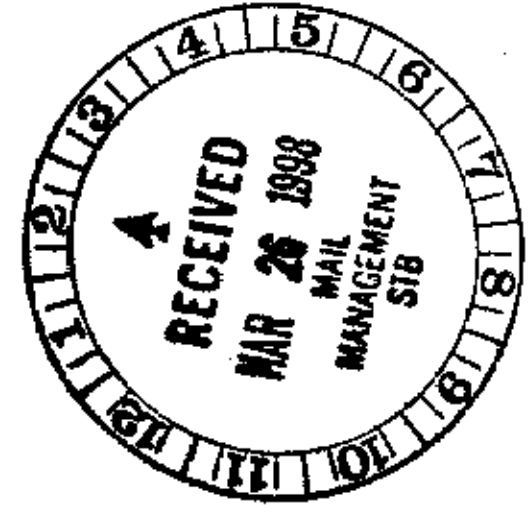


BEFORE THE
SURFACE TRANSPORTATION BOARD



STB EX PARTE NO. 575
REVIEW OF RAIL ACCESS AND COMPETITION ISSUES

COMMENTS OF THE
SECRETARY OF AGRICULTURE

Dan Glickman
Secretary
U.S. Department of Agriculture
Washington, D.C. 20250

Date: March 26, 1998

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AUTHORITY AND INTEREST

At the request of Congress, the Surface Transportation Board (Board) is commencing a review of rail access and competition issues in the rail industry. I believe the Board is providing a valuable service to the public by initiating this proceeding and I am pleased to present these remarks for the Board and all other interested parties to consider.

As the Secretary of Agriculture, I am charged with the responsibility under the Agricultural Adjustment Act of 1938 and the Agricultural Marketing Act of 1946 to represent the interests of agricultural shippers and producers in improving transportation services and facilities by, among other things, initiating and participating in Board proceedings involving rates, charges, tariffs, practices, and services.

PREFATORY REMARKS

There is little dispute that the nation's railroads are safer and more efficient today than at any other time in our nation's history. Since the Staggers Rail Act of 1980, the productivity of our nation's rail network has risen tremendously, yet here we are discussing proposals that could radically restructure an industry that, until recently, was a poster-child for deregulation. Obviously something has gone awry — but what? I submit that *the problem* we face today is that the latest wave of consolidation among Class I carriers has increased the number of shippers who must rely on inadequate legislative and regulatory safeguards to prevent market power abuse by railroads. In the Western United States in particular, the loss of key carriers has reduced not only intra-modal competition, but also severely limited product and geographic competition in key agricultural markets. As a result, the remaining “mega-carriers” have inordinate market power in several important markets.

CONSOLIDATION AMONG CLASS I CARRIERS

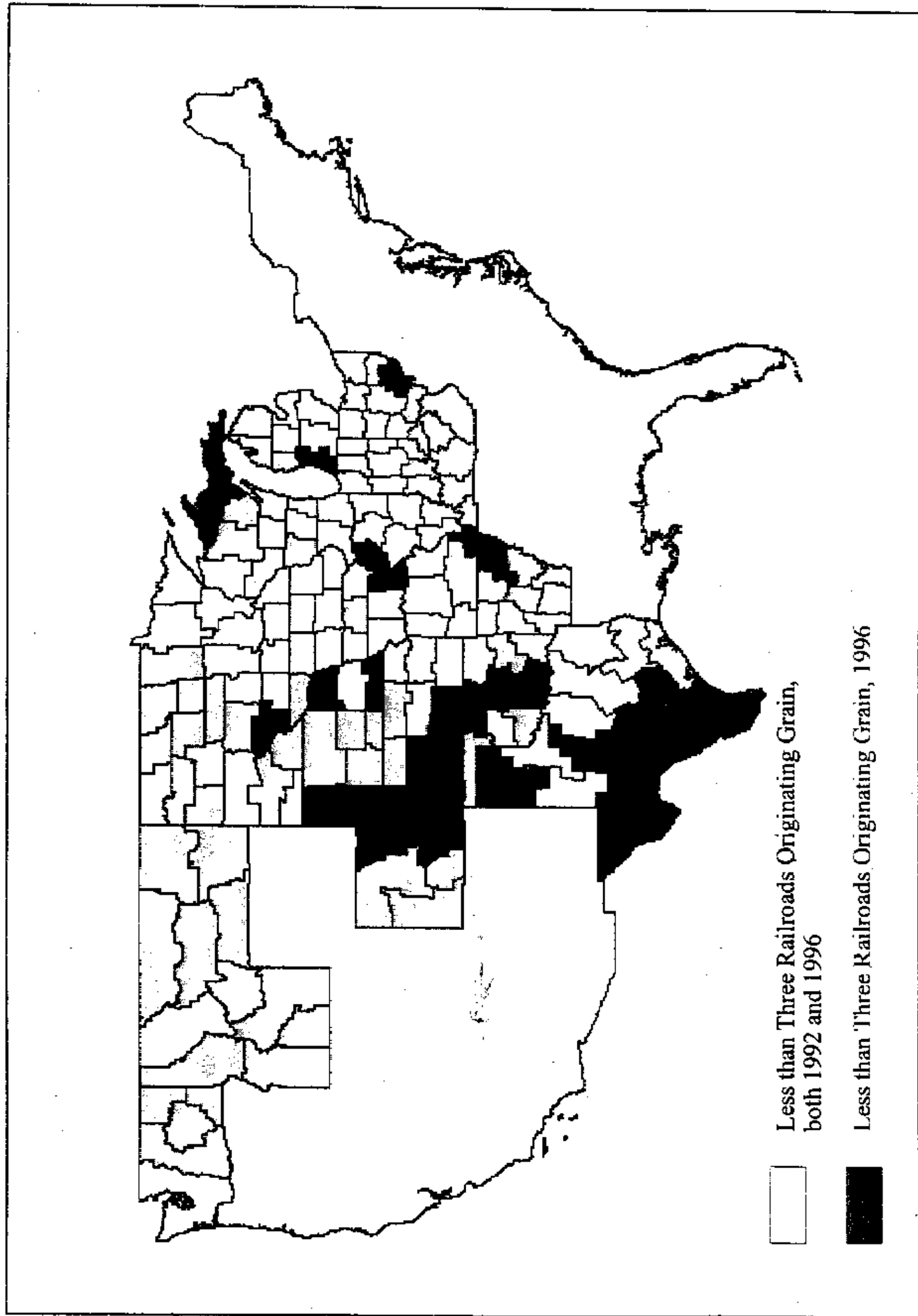
The number of Class I railroads has been declining for years. In 1982, for example, there were 33 Class I railroads — today there are only 9. In many ways that decline has been beneficial. Some carriers were weak, both financially and operationally, and it was in the public interest to allow these carriers to merge with stronger firms. The loss of competition that resulted from merging weak railroads with stronger firms was offset by gains in economic efficiency and improved service to shippers. Moreover, a

number of strong regional railroads, such as the Wisconsin Central, were created after the Staggers Act as a result of "spin-offs" from the Class I carriers. These carriers served to provide some additional competition to the Class I carriers in the origination of grain and grain-related products.

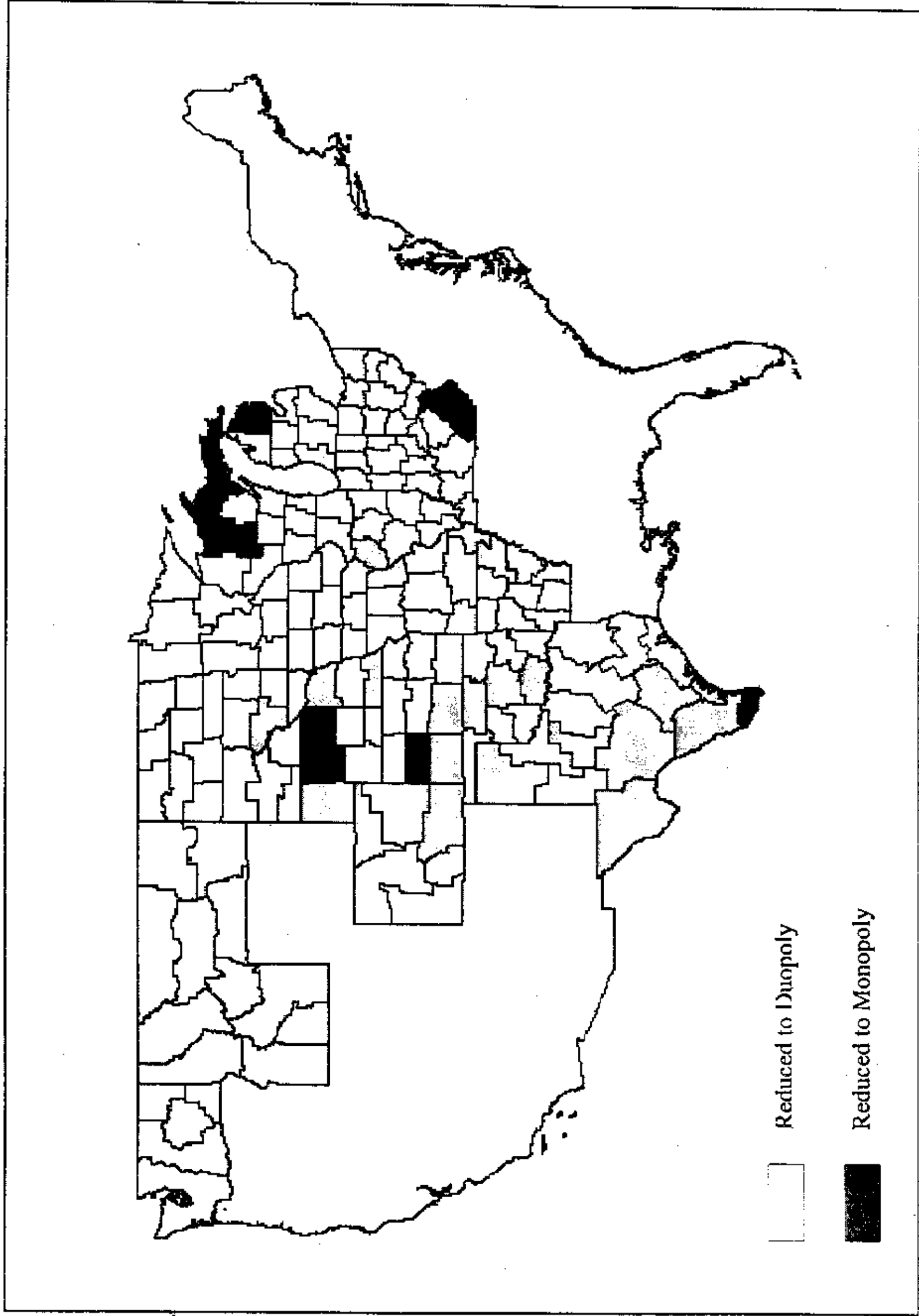
Since 1993, however, the number of railroads serving the agricultural sector has declined significantly. In major transactions, the Chicago and North Western Transportation Company merged with the Union Pacific Railroad (UP); the Burlington Northern Railroad merged with the Atchison, Topeka, and Santa Fe Railway; and UP merged with the Southern Pacific. In addition, the Mid-South Rail Corporation, the Gateway Western Railroad, and the Chicago, Central & Pacific Railroad, each an important regional railroad, were purchased by Class I carriers. In these instances, with the possible exception of the Kansas City Southern Railway's purchase of the Gateway Western, the perceived benefits of consolidation was a more important factor in explaining these mergers than financial and operational weakness.

The following maps show that this wave of consolidation has resulted in fewer suppliers of rail transportation services to the agricultural sector. Each of these maps displays the crop reporting districts (CRDs) in the top twenty grain producing states. Each CRD is a sub-state, multi-county area representing a geographically distinguishable region that is relatively uniform in its crop production, land use, and transportation characteristics. The states represented on these maps account for over 90 percent of all U.S. grain production.

Map 1 -- Number of Railroads Originating Grain in Key Crop Reporting Districts



Map 2-- Reduction in Railroad Competition in Key Crop Reporting Districts, 1992- 1996



Map 1 shows the 87 CRDs with fewer than three railroads originating grain traffic in 1996. Of these 87 CRDs, 58 were served by fewer than three railroads in 1992. So, twenty-nine CRDs lost competitive choices between 1992 and 1996 — only six CRDs added competitive choices. Thus, there has been a 38 percent increase in the number of CRDs served by fewer than three railroads in that time frame. Map 2 shows CRDs that have been reduced to monopoly or duopoly status. It is instructive to see how dramatically competition has fallen in the Southern Plains.

ECONOMIC IMPACT OF CONSOLIDATION

These maps are very interesting because economic theory suggests that as the number of competitors increases, the price firms can charge declines. USDA has confirmed the importance of intra-modal competition on rail rates. According to our analysis “moving from a monopoly to a duopoly in a corn market 75 miles from water reduces rates by 17.4 percent, and moving further to a triopoly reduces rates another 15.2 percent;” similar results were observed for wheat.¹ Moreover the further one moves away from navigable water, the greater the effect on rates as additional railroads enters the market.²

¹MacDonald, James M (1989). *Effects of Railroad Deregulation on Grain Transportation*. Commodity Economics Division, Economic Research Service, U.S. Department of Agriculture. Technical Bulletin No. 1759, p. 32.

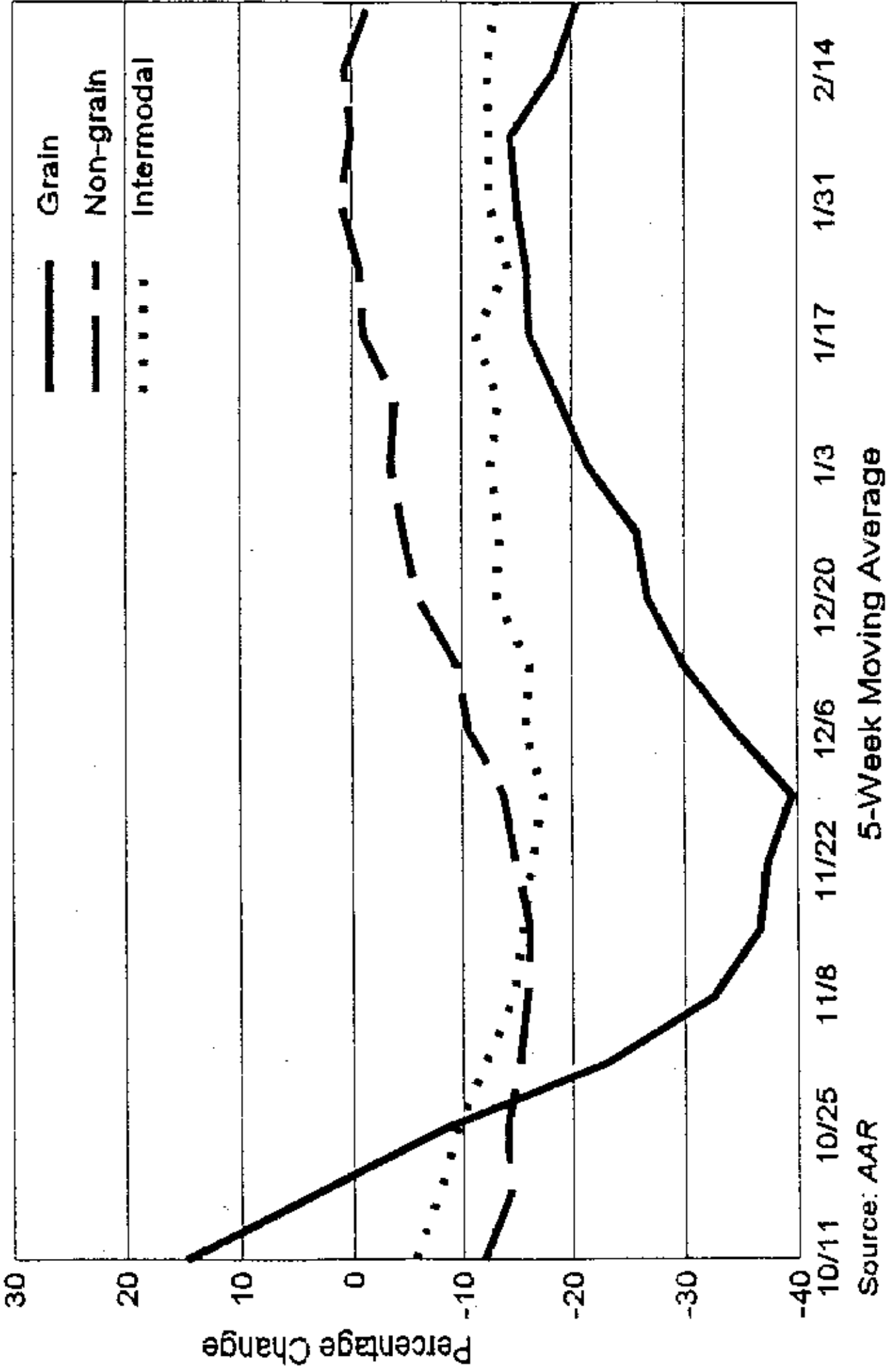
²Ibid., p. 33.

These results are not likely to come as a surprise to grain shippers in Montana, where Burlington Northern Santa Fe (BNSF) has long been the only railroad operating in the Northern and Eastern portions of that State. Rates for wheat shipments out of Montana are much higher than the rates charged to Nebraska wheat that must be hauled hundred of miles before passing through Montana. While some use of differential pricing is necessary to cover the high fixed costs that railroads incur, both the law and the Board specify that these rates must not be exorbitant. Unfortunately, under the present guidelines related to revenue adequacy and reasonable rates, it is extremely difficult to establish that railroads are charging unreasonably high rates. Small shippers in particular are deterred from challenging rates because of the cost, complexity, and uncertainty that attends such legal battles. One step the Board should take is to greatly simplify the regulatory provisions governing maximum rate cases. As part of this process, the Board should relax its present standard for determining market dominance and examine the current use of revenue adequacy in rate reasonableness cases.

Discrimination can also occur in the quality of transportation services that railroads supply. Grain shippers know very well that there often seems to be a negative correlation between rates and service quality: shippers who pay the highest rates often seem to receive the worst service. A classic example of such service discrimination occurred last fall in the Western rail service crisis. As the following charts demonstrate, in an effort to solve its congestion problems, UP/SP dramatically cut its service to agricultural shippers during the height of the fall shipping season. UP/SP's main competitor, BNSF also practiced service discrimination against grain shippers — as its

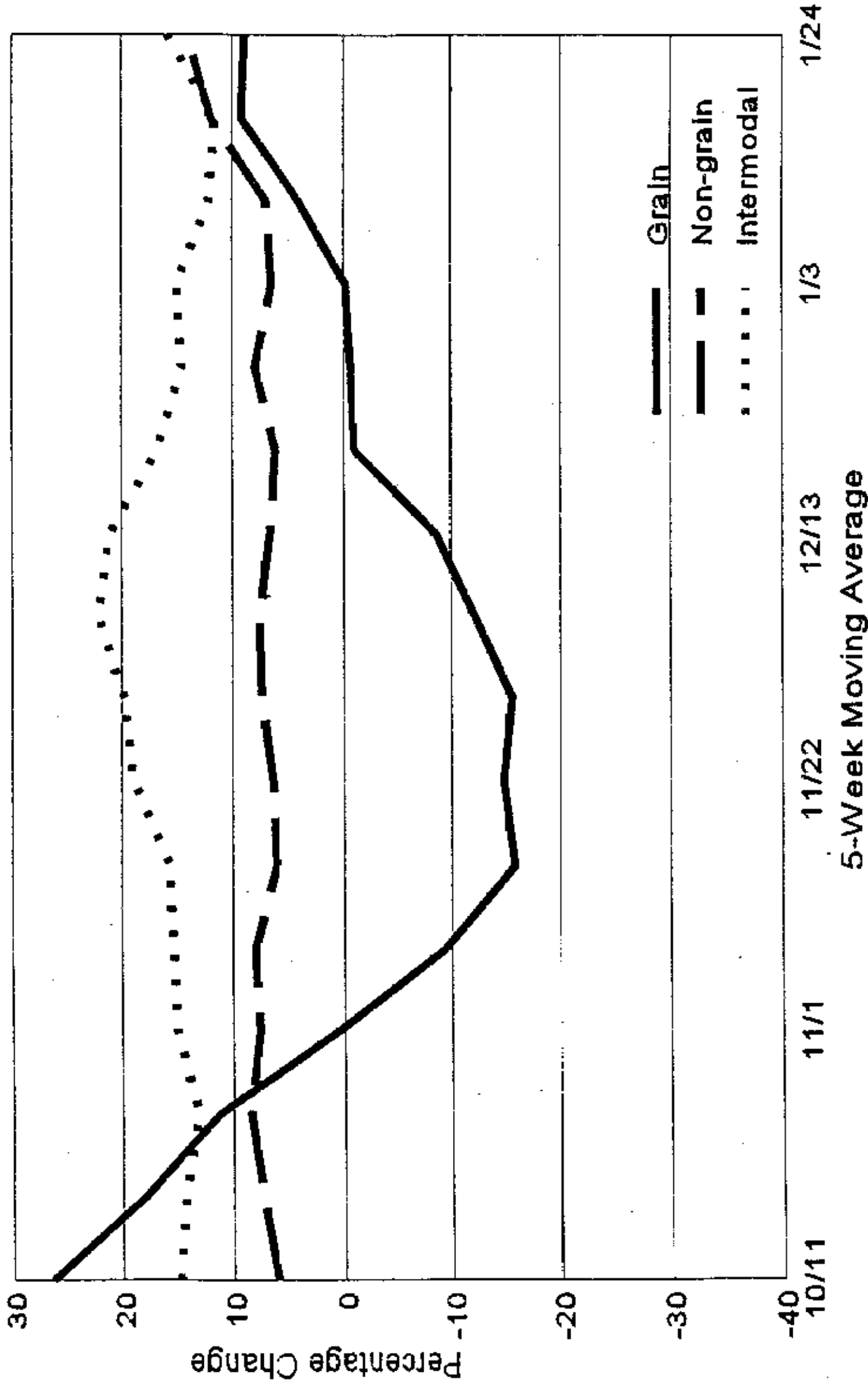
UP/SP Percentage Changes in Carloadings

Changes from Year-Ago Levels



BNSF Percentage Changes in Carloadings

Changes from Year-Ago Levels



Source: AAR

intermodal traffic soared, its grain shipments fell. This greatly complicated the logistical problems of feeders and processors across the country.

Had there been more effective intra-modal competition, it is likely that agricultural producers would have received better service during last fall's rail crisis. Although agriculture's competitive viability in domestic and export markets depends on rail transportation, it seems that, too frequently, agriculture finds itself at the bottom of the service priority list when rail problems occur.

Service quality also declines when grain shippers are forced to bear a greater responsibility for car supply, grain assembly, and other functions that railroads formerly provided. Transportation is but one component of a firm's logistical costs and to enjoy the "cost savings" that railroads offer, firms must often make additional private investments. For example, to attract 100-car "unit-trains," grain elevators must invest in sidings, inventory, storage capacity, and loading facilities. USDA believes that the current push for 100-car unit shipping has as much to do with the market power of Class I railroads as it does with the technological innovations of those same carriers.

The effects of increased competition are even greater when one considers that the recent wave of mergers has greatly limited product and geographic competition for key agricultural products, particularly wheat. BNSF, for example, handles over half of all railed wheat shipments, with an even greater share of the high protein red wheats. It is nearly impossible to negotiate a favorable rate when the same railroad is also the sole shipping option for alternative supplies of the same or a substitutable commodity.

PROMOTING EFFECTIVE COMPETITION

With the exception of the UP/SP merger, where the Board retains oversight authority, the mergers that have taken place these last five years cannot be undone. And it is not clear to me that they should be undone. What I do believe is this: if railroads were subject to the same antitrust scrutiny as any other industry, many of their practices would be prohibited and most of the recent mergers would never have taken place. I believe the Board has the power to prevent abuses of market power and it behooves the Board to exercise that power more aggressively in the future.

MERGER POLICY

If the problem is increased consolidation among Class I carriers, then the merger policies that guide the Board are relevant to this proceeding. USDA has previously urged the Board to examine its merger policy. We recognize that the Board is bound by the statutory provisions codified at 49 U.S.C. 11321-27. Of particular concern are the five factors laid out in Sec. 11324(b). USDA believes that these five factors must be evaluated in light of the nation's rail transportation policy set out in 49 U.S.C. 10101. As we have stated before to this Board in testimony and written statements —

Examining the goals set out in the rail transportation policy, USDA believes that [the Board] has placed too much weight on the achievement of efficiency and too little weight on effective competition.

Of course, efficiency is an important policy objective: efficiency is associated with the cost-minimizing organization of economic activity. USDA simply notes that effective competition also has many concrete, salutary benefits. It promotes reasonable rates, minimizes the need for regulatory control, and encour-

ages honest and efficient management of railroads. By contrast, efficiency benefits (including *potential* cost savings) are inherently more speculative. Not only might the proposed benefits of a merger never be realized, but, because of market power, whatever benefits do occur may not be passed through to shippers in the form of lower prices.

To USDA, effective competition "to meet the needs of the public" must include effective intra-modal competition — the kind that minimizes the number of captive shippers and the need for regulatory control over rates and services.³

USDA does not oppose all mergers of Class I railroads. But in approving additional mergers, the Board must be more sensitive to the needs of shippers, particularly agricultural and bulk shippers. When approving any future merger, or in the exercise of its oversight function after a merger, the Board should use its broad conditioning powers to advance the public interest in competition.

BOTTLENECKS

One way to promote more effective competition is to examine more carefully the problem of "bottlenecks" in the railway network. Bottlenecks occur when access to the rail network must be gained through a single link. The firm that owns that key segment of track can effectively extract monopoly rents from shippers seeking access to the bottleneck. Thus, shippers dependent upon railroad bottlenecks must pay higher prices for transportation than might otherwise be the case. The Board's recent decision in

³*Comments of the United States Department of Agriculture, Finance Docket No. 33388, CSX Corporation and CSX Transportation, Inc., Norfolk Southern Corporation and Norfolk Southern Railway Company — Control and Operating Leases/Agreements — Conrail, Inc. and Consolidated Rail Corporation. October 21, 1997.*

FMC Corporation v. Union Pacific Railroad permits the scrutiny of bottleneck rates for shipments under contract. USDA would favor allowing more extensive challenges to bottleneck rates and providing a convenient and transparent mechanism to eliminate barriers to switching and to establish appropriate rates to competitive carriers. At a minimum, shippers should be allowed to challenge any part of a haul which involves bottleneck pricing, not just the price of the total move.

POTENTIAL FORECLOSURE OF SHORT LINE RAILROADS

Railroads would claim that it is never in their interest to foreclose traffic that could offset their high fixed costs, and that is probably true. But I believe that Class I railroads may have an incentive to foreclose short line railroads, and, in particular, I worry about the grain-gathering network of short line railroads. It seems to me that Class I railroads do have an incentive to force grain from branch lines (owned by a shortline) to elevators located along the mainline (owned by a Class I). In either case, the railroads cover their fixed costs, but by "foreclosing" the short line through discriminatory pricing or service, the railroads avoid splitting the tariff with the short line, while transferring additional costs on society by way of higher road maintenance expenses as grain is trucked to the mainline. In other words, Class I railroads can create externalities because the social costs of foreclosure exceed their private benefits.

The Class I railroads are bound by the common carrier obligation to interchange traffic with short line railroads. It is unclear, however, how diligently the Class I carriers

attempt to fulfill this obligation. For example, short lines often must obtain permission from their Class I connection to lease cars from third-parties. A Class I railroad could effectively foreclose a short line railroad by failing to provide cars while refusing the short line permission to lease cars. In fact, there have been complaints that this type of abuse occurs, even when the Class I carrier is contractually obligated to supply cars to a short line.

PAPER BARRIERS

Another concern I have is the existence of "paper barriers." These are restrictions placed on a short line railroad that effectively tie it to a single Class I carrier. The ability of a Class I to deny permission to lease cars to a short line cited above is one example of a paper barrier. While these paper barriers are voluntarily agreed upon, typically as part of the sale of a branch line, they serve to restrict the flow of interstate commerce and reduce the total social benefits arising from the rail network as a whole. The reason for this, of course, is that railroads form a network industry; rail carriers must not only compete with but complement one another. Thus, unnecessary restrictions on interchange and car supply, which may be in the private interest of two railroads, are rarely in the interest of the network as a whole.

Another problem with paper barriers is that these restrictive contracts are not self-enforcing because the incentives of short lines and Class I carriers will often be incompatible. For these reasons, I believe eliminating paper barriers would enhance interstate

commerce and relieve, to some degree, the problem of car supply on the short line railroads.

CAR SUPPLY

Car supply is essential to the proper functioning of the rail network. I am concerned that many shippers and short line railroads cannot justify investment in cars because per diem (rental) rates are too low and Class I railroads do not always promptly return cars. For the larger railroads, per-diem charges tend to "net-out," but for smaller railroads, particularly agricultural railroads that often originate and forward nearly 100 percent of their total traffic, per-diem rates can be economically significant. If the per diem rates do not adequately compensate shippers and short line railroads, not only is their ability to purchase or lease cars hindered, they are prevented from providing their customers with reliable transportation service.

I am aware that, prior to 1993, the per diem and mileage fees of freight cars were prescribed and did not respond to changes in the market place. This resulted in artificially high rates of return on investment and an overinvestment in railcars. However, since the decision to phase out prescribed per diem rates, the consolidation of the Class I railroads has weakened the ability of shippers and short line railroad to obtain compensatory rates for their railcars. The rail industry, shippers, and the Board need to find a responsive, market-based mechanism that creates the proper incentives to add equipment (when appropriate), to employ that equipment most efficiently, and to compensate the owners for their opportunity costs if their equipment is not returned.

OPEN ACCESS TO INFORMATION

It is ironic that while the consolidation of Class I railroads has resulted in the rise of new mega-carriers capable of exercising market power over shippers, the amount and quality of data available on these carriers has fallen dramatically. Because of the many mergers and consolidations in the U.S. railroad industry over the past twenty years, and the past five in particular, most localities have service from only one or two railroads. With railroad competition now essentially determined by interaction between pairs of firms, an increasing amount of government oversight is needed so that the pricing and service behavior of these firms can be monitored. Such oversight is ideally provided by requiring the railroads with supposed market power to provide some additional information on how they are performing. Such information was less important when market forces — in the form of extensive intra-modal competition — were present to provide a competitive discipline to the firms in the U.S. rail industry. The public needs information that can identify abuses of market power and the common carrier obligation.

INTERNATIONAL EMBARGOES

Yesterday, March 25, 1998, UP/SP announced a sweeping embargo on shipments crossing the United States border at Laredo, Texas. While this action by UP/SP is directly related to another proceeding this Board is conducting, STB Ex Parte 573 — *Rail Service in the Western United States*, it merits attention in this proceeding as well. As I mentioned earlier, railroads must compete with and complement one another. While

there are undoubtedly occasions when, for safety or operational reasons, it is necessary to embargo traffic, no carrier should have the ability to unilaterally restrict the international trade of the United States as the UP/SP now threatens to do. I am particularly dismayed that UP/SP has taken this action when the other carriers involved dispute the need for an embargo. I urge the Board to exercise its powers under 49 U.S.C. 11123 and prevent UP/SP from implementing its embargo. The Board should immediately gather testimony from the various railroads and determine what actions, if any, are appropriate in light of the alleged rail congestion in Mexico. The Board, and the Board alone, should have final authority to approve disputed embargoes of interstate or international significance.

CONCLUSION

By initiating this proceeding, I believe the Board is providing a valuable service to the public. Among shippers, and the public at large, there is a considerable and growing anti-railroad sentiment. It is clear that important segments of the public have lost confidence in the current system of oversight and something must be done to restore that confidence, if only to prevent the return to wholesale regulation of the rail industry.

Fortunately, we still have time to make the pro-competitive changes that the country needs. But my view, as the Secretary of Agriculture and a former member of Congress, is that time may be running against us. It is in everyone's interest — the public's interest, the shippers' interest, even the railroads' interest — to consider all the proposals this proceeding generates in a fair and dispassionate manner.

The increased concentration in the rail industry that has arisen in recent years has placed the Board, and Congress, under great pressure to revitalize the current system of oversight. Of course, there is no "one size fits all" approach that the Board could adopt that will protect shippers while preserving the ability of the railroad industry to earn the profits it needs to maintain and enhance our vital rail network. What is needed is a regulatory regime that promotes competition and transparency.

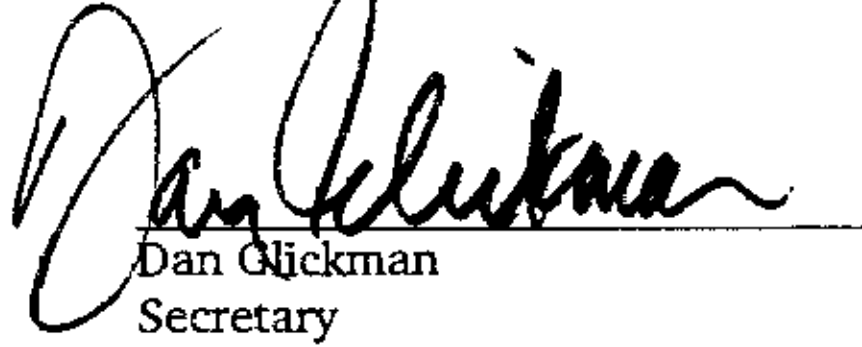
Not long ago, railroad executives were proclaiming the 1990s as the dawn of a new golden age of railroading. While the events of the past year have shaken that optimistic vision, I am persuaded that railroads, properly regulated, do have a golden future ahead of them — as do all the shippers that rely on rail transportation. But that future can be secured only if those of us here in Washington roll up our sleeves and do the people's business.

In this statement I have made a number of specific recommendations that, if adopted, would help the Board rebuild public confidence and restore a competitive environment for agricultural shippers, producers, and railroads. I would like to conclude my remarks by repeating those recommendations. The Board should:

- 1) *Simplify regulatory provisions governing maximum rate cases.*
- 2) *Relax present standards for determining public dominance and examine the current use of revenue adequacy in rate reasonableness cases.*
- 3) *Reexamine current merger policy.*

- 4) *Be more sensitive to the needs of shippers, especially agricultural and bulk shippers, when considering the public's interest in competition. This is particularly important when the Board is evaluating mergers.*
- 5) *Allow more extensive challenges to bottleneck rates.*
- 6) *Develop a responsive, market-based mechanism that generates the incentives to add equipment (when appropriate), employs that equipment efficiently, and fairly compensates owners for the use of their equipment.*
- 7) *Monitor the behavior of Class I carriers to insure that they fulfill their common carrier obligation to interchange traffic with short line railroads and do not foreclose short lines by failing to provide adequate car supply.*
- 8) *Remove paper barriers that restrict interstate commerce by limiting ability of short line railroads to access the entire rail network.*
- 9) *Require Class I carriers to provide such information as will enable the Board to identify possible abuses of market power and the common carrier obligation.*
- 10) *Prevent UP/SP from implementing its embargo on rail traffic to Mexico and determine what actions, if any, are appropriate in light of the alleged rail congestion in Mexico.*

Respectfully submitted,

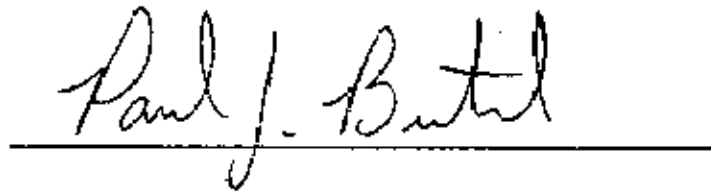


Dan Glickman
Secretary

U.S. Department of Agriculture
Washington, D.C. 20250

CERTIFICATE OF SERVICE

I, Paul J. Bertels, certify that on this 26th day of March, 1998, I caused a copy of the foregoing document to be served by first-class mail, postage paid, on all parties of record in STB Ex Parte 575.

A handwritten signature in cursive script that reads "Paul J. Bertels". The signature is written in black ink and is positioned above a solid horizontal line.

Paul J. Bertels
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