

TESTIMONY OF WILLIAM B. JOHNSTON, ASSISTANT SECRETARY FOR POLICY AND INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF TRANSPORTATION, BEFORE THE SUBCOMMITTEE ON TRANSPORTATION AND COMMERCE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES, MARCH 31, 1980

Good morning, Mr. Chairman and Members of the Committee. It's a pleasure to be here today. The issue presently before the Committee is regulatory reform of the railroad industry, a subject that deserves serious national attention and debate. We are here this morning to comment on the Subcommittee staff's preliminary working draft number two of the "Rail Act of 1980." Joining me are Charles Swinburn, Deputy Assistant Secretary for Policy and International Affairs, Mr. Robert Gallamore, Deputy Administrator of the Federal Railroad Administration, and Mr. Edward Hymson, Chief of our Regulatory Analysis Division.

The Administration's objectives regarding rail regulatory reform are clear. We want to create a regulatory environment in which railroads can compete successfully with less regulated transportation modes. Why are we committed to regulatory reform? The answer is simple: Railroads are important to our nation's economy; their continued operation is, as the Midwest rail crisis demonstrates, vital to our economic well-being; and we are going to need the industry even more in the future. Railroads are also vital to our national energy policy, providing an energy-efficient form of transporting our nation's goods.

Over the past several months, the industry's problems have

been described to this Committee in great detail. I see no need to repeat that evidence again. Indeed, the symptoms that precede market failure are, even to the casual observer, already too apparent: the deterioration of railroad facilities, the lack of adequate equipment and frequent substandard service, low productivity growth, a declining market share, and a worsening financial situation.

Reduced Federal economic regulation is essential to resolving these problems. Regulatory reform is not a panacea, but without it all other remedial actions -- no matter how well-intentioned -- will fail. Our regulatory system is simply too rigid to accommodate the ever-changing demands being placed upon the railroad industry. The system is inadequate; it needs to be scrapped; and it needs to be replaced with something better.

We believe that any reform, to be successful, must adopt two essential elements. First, railroads must be permitted to price their services as market conditions dictate. They should be allowed to raise and lower rates rapidly in response to altered competitive conditions, and without fear of regulatory involvement in their day-to-day pricing decisions. This doesn't mean that all forms of rate regulation should be eliminated for truly "captive" shippers; it shouldn't. But neither does it suggest that the railroads should, because of Federal regulations, be unable to earn adequate revenues, including, of course, earnings sufficient to attract and retain investment capital. Reform legislation must acknowledge that market competition, not regulation, can best be relied upon to assure reasonable

rates in the vast majority of transportation markets.

Second, and equally important, the industry must have the flexibility necessary to restructure and rationalize its operations and physical facilities, to offer shippers new and better services, and to reduce system-wide operating costs. Adopting reforms that permit railroads to earn more revenue is important, but the more fundamental and enduring benefit of reduced regulation is to permit railroads to adapt their daily operations, marketing initiatives, and investment strategies to the transportation market place. The railroad industry will not be made healthy again simply by permitting cost-plus pricing; it also has to become efficient and responsive, and structural reforms are necessary to bring this about.

The preliminary staff working draft number two adopts such a comprehensive framework for lessening regulation, and we applaud its efforts. That is not to say that the draft is yet perfect, it isn't; or that it can't be improved upon, it can. We have doubts about the benefits of certain provision, and we have strong objections to others. Nevertheless, this draft, if modified as I will later suggest, will offer a comprehensive and generally sound reform agenda. We are optimistic that the "Railroad Act of 1980" will be the basis for meaningful reform, and we look forward to working with the Committee and its staff to resolve our concerns.

Let me comment briefly on specific sections of the draft, making suggestions for changes as I go. Because of the short time we have had to react to this draft, and because it is obviously a document

subject to change, I would, with your permission, Mr. Chairman, like to reserve our right to comment on this and subsequent versions in more detail, by letter to the Committee.

Less rate regulation must obviously be a major part of any reform bill. Railroads require considerably more pricing flexibility than they now have, if they are to be in the financial condition to provide safe, efficient and reliable service. By relying upon "effective competition" and by establishing guidelines for the development of a "full cost percentage ratio," the draft offers an imaginative approach to reducing unnecessary and burdensome rate regulation. By placing the burden of proof on protestants to demonstrate the absence of competition -- rather than upon the carriers to show its presence -- it would replace an outdated standard with a better one. The industry's declining modal share and its low earnings convincingly demonstrate the presence of competition, and we believe it is incumbent upon protestants to prove its absence. Reducing the Commission's authority to suspend rates also would prevent needless and detrimental regulatory interference in carrier pricing decisions.

Section 204 would permit broad authority for carriers to offer contract rates. We heartily endorse the draft's provisions in that regard. Contracts between shippers and carriers will permit tangible benefits to both parties. Railroads will be able to adapt their services and capacities as shippers require, charging rates that accurately reflect costs. Shippers will benefit by receiving specifically tailored service and by the greater certainty that contracts provide.

And we believe that, as the draft provides, once a contract is agreed to by the parties and permitted by the Commission, equipment used to fulfill that contract should not, except in a national emergency, be under regulatory control.

The provisions of Section 205 permitting demand-sensitive rates also would represent a meaningful change in the regulatory environment. For the first time, carriers would be able to respond to changes in market conditions rapidly. Of course this means that rates would rise when market demand is strong and decline when demand is slack. Such market adjustments should be encouraged, not impeded. Additional pricing flexibility and contracting provisions would permit the industry to become much more competitive.

Similarly, a market-oriented approach is, we maintain, the best way to encourage additional investment in equipment, as well as its proper allocation among shippers. Unfortunately, Section 309, dealing with car compensation, would do nothing more than continue the current Commission practice of assessing additional charges to car rental if it was determined that the supply of a particular type of car was inadequate. We believe the shortages of particular car types that occur periodically demonstrates that this policy has not worked. A greater reliance on pricing equipment -- and additional industry revenues -- would go far to assuring an adequate supply of equipment.

A lenient provision for exemption from regulation is also important, and we endorse the language contained in Section 209. Given the

opportunity -- and the available evidence of the deregulation of fresh fruits and vegetables bears this out -- railroads can provide good service and be tough competitors. Broader exemption authority would permit the Commission to deregulate traffic when it finds that continued regulation is not in the public interest.

We fully endorse the objectives of the cost accounting provisions contained in the draft bill. We have long shared the Committee's concerns that better techniques and more accurate data be developed to determine the costs of providing specific railroad services. Indeed, we felt so strongly about the need to improve current railroad costing procedures that we included several reform provisions in the Administration's railroad deregulation bill. For many years, we have been urging that accounting and operating information be developed in sufficient detail to permit accurate costing estimates. The Department has invested considerable time and resources in improving the state-of-the-art in railroad costing. We believe that this investment is now beginning to pay dividends.

The Commission has made considerable improvements in costing techniques in the past year, and for this reason we believe it should be given responsibility for developing the proposed costing system. If a Cost Accounting Board is created, its proper role should be as an advisory body to the Commission. It would be wasteful not to take advantage of the experience and expertise that the Commission has developed over the past few years. Thus, we oppose the mandatory Cost Accounting Board proposed in this bill. However, an independent

Board, with authority to advise, assist and critique the work of the Commission could make a significant contribution to the standards and techniques ultimately developed. New and better regulatory costing estimates are essential to the proper functioning of a regulatory system, and we look forward to assisting the Committee in developing the needed improvements in regulatory costing.

The benefits the industry receives from less rate regulation should be accompanied by discarding certain regulatory appendages -- the most significant being the antitrust exemption that allows carriers to meet, discuss, and vote upon rates. We oppose continued antitrust exemption for one reason: it is anticompetitive. This draft bill would further restrict carriers from meeting, discussing, and voting upon rates; and this is highly desirable. The intercarrier discussions and pricing agreements that would be permitted in this bill do not, we are convinced, require such immunity. However, the bill's language assures that what we believe to be lawful will continue to be permitted without fear of legal challenge. We also strongly believe that all rate bureau meetings and discussions should be open to the public.

The last sentence in Section 304(d) of the proposal specifically authorizes the Commission to investigate whether parties to an agreement to jointly publish tariffs have engaged in conduct that was beyond the scope of their approved agreement. We recommend that this sentence be dropped for two reasons. First, the Commission has inherent power to review all approved agreements and to terminate those that are no longer in the public interest. This sentence is at best redundant of existing Commission authority.

Second, and more important, the antitrust laws apply fully to unapproved agreements, including agreements knowingly entered into that are beyond the scope of ICC approved agreements. The last sentence in Section 304(d) could give authorized defendants the opportunity, doubtlessly unintended by the drafters, to argue that unapproved agreements could be investigated only by the ICC and not by the Department of Justice.

The role of collective ratemaking in a new regulatory system cannot, of course, be divorced from the question of general rate requests. Once again, we believe that carriers must price their services as their individual operations and competitive environment dictate, not in response to competitors' revenue needs. For this reason, we continue to strongly support a phasing out of industry-wide general rate increases. As the railroads become accustomed to greater ratemaking freedom, we expect that individual carriers will be requesting increases to cover the general cost increases they experience, and there will be no need for a group of railroads, or the ICC, to act for individual carriers in estimating their overall revenue needs or the rates they require to achieve adequate revenues.

As drafted this bill would terminate general rate request in 1983, but would replace them with inflation adjusted percentage increase prescribed by the Commission, with carriers having the ability to exclude their rates from the increases. We cannot support

this provision Mr. Chairman. Inflation must be reflected in pricing decisions, but we believe that individual carriers -- not the ICC or the industry collectively -- should set their own rates in response to market conditions and revenue requirements.

We are, of course, concerned that railroads be allowed to adjust their rates to cover rapidly rising labor, fuel, equipment, and material costs. Beyond the rate adjustments necessary to counter the effects of inflation, railroads must be permitted additional pricing latitude. In that regard, we are concerned that Section 204 does not make it clear that the 10 percent per year limitation on rate increases outside the Commission's jurisdiction is after rates have been adjusted to recover inflationary cost increases. Any final reform legislation must ensure that carriers are not restricted to a 10 percent annual increase in rates.

The overly rigid system that prevents carriers from adjusting joint rates and divisions must be replaced. An alternative system must ensure that carriers are not required to participate in non-compensatory interline traffic. It is not surprising that carriers facing the prospect of carrying non-renumerative traffic decide that it may be in their best interest to provide poor service for that business. The Committee's joint rate provisions of Sections 301 through 303 greatly reduce these problems, and we applaud the Committee's work in facilitating a compromise. If these provisions are adopted in final legislation, a carrier will be free to raise

the joint rate so its share of the revenue more than covers the variable cost of providing the service. The proposed reforms also permit carriers to recover the additional costs of serving shippers and receivers located on light-density branchlines. We believe these provisions will encourage traffic to move over efficient routes. The joint rate provisions are sound and we hope they will be incorporated into a final reform bill.

As evidenced by the number of recent railroad merger proposals, substantial changes are underway in the industry's corporate structure. While experience with past railroad mergers is not particularly encouraging, under certain circumstances mergers could lead to improvements in service and operating performance.

The Department testified at length on reforms affecting rail mergers before this Committee last November. We stressed that the current merger standards are murky, conflicting, and complex. Our alternative was to make railroad mergers subject to the antitrust laws.

The draft proposal leaves jurisdiction with the ICC, and adopts two separate tests for approving mergers. First, a merger may be approved if there is no substantial lessening of competition or other anticompetitive effect. Second, the Commission's authority under 11344a(b)(2) would further allow it to approve a transaction -- despite potential anticompetitive effects -- as long as it is "consistent

with the public interest." This second standard would foster the same complexities and delays in merger proceedings that occur today, and permit approval of anticompetitive mergers where there are no Commission's authority to impose conditions, such as the inclusion of other carriers in a merger, the proposed standards may further dilute the potential merger benefits.

We recognize that there may be conditions under which a proposed merger should be approved even if it would not be permitted under established antitrust criteria. That is why we endorse the language contained in the first draft bill. That draft required that antitrust standards be utilized, and permitted approval of any anticompetitive merger only if "significant transportation needs could not be satisfied by a reasonably available alternative having materially less anticompetitive effect."

The Department continues to place a high priority on railroad restructuring, particularly in transactions negotiated under the authority of the Secretary of Transportation, as provided for in Section 401 of the 4R Act. These efforts have been of great value in working out solution to complex problems in the Midwest. We urge Congress, in its reform efforts, to adopt the proposal advanced by the Administration to accord substantial weight to the recommendations of the Secretary in any application for abandonment, merger, or other railroad transaction proposed as part of a 401 process, and to simplify the standards for such transactions.

Less stringent abandonment standards are also essential. Too many light-density rail lines operate to the detriment of the entire railroad system. These lines are a severe financial burden that the railroad industry can ill-afford. Continued branchline operations force carriers to use equipment and personnel that could be more effectively employed providing service elsewhere in the system.

But while reforms in the abandonment process are necessary and desirable, the conveyance and railbank program established by Sections 503 and 504 of the proposed legislation would establish what we believe to be an unacceptable approach to the problem of non-economic branchlines. Under these provisions railroads would be forced to choose between the current lengthy abandonment procedures, in which they would receive some compensation for their property, or the relatively quick divestiture of the proposed conveyance program, which would require foregoing any payment. If railroads choose the latter, the Federal Government will become overseer of a potentially very expensive, wide-ranging, and disjointed empire of virtually useless rights of way. States now have the authority, and the means, to acquire, subsidize or rehabilitate lines under both the Federal Railroad Administration's Local Rail Services Assistance Program and their own programs, and the States are much better able to make the local and regional decisions involved with continuing those lines. It is also unrealistic to assume that during one three-year catharsis branchline restructuring would be completed. Railroads should evaluate their services continually to determine if further changes are necessary to improve service or reduce costs. Branchline

problems are best addressed by active efforts on the part of railroads, shippers, labor and local government to find workable rates, operating patterns, and rehabilitation assistance. If these efforts fail, the only responsible course is a fair but swift abandonment process, rather than shifting the operational and financial burden onto the back of taxpayers. We believe that the proposal established by this section of the bill will require a complete reformulation by the Committee.

We are very concerned that the "Safe Railroad Reinvestment Requirements" provision contained in Section 212 is contrary to the goal of letting the market place govern the allocation of railroad resources. We also believe that this provision may be totally unworkable, or at best, a constant source of litigation. It would not, for example, prevent railroads from disinvesting to Class I standards -- where the speed limit is only 10 m.p.h. -- as long as the railroad maintained this speed limit and operated according to a regular schedule.

Finally, Sections 506, 507 and 508 of this draft bill contain the Railroad Restructuring Assistance program in virtually the same form as proposed by the Department last May. We are pleased with the Subcommittee's acknowledgement of the importance of the financing of railroad restructuring and labor productivity improvements. The only major difference in the proposal is that the draft would make Conrail eligible for assistance while our program excluded

Conrail. We believe that Conrail eventually should be placed on an equal footing with the railroad industry in applying for the limited amount of Federal funds available for railroads. The Department further believes that the Title V-type approach, in which fixed plant rehabilitation and improvement financing would go to Conrail through the Department on a project-by-project or group-of-projects basis, is appropriate.

While this draft did not contain an authorization amount for the program, I must emphasize the Administration's insistence that the \$1.475 billion level be adhered to. The Department will be presenting tomorrow to this Subcommittee, the reasons why we agree with Conrail that no additional authorization for the railroad should be planned for 1981, and thus why the Administration has not budgeted any financing over the existing \$3.3 billion in the 1981 fiscal year. In the event that Conrail develops emergency financing requirements in FY 1981, we will present to the Congress at that time our recommendations as to the amount of funding and the appropriate mechanism. Given Conrail's current progress towards self-sustainability and the Department's and Conrail's desire to maintain this progress, and we do not believe that a fiscal 1981 authorization is necessary, absent an emergency situation.

Mr. Chairman, I think it is clear from the tenor of my remarks that we are generally positive about this draft legislation. It contains many good provisions, several proposals that could be strengthened

considerably, and a few sections that we feel should be replaced. We, of course, would welcome the opportunity to work with the Committee and staff to resolve these differences.

Again I would like to emphasize that the time we had to review this preliminary draft was very short. As we continue to review it and as we consult with other Executive Branch agencies, we may want to provide the Committee with additional comments.

This concludes my prepared remarks, Mr. Chairman, and I am ready to try to answer any questions you or the other Members of the Subcommittee may have.