STATEMENT OF ROBERT E. GALLAMORE
DEPUTY ADMINISTRATOR, FEDERAL RAILROAD ADMINISTRATION
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MR. GALLAMORE:

Thank you for inviting me here this morning to discuss rail rates and Southern Appalachian coal. Initially, I would like to say that the Department of Transportation neither supports nor opposes any particular rail rate. DOT's goal, instead, is to encourage efficient use of the nation's transportation resources, and we recognize that rate levels guide shippers' transportation decisions.

On average, the revenues earned by the nation's railroads are not sufficient to cover costs, including an adequate return on investment. The Penn Central, Milwaukee and now the Rock Island are only the most extreme examples of the poor financial circumstances facing the industry. If present trends continue, we will see more bankruptcies, and more railroads unable to operate without massive financial support from the Federal Government. The forces already at work could push us to a nationalized rail system.

If we hope to avoid nationalization and restore the railroads to health in the private sector, all of us are going to have to work together to reverse current trends. President Carter reemphasized last Thursday that he hopes Congress will act to change the existing regulatory system and thus help the industry generate the earnings it needs to maintain and improve service.

No single element can be blamed for the railroads' present difficulties, but one important factor has been a rail rate structure that does not meet market conditions or carrier needs. This is particularly evident in coal transportation. When petroleum prices went up in 1973 and 1974, steam coal became a more attractive alternative for industrial plants, including utilities in the Gulf and South Atlantic states that had been relying on oil and gas. The combination of large increases in coal traffic and major shifts in prime markets has necessitated heavy maintenance expenditures, construction of new track, and purchase of new coal hopper cars and locomotives by the railroads. The sudden change in coal consumption placed an immediate and severe strain on coal carriers' already tight operating and capital budgets.

In the Southern Appalachians, for example, the majority of the coal is now moving in a different direction over different rail routes than it did in the early 1970's. Between 1970 and 1978, the total volume of coal shipped to the Southeast from Eastern Kentucky alone rose from 25 million tons to approximately 75 million tons.

The experience of the Louisville & Nashville Railroad provides one of the best illustrations of the effects of the change. Until recent years, the L&N's largest market for coal was in the industrial centers surrounding the Great Lakes. Heavyweight rail, double track, sidings, and centralized traffic control were installed on the L&N main line leading north from the Eastern Kentucky coal fields through Cincinnati. Now the tonnage moving over L&N track south from the coal lines exceeds the tonnage north.

Adjusting to the shift has meant sharp increases in costs to the railroad. Major portions of the L&N lines to the south were not built with the heavy rail, passing track or signal systems to accommodate high volumes of coal traffic. Compared with movements to the traditional markets, shipments to the new markets also require circuitous routing and longer hauls, as well as additional locomotive power to cross the mountains to the south. The result has been considerably higher costs to the railroad for providing service.

The railroads cannot respond instantly to dramatic changes in the market. Domestic railcar manufacturers are operating at capacity, with a two-year backlog of orders. Labor and materials for constructing or rehabilitating track and equipment are becoming increasingly expensive. Finally, the coal rate structure established before the oil embargo did not provide for the large investments the railroads are now facing.

In fact, steam coal has never been a high profit commodity for the railroads on a per ton basis. For all coal-carrying lines, coal makes up a far smaller proportion of revenue than of total carloads.

Several characteristics of the Appalachian coal-producing areas make rail operations particularly expensive for carriers. A major factor in the high-cost structure is the large number of small mines and the extreme variation in their production. In recent years, approximately 2,000 coal mines have been in operation in Eastern Kentucky. Three quarters of them produce less than 50,000 tons annually, and one-third produce less than 10,000 tons, or 10 rail carloads a month. Most small mine operators open or close their mines or adjust their level of production year-by-year in response to the market.

Although in the Appalachians coal is generally trucked to a rail loading facility serving several mines, the L&N and other Eastern coal carrying railroads still load coal at hundreds of originating points, most of them built to load only one car or at most a short string of cars at a time. Devoting locomotives and labor to picking up, assembling, switching, and delivering single carloads of coal--especially on short notice--is one of the most costly and least efficient uses of transportation resources. That is particularly true when the nation's demand for coal is highest and the railroads are called upon to move the largest possible volume of coal.

The effects of high operating costs, heavy investment requirements, and historically low rates for coal have been reflected in equipment problems, deteriorating roadbed, and inadequate capital for improvements on many railroads, including the L&N. During the last five years, the railroads frequently have been unable to supply all the coal cars shippers ordered. Coal operators now shipping by rail are concerned that rates will continue to increase without commensurate service improvements, and that they will be left with no reasonable transportation choice.

We know of the Subcommittee's specific interest in Southeastern railroads. Because of the recent shift in coal markets, they have suffered particular difficulties. We have prepared a paper on Eastern Kentucky coal, which we have submitted to the Subcommittee, and I will provide some figures on the L&N from our research.

Coal accounted for 65 percent of L&N's originated tonnage and 30 percent of its total revenue last year. The L&N and its parent, the Seaboard Coast Line Railroad, are well-sited to carry coal to the large markets in the South and Southeast, but they are now concerned about the future of their coal operations.

The L&N reported a loss of more than 30 million dollars in 1978, and more than 10 million dollars during the first quarter of 1979. As of August 31st, its parent company, the Seaboard Coast Line Railroad, had advanced more than 40 million dollars in loans to the L&N since the beginning of the year. Despite its financial troubles, L&N management has instituted an extensive program to build or rehabilitate track and yards and to purchase cars and locomotives to accommodate increased coal traffic. Almost 100 new locomotives have already been delivered this year, and coal producers are reporting considerable improvements in L&N service. To cover the costs of the coal projects and operations and enable the railroad to attract needed capital, the ICC has approved the L&N's proposal for a 22 percent rate increase in coal rates, with the condition that the funds derived be used for coal-related investments. As I noted earlier, DOT is not defending the rate increase but presenting the background information necessary to evaluate L&N's rate actions.

Since the beginning of the year, soft demand for Appalachian coal has reduced the pressure on the railroads to supply cars and locomotives. As the market dropped off last spring, many Eastern mines shut down. The small mines selling on the "spot" market were particularly hard hit. Some coal operators in Eastern Kentucky placed the blame on higher rail rates but Kentucky Coal Association spokesmen acknowledge that the railroads have been only a small factor in a serious slump that is affecting coal producers throughout the East. Although the slump may have eased the immediate strain on the railroads, they are also being hurt by the reduction in demand. They cannot maintain their coal operations or proceed with coal-related improvements if coal traffic does not reach planned levels. Existing investments in coal facilities and equipment will not pay for themselves if the coal market remains soft.

Similar risks that future traffic may not cover the cost of investments face the railroads as they determine the rates they charge for moving coal. In the competition with other carriers serving other coal producers, no railroad can afford to raise rates that would price the coal on its lines out of the market. At this point I want to make clear that DOT does not advocate rail rates that would raise the cost of burning coal to the cost of using a competing fuel. I expect market forces to hold rail rates at a much lower level. An essential element in achieving appropriate rates for coal is the greater use of contracts between railroads, producers, and receivers that guarantee rail service at a particular rate.

We are urging Congress to grant the railroads greater rate flexibility, to give explicit permission for legally binding long-term contract rates, and to reduce the opportunities and incentives for broad general rate increases, in order to permit the railroads to achieve a rate of return sufficient to attract private capital and reduce their growing reliance on Federal investment. The railroads must be able to set all rates at compensatory levels and to price their services to achieve efficient use of their equipment and facilities. That will require some changes in the railroads' pricing and marketing practices. In particular, the railroads will have to make better estimates of their costs, if they are to manage their own operations effectively and to negotiate efficient rates.

Shippers also may have to make adjustments in their marketing and distribution patterns, and this may cause some difficulties to individual firms. Those shippers who are left without very good alternatives may require some protection from rail rate increases, but we believe that coal customers and all others shipping by rail must face the true resource costs of receiving service. Just as railroads cannot grow profitable to the detriment of shippers, shippers cannot be subsidized by rail rates held below compensatory levels.

Railroads have to be able to manage their resources and to compete for traffic on an equal basis with other carriers and other sources of supply. If we do not allow the railroads those opportunities--in coal as in other markets--service will deteriorate, carriers will fail, and the rail network will not be able to fulfill its central role in the transportation of coal or other commodities.