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STATEMENT OF CHARLES D. BAKER, ASSISTANT SECRETARY FOR POLICY AND INTERNATIONAL AFFAIRS, DEPARTMENT OF TRANSPORTATION, BEFORE THE SUBCOMMITTEE ON SURFACE TRANSPORTATION OF THE SENATE COMMERCE COMMITTEE, CONCERNING PROBLEMS AFFECTING THE RAILROAD INDUSTRY, THURSDAY, APRIL 22, 1971.

Mr. Chairman and Members of the Committee:

I am pleased to be here for these railroad industry oversight hearings and to have the opportunity to present our assessment of the situation and of course benefit by the information and understanding that this series of hearings will generate.

It is very timely and appropriate for your Committee to be concerned about the problems affecting present and future rail transportation. If the trends indicated by the railroad industry's posture, financial and otherwise, are to be reversed, it seems clear to us that a serious effort to deal with fundamental problems must be undertaken. Any discussion of rail transportation is necessarily dominated by the magnitude of the industry and its importance to our national interests. The fact that in 1970 the railroads generated $12 billion in gross revenues but realized less than $200 million in after-tax net income is an indication both of the importance of this industry and the scope of its problems.

I am pleased to have the opportunity to talk to the Committee about problems affecting rail transportation, both in the short term and long term. Solutions to the many problems that we or others may identify are not easily developed, but it is clear that we are dealing with two related but nonetheless distinct questions. First, what needs to be done

to cure the chronic ills of this industry--assuming they should be cured; and second, what needs to be done to keep the patient in some semblance of health while cures are being effected. We must carefully avoid piecemeal solutions. Further, since real "solutions" clearly take time, plans must now be laid to assure the progress of the railroads into the 1980's.

As shown in Exhibit I, and as the Penn Central, Lehigh Valley, and other bankruptcy cases make us grimly aware, the industry is sick. But let me say at the outset that it is my view the Nation neither needs nor wants a Federally owned and operated rail system in the 1980's. We will need a strong, independent industry that is capable of hauling 30 percent more ton miles of freight than it hauls today, at reasonable rates and with an expectancy of on-schedule delivery not less than 90 percent of the time.

Why am I of the view that the rails are vital? First, they are the largest modal carrier of freight (Exhibit II). Second, even at a slightly reduced share of all traffic by 1980, the rails will carry at least one trillion freight ton miles. Third, some major commodities depend very heavily -- some 2/3 or 3/4 of their tonnage -- on the rail mode. Exhibit III shows the importance of the rail mode in an all commodity review. Thus, it is clear that this country cannot function without its rail network in the predictable future. But given the sorry and worsening state of railroads today, it is clear that absent major

change; absent legislative, executive and industry leadership; absent labor-management vision; absent shipper-user involvement and concern; this transportation system is headed rapidly downhill and the prospects for the 70's and 80's become bleak indeed.

PROBLEMS OF THE RAILROADS

Now I would like to turn to the problems which presently prevent the rail mode from realizing its potential contribution to satisfying the Nation's total transportation needs.

Financial Condition

First of course, is the industry's deteriorating financial condition. The most dramatic evidence of the seriousness of this condition is the bankruptcies that have already occurred, and the current struggle of a number of carriers to avoid that fate. Further, evidence of this condition for the industry as a whole is found in some of the worsening trends in the railroads' fiscal picture.

The railroads' net railway operating income declined to $411 million in 1970, the lowest figure in the past 15 years (Exhibit IV). Gross operating revenues increased to a record high of $12 billion in 1970, but the margin of net operating income to gross is now down to about 3.4 percent, also a new low. The net income before taxes is improved by the addition of income from sources other than railway operation, but here again the trend is also down, from $1,341 million in 1955 to $215 million in 1969 (Exhibit V).

Return an investment reached a post-war low of 1.97 percent in the recession year of 1961. From that low, the figure rose to a high of 3.90 percent in 1966. Since then, however, it has steadily dropped, to reach an estimated new low of 1.47 percent in 1970 (Exhibit VI).

Net working capital has declined steadily since 1963, when it was $828 million. On December 31, 1970, this figure was $110 million (Exhibit VII). To give this some perspective, $110 million represents no more than five days' worth of operating expenses for the industry as a whole. In contrast, the accepted rule of thumb would view something over $750 million -- representing 30 days' expenses -- as a minimum level of net working capital. This is roughly equivalent to the $600 million figure which your Committee indicated was the minimum figure in 1958.

In recent years, cash flow from retained income and depreciation retirement charges has provided for only about 60 percent of gross capital expenditures. The remainder has come principally from drawing down working capital and from additional borrowing for equipment. This caused the railroads' total outstanding debt to reach $10.5 billion at the beginning of 1970 (Exhibit VIII).

Despite this fiscal plight, the railroad industry has attracted capital and modernized some of its physical property over the past twenty years. Since 1950, net investment in transportation property has increased over 30 percent, yet pre-tax earnings declined almost 50

percent over the same time period (Exhibit IX). Another picture of cash shortages is the fact that the railroads, as a whole, have used a large percentage of available cash for dividend payments. The percent of dividends to cash flow was 39.1 percent in the 1965-1969 period (Exhibit X).

As we view it, the broad problem the railroads face is to generate sufficient earnings to cover operating expenses and to attract additional capital for further modernization of equipment and facilities. The immediate problem of some of the railroads is sufficient cash to maintain current operations.

For example, over the past 15 or 20 years, there has been a decline in the installation of new ties. In 1950, the railroads were averaging a replacement program of 120 ties per mile. By 1967, this average declined to 63 ties per mile, a level adequate only if ties lasted 50 years. In fact, average ties actually last about 30 years.

We see a similar trend in the size of the freight car fleet. Over the past decade, although the railroads have added increasing numbers of freight cars each year, they are retiring them even faster, and the absolute fleet has declined from 1.9 million in 1960 to 1.8 million in 1970.

These examples serve to illustrate that the railroad industry is strapped for capital at a time when the "plant" and equipment are already in sad shape.

Let me stress, however, that when I speak in terms of industry averages, it does not highlight the fact that some railroads are in far worse shape than others. For example, the Southern Pacific made close to $100 million in 1970, while the Penn Central went into bankruptcy.

Rate Structure

Because of the industry's narrow spread between revenues, expenses and earnings, it has been suggested that a major contributing cause of the problem of inadequate revenue lies in the existing rail rate structure and the lack of a meaningful and rational approach to the pricing of rail freight service. I find this argument fairly convincing. Although over the past ten years the rail industry has received authority to increase their rates some 33 percent on a cumulative basis, their average revenue per freight ton mile has increased only 10 percent over the same period of time. This serves to confirm to me that the problem is one of structure and composition of the rates. While there have been a number of significant exceptions such as the Rent-a-Train concept, the basic rail rate structure and the considerations that are taken into account in the pricing of rail service still appear to follow a "value-of-service" philosophy of pricing. This would be more suitable to the times when railroads dominated the transportation of freight than to the competitive situation we have today. This approach leads to situations where certain commodities are carried at less than their direct costs-of-service, in

turn leading to a measure of cross-subsidization from higher-rated commodities. The Penn Central trustees estimate their below-cost rates are producing losses estimated at more than $80 million a year. From a preliminary analysis -- and we recognize there is considerable controversy on this subject -- we estimate the losses to the railroad industry resulting from below-cost rates at about $600 million a year.

The present rate structure appears to exhibit the characteristic that across-the-board percentage increases in rates do not produce equivalent percentage increases in revenues. In part as a result of a statement we filed with the ICC last November (Exhibit I), that agency decided that the problem required further study and ordered Ex Parte 270, Investigation of Railroad Freight Rate Structure, on December 11, 1970. A copy of the pleading of the Department in that case is submitted for the record (Exhibit XI).

Another approach to achieving a more effective rate structure for the railroads has been suggested by the Council of Economic Advisers in their Economic Report to the President. This approach, by way of lessened regulation of the railroads, is complex because there are both a number of separate "deregulatory" steps that can be taken and because each of these steps can be phased rapidly or slowly. There is no question in my mind, however, that adjustments must be made to the current Federal system of economic regulation to bring it into tune with the realities of today's transportation market.

Plant Utilization

Another major problem facing the industry is the poor utilization of the railroad plant. Simply stated, the existing railroad plant far exceeds the needs of present and projected traffic. Today, we still have 90 percent of the line-miles (in fact, 90 percent of the track as well) that we had in 1939. This trackage predates the construction of 44,000 miles of our Interstate Highway System, the eightfold increase in pipeline mileage and ton-mile capacity, and the decline in intercity rail passenger service from two thirds of the passenger volume to less than 10 percent. In spite of the dramatic change in intercity transportation requirements, the rail plant has remained essentially the same.

Unproductive branch lines constitute a substantial drain on railroad resources, and, in many instances, their shippers would seem more economically served by other modes. As the Rock Island's experience showed, substitute truck services under rail tariffs can be as popular with shippers as with the railroads. Nonetheless, these uneconomical branch lines remain in place. A Brookings study way back in 1933 estimated the light density route mileage which then existed constituted 58,000 of the 239,000 miles in the system. Today, more than half of that 58,000 miles remains.

Duplicate main lines are also part of the problem. Estimates of the utilization of main line capacity range from 20 percent to 30 percent. Exhibit XII shows that if our actual rail system worked as one

coordinated system, 80 percent of the ton miles could move over less than 40 percent of the route miles.

A particularly incredible but factual illustration of this problem is found where the bankrupt Central Railroad of New Jersey runs side by side with the bankrupt Lehigh Valley between metropolitan New York and Scranton, Pennsylvania. A third marginal carrier, the Erie-Lackawanna, operates another parallel line competing for the same traffic. It is impossible to justify these costs and plant capacity.

This excess line capacity is also directly related to the estimated $1.8 billion of deferred track maintenance which now exists. And, the implementation of uniform track standards under the Railroad Safety Act of 1970 is expected to further increase the cost of retaining the rail plant at its present size.

Obsolete and inefficient terminals are also a problem. Literally hundreds of switching and storage yards have been built to handle rail traffic. Many of these have now been surrounded by urban development and could better function elsewhere as consolidated facilities.

The St. Louis riverfront is only one example of this. For over 100 years, the Mississippi riverbank has been occupied by rail yards. Nine railroads have facilities on the riverfront. Ten others use the area for interconnections. These obsolete facilities severely restrict rail services through St. Louis (which serves as a major interchange

point for five percent of the Nation's rail traffic) and result in extremely high operating costs.

Similarly, a major cause of the leveling off of growth of piggy back traffic (TOFC/COFC) is the number of small and inefficient intermodal rail facilities. Many of these facilities are no longer adequate to handle higher traffic volumes at reasonable cost.

The railroad industry's structure contributes to the continuation of the excess plant that exists. More than 75 percent of a given carrier's traffic must be shared with one or more additional carriers (Exhibit XIII). This means that rates, costs, and the quality of service for the majority of rail traffic are jointly established by the participants. For example, there are over 3,000 different routes published by the B&O (53), PC (99), and Reading (over 3,000) between Philadelphia and St. Louis. Some of these routes apply via Buffalo or Detroit, across Lake Michigan to Milwaukee, and then south; others apply via Virginia and Kentucky.

Maintaining excessive route choices for shippers has a significant impact on the rail costs incurred and service provided. Excess plant capacity, excess through and local train service, and excess interchange locations and facilities are the necessary outcome of attempts to service these fluctuating traffic volumes.

It is apparent that the problem of plant capacity has more than one cause, and it also has more than one solution. Some argue for more

flexible ICC procedures to abandon uneconomic lines. The ICC itself blames railroad management for a lack of initiative. And rail mergers have been both promoted and cursed as a solution.

Whatever the mix of causes, the 1980 need will demand solutions to these problems. The issue becomes a question of how to concentrate rail traffic flows on a network of well-maintained lines without highway grade crossings which can justify high maintenance standards, modern terminals, reduced gradients, and improved alignments. How well this is accomplished will also have a major impact on rail service.

Service Reliability

Railroad service reliability is a problem of long standing. Freight car shortages and unreliable transit times have been discussed in what often seems a perpetual way. While the ICC has taken various steps in this area, such as the development of mandatory car service rules and changes in per diem and demurrage, the problem is still with us. Given the decline in freight car ownership over the last decade, it is not likely to get better under the existing scheme of things.

There is no doubt that additions to the car fleet must continue, both to replace obsolete equipment and to handle the growth in traffic. The question is how much capacity should be added. That brings me to what seems to be a very basic problem: equipment utilization. The Nation's 1.8 million car fleet moves loaded or empty only 12 percent of the time. It is loaded about 60 percent of the time, and therefore engaged in moving freight roughly only 7 percent of the time (Exhibit XIV).

From preliminary estimates, 30 percent of the average freight car's time is spent in classification and interchange, 40 percent in loading and unloading, 13 percent in waiting to be loaded, and 5 percent out of service. This certainly suggests some opportunities for applied technology, as in the development of new car control systems, as well as marketing and rate making. Even though freight car utilization (expressed in net ton miles generated per ton of capacity) has increased 25 percent since 1960, further improvement is necessary (Exhibit XV). This means better management of car inventory through the national application of a computer control system, the reduction in idle time at interchanges, and the limitation of loading and unloading time to that amount reasonably necessary. Of course, it also means having an adequate locomotive supply available to handle the traffic.

I have mentioned transit time unreliability. For the railroad industry as a whole, a sample survey reveals only one car in three will arrive on the day it is scheduled to do so. In contrast, the trucking industry has an 85 percent to 90 percent on-time delivery record, and consignees obviously prefer on-time deliveries. Thus, railroad performance needs to be improved, but doing so through Federal involvement raises the critical question of the extent to which representatives of the public interest should be involved in the basic railroad managerial process.

Another aspect of this problem is reflected in the industry's unwillingness to invest in certain types of equipment. Because the rate structure encourages hauling high-value commodities requiring specialized equipment, the industry has no incentive to buy or utilize general purpose equipment. Over the past decade the boxcar fleet has decreased by 157,000; gondolas by 76,000; hoppers by 94,000; and stock cars by 20,000. On the other hand, covered hoppers have increased by 64,000; flat cars by 20,000; and refrigerated cars by 35,000. This means, of course, that there are fewer general purpose cars available to provide the service required and adds to the burden of servicing an increasingly specialized fleet.

The shippers also contribute their fair share to the service problem, for example, by holding cars for storage and loading and unloading, and by bunching up demand. 1969 figures on cars of revenue freight loaded indicate that car loadings were greater during the third and fourth quarters (737,000) than during the first half of the year (554,000), and a similar situation exists with carloadings of metal ores (1,230,000 loadings for the second half versus 789,000 for the first). This kind of demand peaking causes the railroads real problems in providing the required equipment.

ROLE OF LABOR AND MANAGEMENT

No discussion of the problems facing the railroads can be complete without a recognition of the need for self-assessment on the part of both

railroad labor and management. Each face many unique situations -- the solutions to which frankly are beyond Federal action or relief and require internal remedial action.

It is gratifying to note that industry spokesmen acknowledge their responsibility. The ASTRO Report acknowledged that "The industry must reckon with its own shortcomings . . . At the very least, the industry should be able to resolve by itself matters of internal managerial responsibility. The creation of arbitration machinery for intra-industry disputes is a necessary first step and should be exploited at every possible opportunity".

Likewise there is no doubt that responsible union leaders recognize the need for this kind of self-appraisal within their ranks. They are equally as meaningful a part of the industry as is railroad management and share in its stake for the future. I understand that two labor-management task forces created last July will soon issue reports on their joint analysis of track and roadway and terminal delay problems. Hopefully, there will be much more of this type of cooperation. The Federal Government will continue to look for ways to bring together the kind of labor-management teamwork that is so necessary for the well-being of this industry.

CRITERIA FOR LEGISLATIVE MEASURES TO ADDRESS PROBLEMS OF THE RAILROADS

We have sketched the demands facing the rail system in 1980, and the major problems besetting the rail industry that will hinder the development of the rail system we will need.

Now I want to describe the principles which I believe should be kept in mind in considering the type of legislative measures that would deal appropriately with such major problems.

Any legislative proposals should address what we consider the major causes of the industry's economic problem -- the inability of the industry to attract sufficient capital for modernization and outmoded regulatory laws and policy. In general, we favor an approach that is intended to return the industry to an earnings level that will enable it to attract private capital.

An environment is needed in which a privately-owned and operated railroad system can exist and prosper. Direct Federal financial support should be considered only as a last resort, and if required, it should be carefully evaluated and certainly held to a minimum.

To the extent rail legislative proposals might create inequities for other modes of transportation, those non-rail modes should also be included in the proposals in the interest of fairness and equality where possible and appropriate.

Finally, any regulatory changes that are proposed should be consistent with the tenor of the Administration's lessened regulation proposals, and we believe that railroad regulatory revision should be appropriately paced and directed to specific identifiable problems of the industry.

Alternatives that have been suggested to us by a variety of sources and which we are examining include the following (I do not claim this list is all inclusive, nor do I suggest that any or all will be found upon full examination to be appropriate for Federal pursuit):

1. On a long-range basis, lessened regulation. This includes a zone of flexibility of rates (high and low) and increased carrier discretion vis-a-vis entry and exit.
2. Feasibility of demonstration projects for such things as TOFC/COFC and yard improvement.
3. Encouragement of research, development and systems analysis to improve the system of freight car control.
4. Elimination of discriminatory taxation.
5. Examination of the pooling concept as it relates to car utilization, and in addition, an examination of the rules of per diem and demurrage as they impact on this problem. The objective is to get a system that produces cars moving loaded with freight -- not necessarily back to the owning railroad.
6. Examination of short-run and transitional problems.

I believe that the things I have discussed today indicate that the government is grappling with the gut policy and program issues. And I think it is accurate to state that historically the government has not always done this.

We need a profitable, efficient, high-service level, private rail industry. We don't need a Federal system nor a Federally-supported system. To get from where we are to where we need to be calls for industry skill and imagination -- management and labor alike -- and government realism in regulation and legislation. We are moving, and we will get there.

Mr. Chairman, that concludes my prepared testimony. Now I will be happy to answer any questions the Committee may have.