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DEVELOPMENT, FEDERAL RAILROAD ADMINISTRATION
AND EDWARD B. HYMSON, ASSISTANT TO
THE DEPUTY SECRETARY OF TRANSPORTATION
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS OF THE HOUSE COMMITTEE
ON INTERSTATE AND FOREIGN COMMERCE
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MR. DITMEYER:

I am pleased to be here today to present the views of the Department of Transportation on the interaction between national energy and rail ratemaking policies with respect to coal. With me today is Edward Hymson, who is Assistant to the Deputy Secretary, and who will assist me in presenting our views on these issues.

We at DOT, like the rest of the country, know that the energy crisis is real. We have undertaken major efforts in the Department to assess how best our country's transportation system -- which uses up 51% of our energy supply -- can help to promote a balanced and economical energy program.

The nation's railroads must do their part in this effort; and their part is very great, because they are a fuel efficient way to transport our nation's goods -- including coal. It is important for this reason to assure that the railroads will be in a position to carry those commodities that can make best use of its energy efficient capabilities. Their role is particularly crucial with respect to coal.

We are deeply concerned that the controversy surrounding rail rate increases on coal will disregard the importance of assuring that financially strong, safe, and efficient railroads can continue to move our nation's coal, now and in the future. Today, twenty percent of all railroad carloads are coal; and in the future coal will become the predominant single commodity for many Western railroads, supplanting their long reliance on the agricultural and forest products for which they were originally constructed. Our energy policy, our energy resources and our energy budget all make clear that the railroads will have to carry even more coal in the future. But this is not without cost to the railroads.

Coal transportation involves significant increases in the level of investment and maintenance needed to assure safe and reliable service. These higher physical plant and equipment requirements, in turn, place new financial burdens upon the carriers--burdens that are predictable, but nonetheless significant.

These new financial demands come at a time when the railroads as a whole face unprecedented capital requirements for maintaining and modernizing their plant and equipment. The Department recently concluded that the railroad industry--if it continues its current structure

and mode of operation--is estimated to fall \$13 to \$16 billion short of the capital it would require over the decade 1976-1985 to stay in business. And this figure excludes Conrail and Amtrak.

I know that you have heard many times that the current financial condition of the American railroad industry is bad; but the figures are really very dramatic: Three railroads are already in bankruptcy, two are surviving only on Federal subsidy, and fully 40% of them are in marginal financial condition. Net railway operating income for the 12 months ending September 30, 1978, was only \$226 million--an all-time low, even though traffic was at an all time high. Net income during the last five years was less than during the worst five years of the Great Depression. The industry as a whole has not managed to achieve even a 4 percent rate of return since 1955. Last year, the railroads' overall rate of return was 0.83 percent. With rates of return like that, it is not surprising that private investment capital is hard or impossible to come by. And yet, as I have just said, the figures also make quite clear that the railroads cannot internally generate the funds they need to maintain--let alone improve--their system.

This has especially ominous implications for coal. For coal makes especially heavy demands on the rail system. Coal unit trains are

efficient--but they're not cheap--in terms of track or maintenance.

And unless massive investment is made to upgrade rail plant, our railroads simply will not be able to carry all the coal we need.

Before we delve more deeply into the specifics of coal transportation, let me mention just a few more of the immutable financial facts of railroad life.

Increases in the prices of major types of rail equipment and materials have been substantial. Over the past ten years, the average price of a hopper car has increased by 150 percent; a boxcar, 270 percent--well above the economy-wide rate of inflation.

Every one cent per gallon increase in diesel fuel cost raises annual railroad operating costs by approximately \$40 million. So far this year, the price of diesel fuel has gone up eight cents per gallon. If this continues, this year's diesel fuel costs will be \$320 million higher than last year. And remember that the entire net income for the industry last year was only \$226 million. The general rate increase that the industry obtained last fall--an increase within the Administration's guidelines--will not come near meeting this far greater than expected fuel price increase.

All of these facts have a bearing on whether the railroads will be able to meet our nation's coal requirements, and how much it will cost them to do so.

I have included six tables that graphically show the income and expense figures I have just discussed. These have been submitted for the record.

Mr. Chairman, I would now like to ask Dr. Hymson to talk about some recent coal rate cases, including one that directly affects Houston, and to explain how the Department sought, in those cases, to reconcile energy and transportation needs.

DR. HYMSON:

Thank you Mr. Ditmeyer. The Department of Transportation is committed to the proposition that railroads should set their rates at the lowest possible level consistent with allowing the railroads to remain privately owned. As Mr. Ditmeyer has pointed out, in the recent past the problem has not been to prevent the railroads from earning excessive profits, but rather to try to prevent them from going bankrupt. And we haven't always succeeded in meeting even that goal. The fact is that healthy, private railroads must charge rates that allow them to cover costs, including the cost of capital. They must earn a rate of return sufficient to attract needed capital. If they do not earn it, they will either go out of business or require massive Federal subsidy. And that choice is, in many ways, at the heart of our testimony today.

Coal, like other rail freight, must pay its way. If it doesn't, then one of two things will happen: coal won't move by the most low-cost, fuel-efficient mode; or other shippers and, most of all, the American taxpayer will have to pour more billions into the rail system.

The Interstate Commerce Commission has determined, in Ex Parte No. 353, Adequacy of Railroad Revenue (1978 Determination), that to retain existing capital and to attract new capital, the railroads must earn a 10.6 percent return on investment. By the way, this is a rate of return substantially lower than the return earned by most electric utilities, and well below the rate of return earned last year by Houston Power & Light. It is, however, higher than even the most profitable railroad is earning today. If railroads continue to earn inadequate rates of return, they will be forced to watch their properties deteriorate and service continue to decline. The decay of our railroad system, first observed in the Northeast, and now very serious in the midwest, will move to the south and west. Taxpayers are already paying billions in subsidy, but the amount can easily grow many times if current conditions persist.

There seems to be general agreement that railroads are an important and energy efficient form of transportation. But for too long every shipper has pointed to his product and declared, in effect, that rail-

roads need more revenue but they should secure it by raising rates on somebody else's shipment. Food producers claim their product is a necessity and they should not pay high transportation prices for it. Natural resource producers point out that their product is essential to the wellbeing of American industry and our balance of payments. They conclude that rates on their products should not be raised. Scrap dealers point out that there are great energy efficiencies associated with reprocessing scrap, and that scrap rates should be held down. Mr. Ditmeyer has described the result of a rate structure that has tried to cater to all of these interests.

Railroads, like utilities, must charge rates sufficient to cover costs if they are to survive. Electric utility regulators must make difficult decisions about which class of customer should pay what percentage of the cost of producing power. It appears to be generally agreed that each consumer should pay at least the variable cost of the transportation services he or she uses. The fixed or nontraceable costs must be allocated among the consumers in whatever manner the regulator feels is most equitable. Always, however, the question has been who should pay what portion of the costs of producing electric power. The question has never been, shall the electric utilities be allowed to recover their costs.

But that is the question facing the railroads; and for some, the answer may be no. For most, however, the answer is yes, but only if the regulators permit rates to rise on those commodities that will continue to move at higher rates. It's not a palatable answer. But it's the only answer.

In this setting I would like to review the principles of ratemaking that the Department of Transportation has urged the Interstate Commerce Commission to adopt in coal and other rate cases.

First, every shipper should pay a rate that at least covers the costs of providing the service, the so-called variable or incremental costs. Any lower rate would require other shippers, or taxpayers, or both, to subsidize the favored shipment.

Second, since the impact of fixed costs is minimized if they are spread out over a wide number of shippers, a railroad should try to attract any business that covers variable costs and makes some contribution to fixed costs. But many commodities, which have other transportation alternatives, simply will not move by rail if called on to make a very

large contribution to fixed costs. That competitive traffic does help to lower the costs paid by other shippers, and in volume, that contribution can be significant, but each ton-mile shipped doesn't make as big a contribution as other traffic can. So, once you calculate the maximum amount that can be contributed to fixed costs by that competitive traffic, then remaining railroad costs must be covered by the rest of the traffic. Let me emphasize again that attempts to charge the same proportion of overhead to all movements will simply drive off a significant amount of traffic and leave all of the railroad's costs to be covered by the remaining commodities.

From a ratemaking point of view, we are left with three alternative rate structures. First, we can permit the type of rate structure I have outlined above. Such a system will spread the fixed costs over the widest possible base and minimize transportation costs for all shippers. It will, however, result in shippers of some commodities making larger contributions toward coverage of fixed costs than others. Second, we can impose a rate structure that requires each shipper to pay the same pro rata share of fixed costs. Such a rate structure will

inevitably drive away much of the traffic railroads now carry and leave the remaining shippers to cover a larger amount of the fixed costs than they did before. Third, we can artificially hold down rates, force railroads to lose money, let their physical plants decay, and ultimately, provide bigger and bigger government subsidies to keep the railroads running.

In coal rate cases and others, DOT has consistently argued for the first alternative. And I'd like to discuss briefly what that means for coal. At present, the best way to move coal is by rail. Rail is efficient, cheaper than truck, generally more widely accessible than water, and, in and of itself, fuel efficient. What we have had in the past, and are today advocating is a rate structure that will allow today's coal -- and tomorrow's far greater amounts of coal -- to continue to move by rail.

The Department argued to the ICC in a series of coal rate cases that have recently come before it, including one affecting Houston directly, that coal must cover not just the direct costs of moving it. They must

also make a large enough contribution to rail revenues to permit the railroads to attract or earn the capital that will allow them to buy increasingly expensive fuel and locomotives, and replace existing old or lightweight track with the heavier weight track needed to haul increasing amounts of coal.

A DOT coal task force recently concluded that the railroads need billions of dollars of new investment to construct facilities to handle the increased coal movements over the next decade. That's money the railroads need just to carry coal. As Mr. Ditmeyer pointed out, railroads can carry coal efficiently, but not without substantial investment. Coal unit trains use up rail assets faster than almost anything else the railroads carry. And to serve our nation's energy needs the railroads must not only replace the track and other assets they use up, but also build and pay for, massive new amounts of plant and equipment to carry the coal of the future.

And so the question becomes who's going to pay for those needs. The alternatives are not pleasant, but they are simple: taxpayers or shippers. DOT has recommended to the ICC that it be the latter. The ICC has agreed, concluding that not all shipments can make the same

contribution to rail needs. They have allowed many coal rates to rise partly in recognition of the enormous demands that coal makes on the rail system.

They have done this both before and after the 4R Act -- because the fundamental economic principles of which I have spoken weren't changed by that or any other Act. But for the first time in many years, the 4R Act reminded the ICC of the urgency of the railroads' financial need, and directed them to do everything they could to assure the railroads of adequate revenue levels. The so-called market dominance provision of the 4R Act sought to assure that no single shipper pays an unfair share of the railroads' costs. And while we have some serious disagreements with the way the ICC implemented the market dominance provision, we generally concur with the Commission's reconciliation of the market dominance and adequate revenue levels provisions of the Act where coal is involved.

For example, in Incentive Rate on Coal -- Gallup, New Mexico to Cochise, Arizona, the Commission concluded: "We recognize that since much railroad traffic moves at rates below fully allocated cost because

of competitive pressures, a railroad must be allowed to set some rates in excess of their full cost level where competition, market conditions, and demand permit. This is particularly true if 4R Act goals. . . are to be met." A similar conclusion was reached by the the ICC in the Houston coal case. This is the type of rate structure I have been talking about, and that I believe was contemplated by Congress when the 4R Act of 1976 was passed.

But more important in the present context, it is also the rate structure that best harmonizes the needs of our national energy policy with the needs of our national transportation policy. For a sound railroad system is a cornerstone of our energy policy, just as it is an important part of our national defense policy, and, indeed, of our national wellbeing.

As you know, the Administration has introduced a bill designed to enable the railroads to compete more effectively in the transportation marketplace. The Bill, when enacted, will free railroads to attract new traffic, broaden their traffic base and improve the number and quality of price-service alternatives available to shippers. We believe that when enacted, our bill will provide shippers with better and more cost effective service than railroads are now able to offer.

Before concluding, let me address one last important point. Many argue that the lower rail rates are for coal, the faster the conversion from oil and natural gas will occur. The President has recently announced that he will begin a phased deregulation of domestic crude oil prices, looking ahead to the statutorily mandated end of controls in October 1981. In the last six years the price of imported oil has been escalating dramatically.

It is very unlikely that rail freight rates can be raised so high as to lead utilities to choose oil over coal. In another ICC case--having to do with rail rates on coal for San Antonio--we presented evidence showing that at prices for oil then prevailing, railroad rates would have to rise to levels above those requested by the railroad before the delivered price of coal became more costly than the delivered price of oil, per BTU generated. Of course, oil prices have risen substantially since that time, making coal an even more attractive fuel now than it was then.

CONCLUSION

Both our national transportation and our national energy policies demand a safe, efficient railroad system. The prerequisite to such a system is

the opportunity for railroads to earn sufficient revenue to attract the capital they need to provide service. The American public needs a railroad system that can provide the many services demanded of it at rates no higher than necessary to achieve this end. The rate structure we have discussed is the type of rate structure most likely to provide railroads with the adequate revenue needed to provide the essential service to our national energy policy and to the national economy.