occurs only on certain segments of rail routings because the STB required it as a condition for approving a merger transaction, as mentioned above. Although the law allows the STB to order terminal interswitching if the Board finds it to be practicable and in the public interest, or necessary to provide competitive rail service,[22] the STB will only order such interswitching if it finds anti-

[19] As per STB Ex-Parte 575, 1998, the Class I railroads and short-line railroads have formed a Railway Industry Working Group to address a common set of issues in interline agreements between Class I railroads and short-line railroads.

[20] For further railroad and shipper views on paper barriers, see STB hearing, *Review of Rail Access and Competition Issues - Renewed Petition of the Western Coal Traffic League,* STB Ex Parte No. 575, July 27, 2006. Written testimony and a video recording of this hearing is available on the STB's website: http://www.stb.dot.gov. On Oct. 30, 2007, the STB announced proposed regulations requiring railroads to identify any interchange commitment when they seek STB authorization for a rail line sale or lease.

[21] 49 USC 10703.

[22] 49 USC 11102.

competitive conduct.[23] Only if a railroad has used its market powers to extract unreasonable terms on through movements, or if it has used its monopoly position to disregard the shipper's needs by rendering inadequate service, will the Board force terminal interchanges between railroads.

H.R. 2125 and S. 953 states that the Board *shall* require railroads to interchange traffic, if practicable and in the public interest, and would not require that anti-competitive practices first be proven. Captive shippers support this change because they assert that proving anti-competitive conduct by a railroad is excessively onerous. To date, no shipper has succeeded in proving that a terminal owning railroad has engaged in anti-competitive conduct.

The railroads argue that the above proposed change in the law would severely thwart their efforts to streamline their operations. If the law were to require more interchanging of traffic among railroads, the railroads claim that this will increase delays at switching yards, increase cargo handling costs, and therefore make them less competitive relative to other modes. They also contend that if the STB were to require mandatory access to railroad track and terminals, the Board would be put in a position of having to assess the reasonableness of track access charges, thus opening up an entire new area of rail price regulation. The net result, railroads contend, would be more regulation, not more competition.

Shipper Views

Captive rail shippers often supply the nation's basic industries with raw materials, such as coal, chemicals, grain, and construction materials. About 70% of the nation's coal, which generates over half of the nation's electricity, is delivered by rail. According to one report, an electric utility in Arkansas was forced to switch to more expensive natural gas, in part, because the railroad could not deliver coal to its power plants on time.[24] And some utilities have even begun to import coal from South America or Indonesia, at least in part, to lessen their dependence on what they perceive as overpriced and unreliable rail service. Likewise, railroads haul about 40% of the nation's grain. Grain producers have complained about railroads not providing them with enough hopper cars at harvest time to move their product to market. In an attempt to resolve this problem, many grain producers purchased their own fleet of hopper cars, but now they complain that railroads do not provide the locomotives and crew to move their cars.[25] They contend that poor and expensive rail service is driving their customers to overseas sources of grain.

The dispute between railroads and their captive customers is long-standing, pre-dating deregulation, but the dispute has recently been exacerbated by record demand for rail service and higher rail rates. Additional indicators of railroad market power that captive shippers point to are the railroads return to public pricing and the manner in which they have recently assessed fuel surcharges. With some of their customers, railroads have returned to a system of utilizing public tariff rates rather than entering into confidential contracts with these customers. These customers complain that public pricing allows the railroads to raise prices with little warning and, since

[23] See Midtec Paper Corp. v. Chicago & N.W. Transp. Co., 3 ICC 2d 171 (1986), aff'd sub nom. Midtec Paper Corp. v. United States, 857 F.2d 1487 (D.C. Cir. 1988).

[24] "As Utilities Seek More Coal, Railroads Struggle to Deliver," *Wall Street Journal*, March 15, 2006, p. A1.

[25] Written testimony of National Association of Wheat Growers, Senate Committee on Commerce, Science, and Transportation, Subcommittee on Surface Transportation and Merchant Marine, *Economics, Service, and Capacity in the Freight Railroad Industry*, June 21, 2006.

there are likely only two railroads serving a particular region, provides opportunity for price signaling between the railroads. Shippers have also complained about railroads using recent spikes in fuel prices to pad their freight bills by basing their fuel surcharges on a simple percentage of the freight bill rather than basing it on the actual (or estimated) amount of fuel burned for a particular shipment. The STB investigated this practice and in January 2007 directed the railroads to change their fuel surcharge method to reflect actual costs.[26]

In addition to the captive shipper groups that represent coal, chemical, and grain shippers,[27] some other shipper groups also believe that more rail-to-rail competition is needed in the rail industry. The National Industrial Transportation League (NITL), which represents a wide diversity of shippers and carriers, supports a reversal of the STB's existing "bottleneck" decisions and a lowering of the STB's barriers to reciprocal switching.[28] The NITL argues that,

> Competition drives efficiencies and innovation. It leads to a fundamental shift in thinking, away from a static and ultimately counterproductive effort to protect a "franchise," toward a positive effort to grow business opportunities and eliminate costs. Competition promotes cooperation between transportation providers and their customers as both become partners in an effort to eliminate inefficiencies and improve their market opportunities. The result of these efforts is increased demand for the service—that is, growth.[29]

However, other rail customers do not support the captive shipper legislative agenda. Intermodal rail customers (that utilize the railroads to haul freight in shipping containers and truck-trailers) are more likely to view greater investment in rail infrastructure as a more effective remedy to tight rail capacity and rail service problems. For instance, UPS (one of the railroads' largest intermodal customers) supports the concept of creating a federal rail trust fund to accelerate the pace of rail infrastructure expansion. Ocean container lines and intermodal truckers stress the importance of maintaining a regulatory environment that does not impede the railroads' ability to reinvest in their infrastructure. Some intermodal shipper groups, like the Waterfront Coalition, the Intermodal Association of North America, the National Retail Federation, the Retail Industry Leaders Association, and the American Apparel and Footwear Association support a 25% rail investment tax credit legislative proposal.[30] These rail customers may be concerned that if the captive shippers' legislative proposals are adopted, more rail resources, already in tight supply, will be shifted toward serving captive customers at the expense of serving the fast growing intermodal segment of the industry.

While captive shippers have been the most vocal about railroad market power and alleged poor rail service, tight rail capacity and higher rates have prompted some intermodal customers to also express concern on these matters. For instance, UPS stated at an STB hearing on rail capacity, "Are we captive? No. Are we constructively captive? Yes."[31] UPS also stated that while it views

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[26] see STB Ex Parte No. 661, *Rail Fuel Surcharges*, January 25, 2007.

[27] These groups include the Western Coal Traffic League, National Grain and Feed Association, American Chemistry Council, Consumers United for Rail Equity, and the Alliance for Rail Competition.

[28] Written testimony of NITL, STB hearing, *The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead*, STB Ex Parte No. 658, October 12, 2005.

[29] Written testimony of NITL, House Transportation and Infrastructure Committee, Subcommittee on Railroads, *The Status of the Surface Transportation Board and Railroad Economic Regulation*, March 31, 2004.

[30] The Freight Rail Infrastructure Capacity Expansion Act of 2007, S. 1125, introduced by Senator Trent Lott and H.R. 2116, introduced by Representative Kendrick Meek.

[31] Oral testimony of Thomas F. Jensen, Vice President UPS at STB hearing, *Rail Capacity and Infrastructure*
(continued...)

the railroads as partners in moving UPS freight, it is dissatisfied with the overall level of rail service, the slow pace at which railroads adopt technological innovations that could help address service shortcomings, and the railroads' annual spending on infrastructure improvements. Ocean container lines, which rely on railroads extensively to move their containers between U.S. ports and distant inland destinations and origins, reportedly are experiencing railroad rate increases of 30% to 40%, with one shipping line executive noting that railroads have "immense bargaining power" because of their "virtual duopoly in each half of the country," while a container shipper notes that railroads "can almost dictate this [the rate increase]" because "we don't have anywhere else to go."[32] The rationing of intermodal rail service at West Coast ports in 2004, in which two railroads limited the number of marine containers they would accept on a daily basis at these ports, is another indication of railroad market power, according to some observers.[33] The largest trucking firms, which utilize the railroads for line-haul movement of their trailers on their busiest traffic lanes, have also expressed disappointment with rail service and note that they have shifted more of their trailers back to the highway mode because of inconsistent rail service.[34] Although intermodal shippers theoretically have the option of shifting to the truck mode, increases in fuel prices[35] and insurance rates, truck driver shortages, and new hours-of-service rules for truck drivers means that large volume intermodal shippers like UPS, ocean container lines, and even large trucking firms cannot realistically shift their long-distance freight to the truck mode without "pricing-out" a significant portion of their customer base.

Railroad Industry Views

Rather than being indications of excessive market power, the railroads argue that their recent pricing and investment strategies are rational responses to changing economic circumstances. They argue the shift from a rail market with excess capacity to a rail market with excess demand dictates price increases and a preference by the railroads for shorter term contracts or, in some cases, public pricing. The railroads note that many of the contracts that recently expired were negotiated many years ago when the railroads had excess capacity and thus were eager to sign long-term contracts.

Railroads argue that rail infrastructure is a fixed and long term (30 to 40 years) investment and thus they must be confident that a demand increase is going to be sustained over the long-term and is not a temporary phenomenon, before making additional investments. Recent coal delivery problems and the allocation of train service at West Coast ports in 2004 were the result of an unexpected surge in traffic in these rail markets, they contend. They note that their supply chain partners, like coal producers and public utilities, also face a need to upgrade and modernize their train loading or unloading equipment to handle more reliably larger amounts of coal. Steamship lines and terminal operators also play a role in the container supply chain—a shortage of dockworker labor was a significant contributing factor to the backlog of container operations that occurred at West Coast ports in 2004. As for grain delivery issues, railroads view this market as

(...continued)

Requirements, STB Ex Parte No. 671, April 11, 2007.

[32] William Armbruster, "Power Play," *Journal of Commerce*, November 27, 2006, p. 26.

[33] John Gallagher, "Peak Service, Peak Prices," *Traffic World*, August 16, 2004, p. 26.

[34] See, for example, John D. Schulz, "Lofgren On Rail: 'Disappointing'" *Traffic World*, August 23, 2004, p. 11.

[35] Per ton of cargo, trucking is much more fuel intensive than rail.

especially volatile—not only in the size of the harvest each year but in the destinations that grain producers may want to ship to from year to year. As the U.S. DOT has stated on rail capacity and infrastructure requirements, "The bottom line on any rail expansion is the requirement by investors for an adequate return on that investment. The industry appears to be making capacity-enhancing investments at a responsible pace, but is unlikely to invest to meet what it observes as surge demand."[36]

The railroads assert that they are expending enormous resources to improve their asset base, adopting new technology to increase railroad efficiency and safety, and entering into innovative collaborations with one another to offer better service. The Association of American Railroads (AAR) reports that Class I railroads typically spend 40 cents out of every revenue dollar on capital and maintenance expenses related to infrastructure and equipment.[37] A sample of infrastructure expansion projects cited by railroads in 2007 includes double- or triple-tracking about 40 miles of BNSF's southern transcontinental route, double-tracking more than 60 miles on Union Pacific's (UP) Sunset Corridor, and adding 60 miles of third or fourth track to the Powder River Basin joint line in Wyoming that both these railroads share. CSX is adding capacity on its lines between Chicago and Florida and between Albany and New York, and Norfolk Southern Railway and Kansas City Southern Railway are improving capacity on the "Meridian Speedway" between Meridian, MS and Shreveport, LA. In addition, the industry is hiring thousands of new employees and adding hundreds of locomotives. The railroads are testing new train control technology and new braking systems that will increase safety but also increase the train capacity of existing track. Eastern and western railroads are partnering to offer faster service for coast to coast shipments. For example, CSX and UP offer an "Express Lane" service from the Pacific Northwest to New York to haul fruits and vegetables. UP and NS partnered to cut 150 miles off a route between Los Angeles and the Southeast, and UP and Canadian Pacific Railway (CP) improved their interchange of export grain shipments in Idaho by streamlining the customs clearance process.

Railroads also note that they compete with trucks and barges for much of their traffic base and they believe that these modes have an unfair advantage. While railroads by and large finance their own infrastructure and pay property taxes on it, taxpayers pay for most of the locks, dams, and dredging that barges rely on, and the heaviest trucks, in the view of railroads, are cross-subsidized by lighter vehicles in the provision of highway infrastructure.

An Issue for Congress or the STB?

Captive shippers contend that the STB is biased in favor of the railroads in interpreting statute and thus believe legislative change is needed to overrule certain Board decisions. However, they note that the STB could, under its existing authority, give greater weight to competition as opposed to railroad revenue adequacy in interpreting the Staggers Act. For instance, they note that the STB modified rail merger rules in 2001 to require that future rail merger applicants demonstrate how the proposed merger would enhance competition rather than merely preserve competition through such means as terminal switching arrangements, trackage rights, and

[36] Written testimony of Jeffrey Shane, Under Secretary for Policy, U.S. DOT, STB hearing: *Rail Capacity and Infrastructure Requirements*, Ex Parte No. 671, April 4, 2007.

[37] Statement of Craig Rockey, Association of American Railroads to the National Surface Transportation Policy and Revenue Study Commission, March 19, 2007.

eliminating restrictions on interchanges with short-line railroads, among other measures.[38] Other shippers note that the STB could, under its existing authority, assist captive shippers by establishing, monitoring, and publishing railroad service performance metrics.[39] By shining the spotlight on poor service, these shippers believe railroads would improve their performance.

In 1998, the Senate Commerce Committee sent a letter to the STB asking it to hold hearings and consider written comments on the subject of railroad competition issues. Hearings were held, and the STB also directed the railroads to arrange meetings with shippers to see if they could mutually identify certain measures that would facilitate greater railroad access where needed.[40] Neither the hearings nor the meetings produced any clear policy direction and the STB Chairman at that time reported to the Senate Commerce Committee that rail competition policy would be more appropriately established by Congress, than the more administratively focused STB:

> The differences between the railroads and the shippers on the Board's competitive access rules are fundamental, and they raise basic policy issues—concerning the appropriate role of competition, differential pricing, and how railroads earn revenues and structure their services—that are more appropriately resolved by Congress than by an administrative agency....[41]

Policy Implications

Although the captive shipper debate has continued for over two decades, some believe changing economic circumstances have recast the debate. Captive shippers assert that the recently improved financial health of the railroad industry warrants a reexamination of the goals of railroad policy as stated in the Staggers Act. They contend that existing interpretations of the statute are based on precedents established in an outdated era of excess rail capacity. With segments of the rail network now experiencing congestion, captive shippers argue that, as a matter of public policy, rail shippers should be given greater latitude to reroute their traffic to less capacity-constrained routes. The railroads counter that the unprecedented demand for their services requires them to shift from a strategy of shedding underutilized capacity to one of financing an expanded rail network. Determining how much intramodal rail competition is optimal is central to striking the appropriate balance between these two objectives.[42]

The railroads believe that the kind of increased rail-to-rail competition captive shippers seek would be harmful to the financial health of their industry.[43] If railroads are forced to share their

[38] see STB Ex Parte No. 582 (Sub-No. 1), *Major Rail Consolidation Procedures*, June 11, 2001. No Class I railroads have sought a merger under the new procedures.

[39] In response to a GAO recommendation, the STB hired an economic consulting firm to conduct a study on the current state of competition in the railroad industry that is expected to be completed in the Fall of 2008. See STB press release no. 07-31, dated Sept. 13, 2007.

[40] see STB Ex Parte No. 575, *Review of Rail Access and Competition Issues*, hearings held April 2 and 3, 1998.

[41] Letter dated December 21, 1998 from the Honorable Linda Morgan, Chairman, Surface Transportation Board, to the Honorable John McCain and the Honorable Kay Bailey Hutchison.

[42] Further information on shipper and railroad views on this issue is available from an STB public hearing, "The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead," Ex Parte 658, October 19, 2005. Written testimony and an audio recording of the hearing is available at http://www.stb.dot.gov.

[43] For further discussion of the railroad industry's point of view, see Richard A. Allen, "Rail Access in the 21st Century: A Rail Attorney's Perspective," *Journal of Transportation Law, Logistics, and Policy*, vol. 70, no. 2, 2003, p. 192.

right-of-ways with other railroads, even at compensatory rates, they argue, it would undermine their incentive to reinvest in their infrastructure. For example, they assert that the Dakota, Minnesota, and Eastern Railroad (DM&E) would never have undertaken its effort to build a third rail line into the Powder River Basin if it were required to share that line with competitors.[44] The railroads argue that if they are not able to price their service based on the demand for rail service, they will not be able to recover their costs, and eventually could require government subsidies to continue operating. Furthermore, they assert that just as few U.S. cities are able to support two major league baseball teams, not every shipper can sustain the services of two railroads. In other words, even if a bottleneck shipper were to gain access to a second railroad, that shipper may not generate enough business to attract more than one railroad's investment in the physical facilities necessary to serve that customer.

On the other side of the issue, captive shippers believe that increased competition is the means for improving railroad financial health.[45] They argue that competition spurs efficiency and innovation and creates a sense of urgency. In the words of one industry observer, "The culture of 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."[46] Proponents of competition criticize the railroads' position as relying on a static economic model that fails to recognize the financial benefits that increased competition generates. They assert that competition leads to more responsive service, which leads to more rail traffic and an emphasis on eliminating unnecessary costs, which leads to price reductions that stimulate more demand for rail service, which would lead to more railroad revenue. In short, achieving railroad financial viability and satisfying railroad customers are, in this view, two sides of the same coin.

Increasing competition among railroads could, in the view of some, result in a reduced geographic scope of the rail network that serves only higher margin customers. This view was articulated by Linda Morgan, a former chairwoman of the STB:

> The shape and condition of the rail system that open access would produce is a significant issue that was not resolved at the hearings. The shippers assume that the replacement of differential pricing by purely competitive pricing would reduce the rates paid by shippers. The railroads, by contrast, would argue that, because their traffic base would shrink, the rates paid by those shippers that would continue to receive service would actually increase, even as overall revenues received by railroads would decline, because the overall traffic base from which costs would be recovered would be reduced. More specifically, carriers could be expected to seek to maintain an adequate rate of return by cutting their costs, which could include the shedding of unprofitable lines. Thus, it is quite possible that open access would produce a smaller rail system (although not necessarily a degraded one) that would serve fewer and a different mix of customers than are served today, with different types of, and possibly more efficient but more selectively provided, service. We leave open for public discussion the issue of whether that type of a rail system, which might not serve shippers of

[44] The Powder River Basin is the Nation's largest source of coal, responsible for the fuel that generates about 20% of the nation's electricity. The most productive part of the basin is currently served by two railroads.

[45] For further discussion of the shipper's point of view, see Nicholas J. DiMichael, "Rail Access in the 21st Century: A Shipper Attorney's Perspective," *Journal of Transportation Law, Logistics, and Policy*, vol. 70, no. 2, 2003, p. 175.

[46] Written testimony of Harvey A. Levine, Senate Committee on Commerce, Science, and Transportation, Subcommittee on Surface Transportation and Merchant Marine, *Oversight Hearing on the State of the Railroad Industry*, May 9, 2001.

> less desirable traffic, would better serve the interest of shippers, labor, and the public generally.[47]

Another view is that multiple railroads operating over the same rail line will actually increase the cost of railroad operations, thus increasing the price of railroad services to all rail shippers. This view was suggested by a study funded by the Federal Railroad Administration:[48]

> Arguments advocating competitive policies in the rail industry generally highlight the textbook advantages of competition over monopoly of a larger sum of consumer and producer surplus due to a restriction on output by monopoly. However, the advantages are only so clear when the costs of providing services are the same for competitive or monopoly firms. In cases where there are substantial economies of scale and scope in the production (as there appears to be in the rail industry), competition can increase the costs of resources used in production, potentially reducing societal welfare.

All agree that the nation needs a robust and efficient railroad system. Its inherent advantage in hauling large volumes of heavy freight long distances is especially beneficial during periods of high fuel prices, rising trade volumes, and growing demand for raw material transport. Whether elimination of the captive shipper problem would be detrimental or beneficial to maintaining a strong and vibrant railroad system is disputed among stakeholders as well as outside observers.

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[47] STB Ex Parte No. 575, *Review of Rail Access and Competition Issues*. Decided April 16, 1998, at footnote 3.

[48] John Bitzan, Ph.D. North Dakota State University, "Railroad Cost Conditions - Implications for Policy," May 10, 2000, p. v. Available at http://www.fra.dot.gov/downloads%5Cpolicy%5Crr_costs.pdf. (Viewed August 1, 2007.)