STATEMENT OF WILLIAM B. JOHNSTON, ASSISTANT SECRETARY OF TRANSPORTATION FOR POLICY AND INTERNATIONAL AFFAIRS OF THE DEPARTMENT OF TRANSPORTATION, BEFORE THE SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION, FEBRUARY 22, 1980

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to be here today to discuss railroad regulatory policy as it applies to ratemaking. Your actions in this area will have important implications for our long-term inflation prospects, the energy situation and the health of our rail industry. You have specifically asked us to comment on the Long amendment.

The maintenance of an adequate railroad transportation system is essential to this country's continued move toward a rational energy policy which would free us from dependence on foreign energy sources. The railroads serve this goal in two ways --they provide transportation that is three to four times more energy efficient than the trucks against which they compete, and they are a major method of bringing coal to the utilities that produce electricity for American households and industry. Unless the rail system is built up to the levels needed for reliable heavy-duty hauling, and then maintained in good repair, we will all pay more, not only for our energy but also for other consumer goods. The railroads are a critical link in the President's plan to convert utilities to coal use nationally, and they must be financially self-sufficient to carry out their responsibility.

At present, the industry does not earn enough revenue even to maintain the system. Last year the railroads in the aggregate earned only a 2.5 percent rate of return on investment and the roads in bankruptcy or generally regarded as "marginal" outnumbered those earning an adequate rate of return. This 2.5 percent rate of return can be compared with the average for all manufacturing industries of 10.6 percent and the average for electric and gas utilities, which in 1978 was more than 11 percent.

The Administration and Congress have been working on reform of railroad regulation for many years. In this process, we have both been giving attention to the need for sufficient rate protection for shippers. At the same time, we must not lose sight of the legitimate revenue needs of the rail industry. Shippers of all commodities in all parts of the country are suffering the consequences of the railroads' long term decline in financial health. The purpose of the regulatory reform effort is to get away from unnecessary regulation, to eliminate extra layers of authority, and return decisions as much as possible to the private marketplace.

Any legislation should not prevent the railroads from adjusting rates and service to the demands of their shippers. Railroads require flexibility in pricing, as do all competitive firms. The Department of Transportation continues to believe that it is inappropriate to use revenue-to-cost

ratios as a final test of the reasonableness of rail rates. Such ratios can be used to provide threshold tests of whether rates are compensatory. Beyond that they are but one of a number of measures of the level a particular rate should be.

To put the Department's position in perspective, I want to discuss briefly some of the economics of railroad ratemaking and railroad coal rates in particular. No matter how rates are set, they must, in the aggregate, cover all of a railroad's costs including a fair rate of return. If railroads do not earn enough to maintain their operations, either service will deteriorate and ultimately cease, or the government will be asked to make up the deficit through subsidies. Such subsidies represent a cost to society just as much as higher rates. In fact, administering a government subsidy program is almost certain to be less efficient and more costly than permitting the railroads to earn the necessary revenue directly from the shippers using rail service. The ratemaking framework which the Congress establishes, therefore, will determine not only whether the railroads can earn enough to survive as private sector entities, but also whether shippers will be able to obtain reliable, efficient rail transportation service.

A number of rate structures have been suggested to produce an adequate overall level of revenues for the railroads. The Department of Transportation supports a system of railroad ratemaking sensitive to the needs and demands of the variety of shippers, which we term "limited demand-responsive pricing." That is the pricing framework we see in the rest of the economy, and the framework that permits the fullest and most efficient use of the rail system.

Under this ratemaking framework, rates on all traffic should cover at least variable or incremental cost. Beyond that rates should be set so as to recover as much fixed or nontraceable costs as market conditions permit, up to limits which are determined by the ICC to be reasonable on a case by case basis and in light of overall carrier revenue needs. Because of differing competitive conditions, some traffic is able to cover more of those costs than other traffic. Generally, shippers for whom alternative transportation or markets are easily available will not pay a large share of non-traceable costs, and the rest must be recovered from the remaining traffic.

Setting all rates equal to fully allocated cost has often been suggested as an alternative to demand-responsive pricing. In this ratemaking system,each shipper pays the variable cost of service plus a pro rata share of the remaining costs. In theory, such a rate structure assures that all costs are covered. But it also causes many shippers operating in a highly competitive transportation

market to divert their traffic to other modes because each shipper must either make the same contribution to nontraceable cost per unit of service as every other or not ship by rail. The overhead costs of the rail system do not decline significantly when traffic is diverted. As a result, this diversion raises the cost of providing service to the remaining shippers. The evidence suggests that many shippers who have access to alternative transportation services, if asked to pay rates based on fully allocated cost, will stop shipping by rail. Commodities such as sand, aggregate, manufactured products, wood chips and pulp, some grain products and lumber will, we believe, be diverted to other modes of transportation or cease to move altogether. We would see more traffic on our already strained highways and waterways, with a consequent increase in capital and maintenance costs for those systems and a loss in the contribution of such traffic to covering overall railroad costs. Fuel consumption would be likely to rise as well as rail rates on remaining rail traffic.

To illustrate this point, let us assume that a railroad ships only two commodities, for example, grain and coal. Let us assume that the variable cost of shipping the two commodities is $100 for each. These two commodities must also cover all of the railroad's overhead, which, let us assume, totals $100. Overall, then, the railroad must have $300 of income to sustain

itself. Ideally, both coal and grain would pay $150 for rail service. Let us assume, however, that, because of competitive circumstances, grain will shift to a truck-barge route if its rate goes above $140. If this happened, coal would have to be charged $200 to sustain the railroad, since it would have to bear the overhead costs not borne by grain. To prevent this from happening, it is necessary for the railroad to price grain at $140 and coal at $160.

In this case, which is reflected in the real world every day in hundreds of rail pricing situations, the railroad has more revenue, and both shippers have lower rates than would prevail if a fully allocated cost system were used. Everyone benefits because demand-responsive pricing results in a more intensive and efficient use of the rail system.

The Interstate Commerce Commission has permitted demand-responsive pricing to a limited extent. The Department of Transportation and many shippers have also recognized that such a ratemaking standard is necessary and to some extent desirable.

In a time in which we are pursuing a national policy of converting to coal, the limits to be imposed on demand-responsive rail pricing, particularly for coal, are critically important. While

coal rates are not at the high end of the spectrum in terms of rate-to-variable cost ratios, the ICC has recently approved a number of coal rates that are somewhat above the fully allocated cost level, on the principle we have just reviewed that not all rates can be set at fully allocated costs if the railroads are to be efficiently used and adequately compensated. The Commission has said that, on average, all commodity movements should yield approximately 150 percent of variable costs to cover fully allocated costs, including a reasonable return on investment. In recent decisions, the Commission has followed a general policy of limiting coal rates to 7 percent above the fully allocated cost level.

As the attached table shows, several coal rates the ICC has recently approved show rate-to-variable cost ratios that are generally close to 150 percent. (These ratios incorporate adjustments to system-average costs to reflect actual movement costs.) We do not think the rates shown are exorbitant. I should note that DOT has never urged the Interstate Commerce Commission to set high rates on coal movements. Instead, we have urged the Commission in coal rate investigations to consider the particular circumstances in each case and to balance the railroad's need to cover costs against both the shipper's interests and the general competitive conditions faced by shippers and railroads.

ICC COAL RATE DECISIONS

	Decision Date	Rate Per Ton	Ratio of Rate to ICC Estimate of Variable Cost at Revenue Need Level
Incentive Rate on Coal-- Cordero, Wyoming, to Smithers Lake, Texas (Houston Power & Light)	11/28/77	$15.60	146%
Incentive Rate on Coal-- Hayden, Colorado, to Kings Mill, Texas (Celanese)	11/7/78	$10.56	151%
Annual Volume Rates on Coal-- Wyoming to Flint Creek, Arkansas (SWEPCO)	5/21/79	$10.24	142%
City of San Antonio, Texas, v. Burlington, Northern, Inc., et al ("San Antonio III")	6/1/79	$17.23	141%
United Train Rates on Coal-- Burlington Northern, Inc. to Council Bluffs to Sergeant Bluffs	7/13/79	 $ 7.25 $ 8.32	139%
Bituminous Coal, Hiawatha, Utah, to Moapa, Nevada	7/31/79	$ 7.91	130%
Incentive Rates on Coal-- Axial, Colorado, to Coleto Creek, Texas (Central Power & Light)	1/15/80	$20.85	140%

The proposed Long amendment has been decribed as setting a "presumptive cap" on maximum rates for coal. However, as written, it would also apply to all other commodities. Such an amendment would concern us for several reasons, most importantly because it would interfere with the modest amount of rate freedom allowed by S. 1946.

We are also concerned that a "presumptive cap" on rates would discourage shippers and carriers from entering into contracts, as S. 1946 is intended to permit. Contracts offer a real opportunity to make railroad service as reliable and responsible as is required by the utilities and other shippers who depend on railroad shipments. A cap could also exacerbate the joint rate issue. If a joint rate on a through route is at or above the presumptive cap it might prove difficult to obtain a rate increase--even if one of the carriers is failing to cover its variable costs.

Most fundamentally, the proposed "cap" would ultimately harm our ability to meet our energy needs because it would lead to deteriorating rail service. Efficient and reliable rail service is essential to carrying coal from mine to utility, where it can benefit the consumer. The health of the railroads is inextricably linked to our ability to utilize coal to meet our domestic energy needs. Although the railroads should not be allowed to charge unreasonably high prices for coal transport,

we do not believe the Long amendment provides an appropriate solution to the problem.

In summary, the Department of Transportation opposes any further amendments to S. 1946 that narrow the range of pricing options and prevent rates that suit the transportation market, thus reducing efficient use of the rail system and impairing a carrier's ability to provide service. Specifically, for the reasons cited above, the Department opposes the Long amendment.

This completes my testimony. I would be pleased to respond to your questions.