Railroad Access and Competition Issues

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Summary

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 recent years, have achieved higher profitability. These changes have left some bulk shippers, particularly those that claim to be "captive" to a single railroad, frustrated with what they perceive as poor rail service and exorbitant rates. "Captive shippers" claim that the railroad serving them acts like a monopoly—charging excessively high rates and providing less service than they require.

Such complaints have led Congress to consider whether the present, largely deregulated, regime should be revised to accommodate the interests of "captive shippers." A major point of contention is whether current railroad industry practices should be changed to guarantee such shippers more railroad routing options. Legislation, supported by captive shippers and opposed by the railroads and other shippers, failed to reach the floor of either the House or Senate in the last Congress, and has been reintroduced in the 112th Congress (S. 49 and S. 158).

In the wake of renewed congressional interest, the Surface Transportation Board (STB or Board), successor agency of the Interstate Commerce Commission (ICC), is reviewing its policies with respect to railroad access and competition issues. It announced a hearing on "bottleneck rates" and "competitive access" matters. Changes in these policies might benefit some shippers of bulk products, such as coal and grain, but could be disadvantageous to shippers of other products, such as maritime containers and domestic truck trailers, that want railroads to maintain high levels of investment in order to provide fast, reliable service for high-value shipments.

The captive shipper issue has wider economic implications than just the division of revenue between railroads and their 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. If it acts in this area, Congress would face consideration of how a legislated or regulatory solution to the "captive shipper" problem would affect the development of a more robust and efficient railroad system.

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Introduction

Beginning in the late 1970s, Congress deregulated the railroad industry by giving railroads more flexibility to set rates and negotiate confidential contracts with their customers. The legal structure under which the rail industry now operates was put in place at a time when railroads were in financial peril. Over the last decade, as major railroads have consolidated and have achieved higher profitability,[1] Some Members of Congress have questioned whether the present regime needs to be revised to protect the interests of rail customers who are poorly positioned to benefit from competition among freight transportation providers—a group often referred to as "captive shippers."

Captive rail shippers often cannot ship their product economically by truck because of its bulk or the long distance of their shipments, and lack viable access to a navigable waterway to ship by barge. They typically claim that the railroad serving them acts like a monopoly, charging excessive rates and providing inadequate service. Organizations representing captive shippers have called upon Congress to reimpose regulation upon certain aspects of railroad operations in order to protect shippers' interests.

Captive rail shippers are a small minority of all rail customers, and the argument between them and the railroads is long-standing. However, the captive shipper issue has wider economic implications than just the division of revenue between shippers and railroads. An important policy question for Congress is whether more competition will lead to a more robust and efficient railroad system or undermine it by discouraging investment in rail infrastructure.

This report provides background on the current railroad regulatory regime. It then explains "bottlenecks" and "terminal switching arrangements," two of the main points of contention between railroads and their captive customers. The Surface Transportation Board (STB or Board) recently began a review of its policies regarding these two issues, and they are addressed in legislation supported by captive shippers. After reviewing 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.[2]

Regulatory Background

The last major changes to U.S. law concerning the economic regulation of railroads 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, U.S. railroads, particularly those in the Northeast, were in a prolonged period of financial distress, and strict federal regulation of railroad activities was blamed for some of the railroads' difficulties.

[1] Freight railroads are classed based on annual revenues (adjusted yearly for inflation). Class I railroads had revenue of at least $401.4 million in 2008, Class II (regional) railroads had revenues of at least $32.1 million but below the Class I threshold, and Class III (short-line) railroads had revenues of less than $32.1 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 Class II and III railroads.

[2] 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.

Railroad deregulation was part of a larger movement to deregulate all modes of transportation in the late 1970s and early 1980s. Before deregulation, railroads were required to post proposed freight rates for various commodities, and the Interstate Commerce Commission (ICC) reviewed proposed rates to determine whether they were "reasonable." Railroads were prohibited from discriminating between shippers in rates and quality of service.

The 4R Act, which restructured the Northeast railroads and created Conrail from the remains of the bankrupt Penn Central Railroad, took the first step toward deregulation, exempting traffic from regulation if the regulation was deemed by the ICC to be an undue burden on commerce and served no useful purpose.[3] The 4R Act also introduced the concept of "market dominance," which it described 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 possessed market dominance.[4]

The Staggers Act greatly advanced the movement toward railroad deregulation by granting railroads more freedom to set rates, to provide different rates and service quality to different customers, and to enter into confidential contracts with customers. Contracts are not subject to regulatory review on the assumption that a contract reflects shipper and railroad agreement.[5] However, the ICC retained authority over rates in situations where it determined a railroad to have market dominance.

The Interstate Commerce Commission Termination Act of 1995 (P.L. 104-88; 109 Stat. 803) eliminated many of the functions of the ICC, abolished the ICC itself, and transferred its remaining functions to STB. STB is bipartisan and decisionally independent from, but organizationally housed within, the U.S. Department of Transportation (DOT).[6] The ICC Termination Act left largely intact the regulatory framework that governs captive rail shipper issues. In addition to determining market dominance, STB must determine that a rail rate exceeds a revenue to variable cost threshold of at least 180% before it can assert jurisdiction to judge the reasonableness of that rate. Depending on the total amount of freight costs in question, STB has different methodologies for rate reasonableness determinations. STB does not evaluate rates on its own initiative; it must receive a complaint from a shipper.

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 transportation system and to require fair and expeditious regulatory decisions when regulation is required."[7] 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." (STB conducts

[3] Section 207 of P.L. 94-210. The first traffic the ICC exempted was fruits and vegetables in 1979, 361 I.C.C. 211 (1979). Boxcar, intermodal, and a host of other commodities listed at 49 CFR 1039.10 and 1039.11 are also exempted.

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

[5] 49 USC 10709(c). (About 70% of rail tonnage moved under contract in 2004, according to the GAO report cited above, p. 24.)

[6] The three Board members are nominated by the President and confirmed by the Senate. One of them is selected by the President to be chairman. No more than two members can be from the same political party.

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

an annual evaluation to determine railroad revenue adequacy based on established standards and procedures.)

DOT under the Obama Administration shares the view of its predecessors that "overall, the regulatory environment since the Staggers Act was enacted has allowed the railroads to respond to market forces that demanded lower costs, greater productivity, and innovation in the form of new transportation products and services."[8] The Obama Administration believes there are public benefits associated with shifting more freight from truck to rail, and has provided federal funds to upgrade rail infrastructure for this purpose.

A 2006 Government Accountability Office (GAO) study found that the rail industry's health had improved since Staggers but that while rates have declined, "they have not done so uniformly, and rates for some commodities are significantly higher than rates for others."[9] The GAO study noted 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."[10] GAO stated 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."[11]

What is a "Captive Shipper"?

"Captive shipper" is not a term found in statute and is subject to interpretation. Most shippers claiming to be captive handle bulky 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 failed to deliver coal to its power plants on time.[12] Some utilities have even begun to import coal from South America or Indonesia, 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 enough hopper cars at harvest time. In an attempt to resolve this problem, many grain shippers purchased their own hopper cars, but now complain that railroads fail to provide the locomotives and crews to move their cars.[13] They contend that poor and expensive rail service is driving their customers to overseas sources of grain.

Few if any shippers are absolutely limited to a single railroad for moving their freight. The question of whether a particular shipper is a "captive" has less to do with physical availability of alternatives to a single railroad than with the economic viability of those alternatives: a North

[8] Written testimony of Robert S. Rivkin, General Counsel, U.S. DOT, STB hearing, *Review of Commodity, Boxcar, and TOFC/COFC Exemptions,* STB Ex Parte No. 704, February 24, 2011.

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

[10] Ibid., p. 19.

[11] Ibid., p. 3.

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

[13] 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.

Dakota wheat farmer always has the option of hiring trucks to haul grain to the Pacific coast for export, but if the cost would make his wheat uncompetitive, rail may be the only economically feasible alternative. If that is the case, and if only one railroad is able to serve his needs, then he could be deemed a captive shipper under STB rules.

In some cases, captivity could be due to the fact that an area does not have the density of production to sustain the existence of more than one railroad. Northern Maine, northern Michigan, and parts of Montana, Idaho, and South Dakota may be examples of this. In other locations, such as Tampa, Nashville, and Green Bay, mergers among railroads have reduced the extent of rail competition.

Yet evaluating captivity is complex. No railroad has unrestrained market power, because it is not in the railroad's interest to make a freight rate so high that its customer is driven out of business. The owner of any facility built since 1980 had the opportunity to avoid captivity by negotiating terms of service with a railroad before starting construction or by locating in a place with access to more than one railroad. And shippers with multiple facilities may have bargaining power even if an individual plant or distribution center appears to be a captive, as the shippers can agree to tender freight at competitive locations in return for favorable treatment at captive locations.

Some shippers that seemingly have access to alternatives nevertheless claim to be captive. For instance, DuPont considers its largest North American plant, located in Richmond, VA, to be captive to CSX Railroad.[14] It is one of 32 North American plants (out of a total of 39) that it considers captive. The Richmond plant is located just south of the city of Richmond along CSX tracks. Bordering the other side of the plant is Interstate 95. Across the highway, just a few yards from the plant, is the Port of Richmond on the James River. This port provides a 25-foot deep shipping channel to Norfolk. Three miles downriver from the Port of Richmond, DuPont owns a wharf along the river where it receives bulk material by vessel. Its river terminal is also served by CSX. CSX's competitor, Norfolk Southern Railroad, can be accessed approximately six miles north of the plant in Richmond or about 15 miles south of the plant in Petersburg. With proximity to a variety of transportation facilities, DuPont's definition of captivity would appear to encompass a large universe of shippers.

In 2007, STB estimated that captive shipments accounted for less than 10% of all rail shipments.[15] In response to a GAO recommendation, STB sponsored a more rigorous analysis of the state of competition in the railroad industry that generally did not find an abuse of market power by the railroads.[16] Among its conclusions, this study asserted that requiring a railroad to interchange traffic with a competitor may not be workable or effective because it could reduce length-of-haul economies.[17]

[14] Testimony of Gary W. Spitzer, DuPont Chemical Solutions Enterprise, E.I. du Pont de Nemours and Co., Hearing entitled Rail Competition and Service, House Transportation and Infrastructure Committee, September 25, 2007.

[15] Testimony of then STB Chairman Charles Nottingham, House Committee on Transportation and Infrastructure, Subcommittee on Railroads, *Rail Competition and Service*, September 25, 2007.

[16] Laurits R. Christensen Associates, Inc. A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition. November 2008, with subsequent updates. Available at http://www.stb.dot.gov/stb/elibrary/CompetitionStudy.html.

[17] Ibid., pp. 22-27.

Captive shippers contend that STB has interpreted the law in favor of railroads and advocate changing the law to overrule certain Board decisions. However, they note that 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 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 eliminating restrictions on interchanges with short-line railroads, among other measures.[18] Other shippers note that STB could, under its existing authority, assist captive shippers by establishing, monitoring, and publishing railroad service performance metrics. Shining the spotlight on poor service, these shippers believe, would drive railroads to improve their performance.

Recent Legislative and Regulatory Activity

In the 111th Congress, the Surface Transportation Board Reauthorization Act of 2009 (S. 2889), reported by the Senate Commerce Committee, and bills reported by the Senate and House Judiciary Committees (S. 146 and H.R. 233, which was also referred to the House Transportation and Infrastructure Committee) would have changed current railroad practices to allow "captive shippers" more access to competing railroads by addressing, among other provisions, "bottlenecks" and "terminal switching arrangements." In the Senate, these bills have been reintroduced in the 112th Congress as S. 49 and S. 158. S. 49, the Railroad Antitrust Enforcement Act of 2011, has been ordered to be reported by the Senate Judiciary Committee.

STB considered initiating a review of competition in the railroad industry in the spring of 2009, but deferred at the request of the Senate Commerce Committee, in light of the legislation noted above.[19] Early in 2011, the Board revisited the subject, requesting public comment and scheduling a hearing.[20] In its announcement, the Board observed that the railroad industry had changed in many significant ways since policies with respect to competitive access were originally adopted in the mid-1980s. Among the changes it mentioned were the improving economic health of the railroad industry, increased consolidation of the Class I sector, the proliferation of short-line railroads, and increased participation of railroad customers in activities that had previously been provided by the railroads, such as railcar ownership and maintenance. The Board also noted that while railroad productivity has increased dramatically since 1980, resulting in lower rail rates, productivity gains now seem to be diminishing, and since 2004, overall, railroad rates have risen.

On February 24, 2011, the Board held a hearing to review the rationale and continuing utility of exemptions from regulation for certain categories of rail shipments, specifically boxcar, intermodal (trailer- or container-on-flat-car, TOFC/COFC), and certain commodities listed in 49 CFR §§ 1039.10 and 1039.11. The Board noted that some of these exemptions had been issued as long as 30 years ago, justifying a review.[21]

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[18] 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.

[19] STB Ex Parte No. 688, April 14 and 17, 2009.

[20] The hearing notice and filings by stakeholders (due by April 12, 2011) can be viewed at http://www.stb.dot.gov, under docket no. EP 705.

[21] As mentioned earlier, this exemption authority was granted in the 4R Act. In the Staggers Act, the ICC was directed to pursue exemptions aggressively and to correct any problems arising from an exemption through its revocation (continued...)

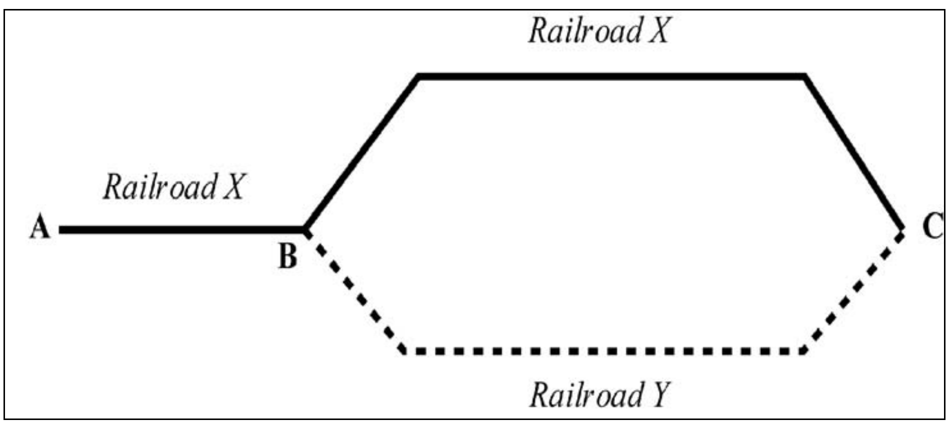
The chairman and ranking Member of the House Committee on Transportation and Infrastructure, along with the chairman and ranking Member of the Subcommittee on Railroads, wrote STB in January 2011, "we would like to ... impress upon you the importance of maintaining the existing regulatory balance between the railroads and shippers," adding, "Any policy change made by the STB which restricts the railroads' abilities to invest, grow their networks and meet the nation's freight transportation demands will be opposed by the Committee."[22]

Among the issues STB intends to review are "bottleneck rates" and "competitive access."

Bottleneck Rates

A bottleneck refers to a situation in which only one railroad has track serving a particular origin or destination but where another railroad also owns track that parallels a portion of the route between the same origin and destination. This situation is most easily explained with a diagram. In **Figure 1**, a portion of the route between points A and C is competitive, but the segment between points A and B is a bottleneck controlled by Railroad X. Under existing practice, Railroad X can capture all traffic between points A and C by offering only a through rate from A to C. This precludes shippers from using Railroad Y for the C-B segment of the haul and using Railroad X only for the B-A segment.

Figure 1. A Bottleneck Situation



Source: CRS.

(...continued)

authority.

[22] The letter is dated January 24, 2011, and can be viewed under docket no. EP 704 or EP 705.

Bottleneck rate practices were affirmed by STB in December 1996 in its ruling on three coal rate cases brought by several utilities.[23] STB ruled that railroads did not have to "short-haul" 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."[24] The Board decided that a railroad only has to offer a rate on the route it deems most efficient for handling the cargo, and need not offer rates for alternative routes that a shipper requests.

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 segment the route and offer a separate rate for the bottleneck portion of the shipment. In practice, however, the non-bottleneck railroad generally has not entered into a contract with a shipper under these circumstances.

Captive shippers seek legislative or regulatory changes that 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 separate rates from A to B and from B to C as well as a through rate from A 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. A shipper could then challenge the reasonableness of the rate from A to 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 created more bottlenecks. Railroads deny this is a problem, asserting that STB frequently requires 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.

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 railroads with parallel track. In an effort to exploit their comparative advantage in long-distance movement of freight, the Class I railroads have sought, in some cases, mergers with railroads whose route networks begin at the end point of their route network. In 1970, the average length of haul for a Class I rail shipment was 515 miles. Today it is more than 860 miles.[25] In addition to focusing on long-distance freight, the Class I carriers are deploying longer trains, utilizing bigger railcars, and trying to operate trains in which all cars have the same origin and destination ("through-blocking"). These practices allow railroads to handle more freight without interchanging cars, reducing operating costs and transit times. The railroads argue that these benefits are passed on to shippers in the form of lower rates and improved service, and consequently, that rail mergers benefit shippers.

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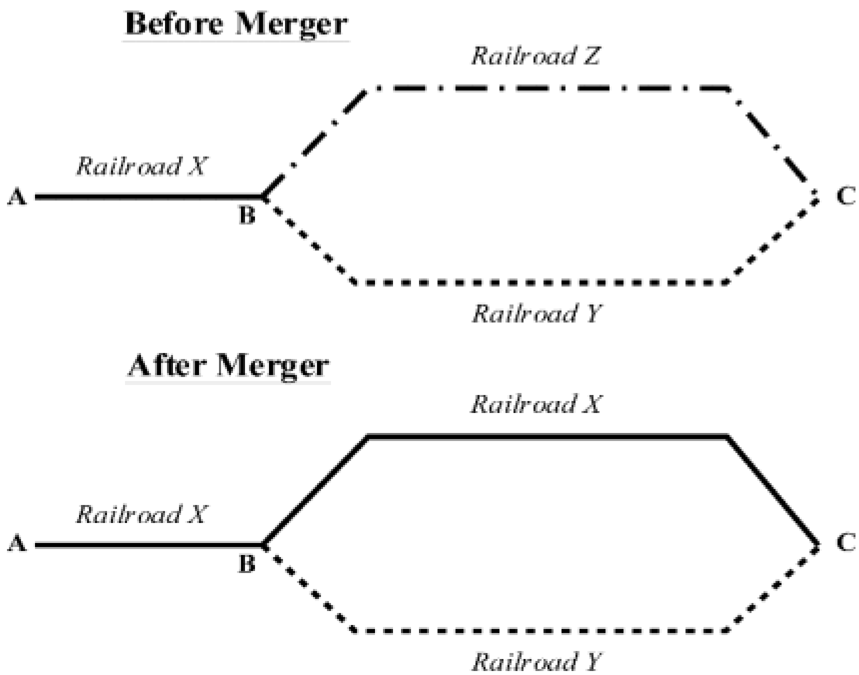
[23] Central Power & Light Co. v. Southern Pacific Transp. Co., 1 STB 1059 (1996) ("Bottleneck I"), modified in part, 2 STB 235 (1997) ("Bottleneck II"), aff'd sub nom. MidAmerican Energy Co. v. STB, 169 F.3d 1099 (8th Cir. 1999), cert. denied, 528 U.S. 950 (1999).

[24] 49 USC 10701(c).

[25] 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.

Competitive Access

The extent to which 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. If two railroads own parallel track in an area with relatively light traffic, they may agree to abandon one track and share the other to reduce maintenance costs. Or, in a dense traffic lane with two sets of tracks, they may agree to share both tracks to increase train fluidity. However, neither of these situations involves granting access to each other's customers.

In other situations, 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, 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.[26] In the case of the breakup of Conrail in 1997, the two acquiring railroads, Norfolk

[26] 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.[27] 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.

Railroads often interchange traffic with one another at terminals located at the end points of their networks, 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 networks.[28]

Another kind of interchange occurs when a railroad hands off cargo to 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 STB required it as a condition for approving a merger transaction. Although the law allows 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,[29] STB will only order such interswitching if it finds anti-competitive conduct, such as a railroad using its market power to extract unreasonable terms on through shipments.[30]

Captive shippers seek to change the statute to state 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 onerous. To date, no shipper has succeeded in proving that a terminal-owning railroad has engaged in anti-competitive conduct.

The railroads argue that this proposed change in the law would thwart their efforts to streamline their operations. If the law were to require more interchanging of traffic among railroads, the railroads claim, 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 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.

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

[28] 49 USC 10703.

[29] 49 USC 11102.

[30] 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).

Policy Issues

The dispute between railroads and their captive customers is long-standing, but was exacerbated by record demand for rail service and higher rail rates, before the recent economic recession. 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 insisted on charging public tariff rates rather than negotiating confidential contracts with these customers. These customers complain that public pricing allows the railroads to raise prices with little warning (tariffs can be changed with 20 days' notice[31]) and, since there are no more than two railroads serving most communities, 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. STB investigated this practice and in January 2007 directed the railroads to change their fuel surcharge method to reflect actual costs.[32]

Not all shippers support the captive shipper legislative agenda. Intermodal rail customers, which utilize the railroads to haul shipping containers and truck trailers, are more likely to view greater investment in rail infrastructure as a more effective remedy to capacity and service-quality problems. For instance, UPS, one of the railroads' largest intermodal customers, supports the creation of a federal rail trust fund to accelerate 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, have supported a rail industry proposal to provide a 25% tax credit for railroad investment.[33] These rail customers may be concerned that if the captive shippers' legislative proposals are adopted, railroads' resources will be shifted toward serving captive customers at the expense of serving the fast-growing intermodal market.

Intermodal customers share some concerns of captive shippers. Although intermodal shippers theoretically have the option of shifting to the truck mode, increases in fuel prices[34] 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 trucks without "pricing-out" a significant portion of their customer base. UPS stated at an STB hearing on rail capacity, "Are we captive? No. Are we constructively captive? Yes."[35] Ocean container lines, which rely on railroads extensively to move their containers between U.S. ports and distant inland points, reportedly experienced railroad rate increases of 30% to 40% in 2006, before the economic downturn, with one shipping

[31] 49 U.S.C. 11101(c).

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

[33] These proposals were introduced in the 111th Congress but have not, as of yet, been introduced in the 112th Congress. See the Freight Rail Infrastructure Capacity Expansion Act of 2009 (H.R. 272, H.R. 1806) and the Comprehensive Rail Infrastructure Investment Act of 2009 (H.R. 1789).

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

[35] Oral testimony of Thomas F. Jensen, Vice President UPS at STB hearing, *Rail Capacity and Infrastructure Requirements*, STB Ex Parte No. 671, April 11, 2007.

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."[36] 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 each day, also indicated railroads' market power.[37] Yet tellingly, at the February 2011 STB hearing on traffic exemptions, two large intermodal customers of the railroads, J.B. Hunt Transport (a trucking firm) and Hub Group (a freight arranger), strongly opposed revocation of the regulatory exemption for intermodal traffic.[38]

The railroads counter shipper criticism by arguing 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 explain that some shippers now face higher rates because 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 respond to complaints about inadequate service by pointing out that rail infrastructure is a fixed, long-term investment that must respond to long-term expectations rather than short-term surges of freight. Recent coal delivery problems and the allocation of train service at West Coast ports in 2004 were the results of unexpected surge in traffic, they contend.[39] As for grain delivery issues, railroads view this market as 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. During the George W. Bush Administration, DOT supported the railroads' position, with one official stating: "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."[40]

Although the captive shipper debate has continued for over two decades, changing economic circumstances may have recast it. Captive shippers assert that STB's interpretations of the Staggers Act are based on precedents established in an era of excess rail capacity. With segments of the rail network now experiencing congestion, captive shippers argue that, as a matter of public policy, shippers should be given greater latitude to reroute their traffic to less capacity-constrained routes, even if those are not owned by the same carrier that serves a particular factory or distribution center. The railroads counter that increased rail-to-rail competition would be harmful to the financial health of their industry.[41] If railroads are forced to share their rights-of-

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

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

[38] Their filings can be viewed under STB docket no. EP 704.

[39] A study by the DOT inspector general (IG) supports this contention, noting that demand for rail service, measured in revenue ton miles, surged unexpectedly in 2004 and continued to climb into 2008. DOT IG, *Quality of Service Provided to Rail Shippers*, Report No. CR-2011-045, February 15, 2011.

[40] 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.

[41] 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.

way with other railroads, even at compensatory rates, they argue, it would undermine their incentive to reinvest in their infrastructure.

Determining how much intramodal rail competition is optimal is central to striking the appropriate balance between these two objectives.[42] Although greater emphasis on competition could lead to increased rail traffic and higher revenues for the carriers, the railroads contend that many of the investments captive shippers want them to make may not generate enough business to earn a reasonable return. The view that increased competition among railroads could result in a smaller rail network that serves only higher-margin customers was articulated in 1998 by Linda Morgan, then chairwoman of STB:

> [C]arriers 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 less desirable traffic, would better serve the interest of shippers, labor, and the public generally.[43]

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:[44]

> 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.

Railroads' 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. Congress faces consideration of whether addressing the problems of captive shippers would be detrimental or beneficial to maintaining a strong and vibrant railroad system.

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[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 are available at http://www.stb.dot.gov.

[43] STB Ex Parte No. 575, *Review of Rail Access and Competition Issues*. Decided April 16, 1998, at footnote 2.

[44] 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/policy/rr_costs.pdf.

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