Railroads, Regulation, and Recession: the Role of the Surface Transportation Board

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U.S. Railroads—Brief History

• Modern U.S. railroad industry can be divided into pre- & post- Staggers Act
• In the 19th Century railroads expanded rapidly especially after the Civil War
• However, much abuse of monopoly power leading to the Interstate Commerce Act and federal regulations
• Federal regulations ultimately extended to all modes, but proved potentially harmful to railroads
Railroad Industry Pre-Staggers

- 40 Class I Railroads
- 9 Railroads bankrupt
- Industry-wide low return-on-investment
- Railroads unable to raise capital
- Railroads faced steadily declining market share
- Regulation prevented RRs from any flexibility in pricing to compete with other modes
- Carriers could not abandon redundant or light density lines to cut costs
- Rates could not cover inflation due to regulatory lag in rate adjustments
Staggers Rail Act of 1980

- Railroads given freedom to set rail rates based on demand
- Streamlined procedures for the abandonment and sale of rail lines
- Encouraged Railroad-Shipper contracts
- Expanded ICC power to exempt categories of traffic
- Rates evaluated by ICC under a reasonableness test
Growth & Decline of Class I Railroad Mileage
### Railroad Industry Cost of Capital and ROI 1996-2007

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<th>CSXT</th>
<th>NS</th>
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Railroad Employment
1939-2007

1,800,000
1,600,000
1,400,000
1,200,000
1,000,000
800,000
600,000
400,000
200,000
0


1,670,000
1,151,000
236,000

2007
Class I Capital Expenditures 1994 - 2007

Billions

$10

Roadway & Structures

Equipment

Total

Since Staggers

- Rail industry freight traffic ton-mile market share has increased from 30.3% in 1980 to 43% in 2006
- Rail rates down 55% on average (inflation adjusted)
- Railroads’ ROI increased
- Railroads substantially increased investment in infrastructure
- Improvement in safety performance
Modal Markets Shares

U.S. Freight Ton-Miles by Mode: 1980-2005

- Railroads
- Truck
- Pipelines
- Water

Data exclude natural gas pipelines. Trucks exclude household, service, retail, and certain other shipments. Source: U.S. Bureau of Transportation Statistics
The Railroad Industry Today

- 7 Class I Railroads
- 525 Class II and Class III railroads
- Much reduced system through rationalization
- Average length of haul – 900 miles
Intermodal Shipments
Beginning 1965

Total 12,030,000
Containers 9,430,000
Trailers 2,600,000
New Regulatory Regime

• STB replaces ICC in 1995
• Three member board—non-partisan
• Railroad rate and service disputes
• Railroad restructuring (M&A)
• Limited jurisdiction over other modes
• Much railroad traffic exempt from STB regulation
• STB regulates where market dominance exists—180% r/vc threshold
Early Experience at the STB

- Board tried to balance shipper desire for low rates and railroads’ need to earn profits
- Board looked favorably on railroad mergers
- Perception among shippers that STB was too pro-railroad
Changes in STB Practice and Procedures

• New Approaches to Handling Rate Cases
• Review of Carrier Operating Practices
• Railroad Restructuring
• Environmental Reviews
• Potential Legislative Changes Affecting the STB and/or the Railroad Industry
New Approaches to Rate Cases

- Streamlined procedures to reduce time and cost for adjudicating large rate cases
- First large rate cases handled under new guidelines
- Guidelines for situations where value of case is too small to justify full blown STB litigation
- Simplified stand alone cost and three benchmark approaches
- First cases brought under new small rate guidelines
Review of Carrier Operating Practices

- STB hearing on the railroads’ common carrier obligation
- Hearing on paper barriers
- STB’s fuel surcharge decision
- STB-sponsored study of RR competition
- STB response to Clean Railroads Act
- New responsibilities in passenger rail areas
Railroad Restructuring

• STB’s Revised Merger Guidelines
• The Board’s Classification of Railroad Mergers
• Canadian Pacific’s Acquisition of the DM&E—Significant
• Canadian National’s Acquisition of the EJ&E—Highly Controversial
Environmental Reviews

- Overall responsibility for environmental review of new railroad construction or abandonments
- DM&E Powder River Basin expansion project and the IC&E
- Yucca Mountain spent nuclear material storage site
- Environmental review of the CN acquisition of the EJ&E
Changes in the STB’s Practices and Procedures

• Rail cost of capital methodology revision and examination of multi-stage discounted cash flow model

• Rail Energy Transportation Advisory Council (RETAC)

• Reorganization of Consumer Protection and Enforcement and Public Affairs Sections

• Proposed disclosure requirements concerning “contract” v. “tariff” rates
Capacity and Infrastructure Needs

• Aging infrastructure problem common to all transport modes
• Ports dealing with larger vessels and until recently rapidly expanding international trade
• Highways are experiencing increased congestion and traffic delays
• Rail capacity problem is of more recent vintage as economic regulation fostered excess capacity
Rail Capacity Issues

Shrinking workforce and infrastructure partially offset by productivity gains but continuous increase in traffic absorbed excess capacity on many mainlines

- Network has become more vulnerable to stochastic events
- Recent traffic declines have freed up capacity
Will/Can Nation’s Railroads Address Long Term Capacity Needs

• Improved earnings yet all Class I’s are not revenue adequate
• Historically RR’s ‘punished’ by Wall Street for making capital investments
• RR’s often found that infrastructure investments failed to generate sufficient income
• Added rail infrastructure is long-lived while demand increases can be short-lived
• Economic downturn has led to reduced infrastructure spending
Carrier Responses to Recent Traffic Declines

- Tens of thousands of railcars and thousands of locomotives in storage
- Layoffs of train crews reaching 15% on some RRs
- Infrastructure expansion efforts put on hold
- Price rationing of available capacity
- RR’s choosing who they will serve and the common carrier obligation
Long-Term Rail Capacity Limits Remain a Concern

• Demand for freight rail projected to grow by 60-70% over next two decades
• RR’s inability to earn cost of capital
• Pressure from Wall Street to reduce capital costs and improve ROI
• RR’s tend to bid L/T contract rates down to L/R marginal costs
Approaches to the Transportation Congestion Problem

• Build more physical infrastructure
• Adopt technological innovations
  – Can RR’s do this and maintain profitability?
• Better utilize existing facilities
• Promote shipper/traveler behavioral changes
• Public/Private partnerships

All have potential but all have limits
Rail Capacity Investment

• RR’s support limited public sector role
• Public/Private partnerships
  – Alameda Corridor
  – CREATE
• RR Trust Fund concept
• Investment Tax Credits
  – Short Lines 286K car issue
  – Class I 25% credit but limited fiscal capacity
• Renew interest in infrastructure investment and GREEN-TEA
Obstacles

- Dollar resources
- Resistance to change
- Labor contracts
- Ineffective lobbying efforts to address freight transportation needs
Need to Focus on Freight Issues & Intermodal Solutions

- Reauthorization of highway program is before current Congress
- Increase visibility of freight issues
- Install a comprehensive evaluation process (i.e. c/b analysis) within in the planning process
- Address limitations on federal funding that dedicates $ to a single mode or non-freight purposes
Legislative Activities Affecting the STB and/or the Railroad Industry

- Shortline railroad investment tax credit
- Class I railroad investment tax credit
- Senate and House measures to change railroad regulatory framework—so-called reregulation bills
- Proposed change to railroad industry anti-trust exemption
• Thank you, any questions