TESTIMONY OF
JOHN H. RILEY
FEDERAL RAILROAD ADMINISTRATION
U.S. DEPARTMENT OF TRANSPORTATION
BEFORE THE
SUBCOMMITTEE ON COMMERCE, TRANSPORTATION
AND TOURISM

COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

JUNE 5, 1986

Mr. Chairman. I appreciate the Committee's invitation to discuss the Department of Transportation's views on H.R. 1140, the Railroad Antimonopoly Act. To set a context for that discussion, it is important to understand a few of the basic principles that guide railroad rate regulation today.

Railroad rates are measured as a percentage of a railroad's variable cost. Overall, a railroad must set its rates to recover at least 150 or 160 percent of variable cost to break-even in an economic sense -- in other words, to fully cover both fixed and variable cost and generate a reasonable rate of return. Because some traffic -- like coal -- does more damage to the track than others, and because competition from trucks and other sources at times forces rates below the system-wide break-even ratio, rates for different commodities will vary above or below the 160 percent level (a concept called "differential pricing").

The Staggers Rail Act established 180 percent of variable cost as the key threshold level in railroad rate regulation. In passing the Staggers Act, the Congress declared that rates set at or below the 180 percent level are reasonable per se. As a consequence, rates below 180 percent are deregulated. Non-exempt rates above 180 percent remain subject to Interstate Commerce Commission (ICC) regulatory authority. In challenging rates above the 180 percent level, the Commission weighs the reasonableness of the railroad's rates on a case-by-case basis -- considering all relevant factors, and balancing both the shipper's right to reasonable rates and the railroad's need for adequate revenue.

More than 80 percent of all rail rates are below the 180 percent level. For coal shipments, more than 85 percent of the rates fall below 180 percent. These figures actually overstate average rail rates, because they do not fully reflect the more than 38,000 contract rates, which are generally lower than published rates.

The Railroad Antimonopoly Act alters this balance in several ways, ways that would prove very negative to shippers and railroads over the long run. As a consequence, the Department of Transportation strongly opposes enactment of H.R. 1140.

The Act would subject the railroad industry to two separate and conflicting regulatory schemes.

The Act would subject the railroad industry to two conflicting regulatory schemes -- one administered at the ICC, and one to be administered by the courts. Because dozens of courts would be weighing rate issues against standards that are less than clear, it is highly likely that railroads would face conflicting standards on different shipments or parts of their systems, depending on the forum in which a case was considered. Railroad rate cases are complex, and courts and juries are ill-equipped to deal with them. In the long run, there would be no winners in this system of confused and conflicting regulation.

The Act imposes remedies where neither monopoly pricing nor an absence of competition exists.

H.R. 1140 is of questionable fairness -- and questionable legality -- because it imposes remedies -- and exposes carriers to civil liability -- in cases where there is clearly neither monopoly pricing nor an absence of competition.

Prior to this bill, antitrust laws were not industry specific. Antitrust policy is premised on a case-by-case examination of all factors relevant to the question of whether monopoly power exists, and whether it is in fact being exercised.

This bill departs from those principles by severing the railroad industry from the rest of the economy, and establishing a set of more stringent requirements that would leave the industry both separate and unequal.

More serious is the fact that it would preclude rather than encourage the consideration of all factors relevant to the question of whether competition actually exists. In particular, the bill does not allow consideration of product competition and geographic competition -- factors that have a real-world impact on market power and the rates shippers pay.

For example, where a firm has the option of receiving the goods that it needs by other modes or even by rail from a different source, at a competitive price, the rates the railroad serving the present source can charge may already be effectively constrained. In a normal antitrust case, evidence on those options would be important and perfectly admissible. Under this bill, a railroad could not offer it and the court could not consider it.

In the same way, a consumer may be able to purchase another product that could substitute for the traffic it receives by rail. The existence of a suitable alternative at a comparable price may effectively constrain the rates a railroad can collect. But again, under this bill, a court would be barred from considering evidence on the existence of product competition.

The court would be precluded from addressing the ultimate question of competition, but the railroad would face penalties as though it were restraining competition. I question the wisdom of the approach. I believe that Congress' power to create an offense, but then to curtail substantially the court's inquiry into the essential elements of that offense, is not without limit under the Due Process Clause, and this provision could very well test that limit.

In addition to violating fundamental fairness and past antitrust policy, the approach would produce absurd results. More than 80 percent of all rail rates fall below the 180 percent level deemed reasonable _per se_. Yet the bill treats 90 percent of rail-served locations, and 83 percent of all rail traffic, as potential monopolies. By precluding consideration of all market factors that limit a railroad's pricing power, it would impose liability in cases where competition unquestionably does exist. It affords remedies without wrongs, and diverts an enormous amount of legal resources into providing legal remedies where there is neither legal wrong nor economic harm.

The bill eliminates revenue adequacy as a goal of the national transportation policy.

The Congress, in the Staggers Act, premised the national transportation policy on two equally significant objectives -- reasonable rates for shippers, and adequate revenues for railroads. H.R. 1140 alters that balance by at least de-emphasizing, and likely eliminating, revenue adequacy as a stated objective of the national transportation policy. It seeks to maximize competitive options for shippers, without regard to the overall financial stability of the carriers. The pre-Staggers experience with railroad bankruptcies and deteriorating service gives ample evidence that there can be no adequate transportation system without financially viable carriers.

<u>The trackage rights provision will create serious safety problems wherever there is unsignalled single-line track</u>.

H.R. 1140 would result in multiple carriers operating over tens of thousands of miles of "dark territory," that is, single-line track without signal systems. That raises a serious safety issue. Whenever multiple carriers share unsignalled track, they encounter train control difficulties that significantly increase the possibility of serious accident. The worst accident we faced in the railroad industry last year involved a head-on collision between two trains on an unsignalled single track. By increasing the opportunities for human error, H.R. 1140 would increase the chance for a recurrence of that type of accident.

<u>The bill would stimulate abandonment of rural, light density lines.</u>

By weakening railroads' cash flows, H.R. 1140 would have a negative impact on shippers situated on rural light-density lines that are only marginally profitable today. Whether from business lost through trackage rights or revenue losses from increased regulation of rail rates, H.R. 1140 would unquestionably reduce the rate of return for many railroads, thus reducing the revenues available to support operations and maintenance on light-density branch lines. When revenues fall, railroads invariably concentrate resources on their heaviest density main lines, rather than the light-density rural and agricultural branch lines. These lines were the hardest hit under pre-Staggers regulation, and they would be at least as adversely affected by this bill. That is particularly ironic, given the fact that the small commodities shippers on these lines would draw little or no benefit from its provisions.

In short, if one believes that H.R. 1140 will have any effect, its benefits would be more accessible to large railroads rather than small regional carriers, large shippers versus small, and cities -- with their high shipping concentrations -- versus rural areas.

H.R. 1140 would likely discourage efficient differential pricing -- hurting railroad and shipper alike.

Railroad rates vary widely within the "zone of reasonableness" that extends below the 180 percent threshold.* That variance, known as differential pricing, is both appropriate and beneficial in most cases. It allows railroads to spread their fixed costs over the maximum amount of traffic they can capture. A railroad could be penalized for deviating from some uniform level the courts considered competitive. The practical effect would be elimination of differential pricing, particularly because the bill encourages courts to assess rate reasonableness and impose damages without examining market circumstances.

While some rates at the upper end of the zone of reasonableness might be forced down, railroads would be forced to compensate by raising rates at the lower end of the zone of reasonableness (or allowing lost revenues to be reflected in deferred maintenance). Shippers would receive little if any net gain -- costs would simply shift from one group of shippers

---

* Of course, rates above 180 percent are not per se above a maximum reasonable level. The ICC simply has the authority to review rates above that level to determine whether they are reasonable

to another. Moreover, higher prices on the highly competitive traffic at the low end of the zone of reasonableness would drive some of that business off the railroads and onto trucks. That would start another vicious cycle like those of the 1940's to 1970's. With the loss of such traffic (and the associated revenues) the remaining traffic would have to bear a larger share of the carrier's overhead expense, leaving the shippers worse off than they were before.

The bill would virtually ensure the latter result for another reason. The trackage rights provision invites competing carriers to come onto another railroad's lines and "cherry-pick" the more lucrative traffic, the traffic moving at rates in the upper end of the zone of reasonableness. The new carriers could underbid the more lucrative traffic at the upper end of the zone, and ignore the lower rated traffic. By leaving existing carriers with either lower revenues on their best traffic, or access only to the less remunerative traffic, cherry-picking would force higher costs on grain shippers, lumber shippers, produce farmers, and others who now benefit from lower prices due to differential pricing.

<u>The bill provides no basis for assessing the reasonableness of trackage rights fees or rail rates</u>.

Determining a just and reasonable price in any market is a difficult analytical question. H.R. 1140 affords little guidance on how such a judgment should be made, and courts are not well equipped to deal with that issue. Judges and juries simply do not have the expertise necessary to evaluate the appropriate level of rail rates or charges for trackage rights fees, and under the antitrust laws applicable to other industries, they are not involved in that sort of decision. If the bill forced the courts to rule on what a railroad should be charging for access to its line or service, in the absence of any accepted system, the railroads would be subject to a multiplicity of standards, without any assurance of coordination or consistency. Any miscalculation by the courts would lead to declining earnings, deferred maintenance, and deteriorating service. Moreover, the lack of any clear standards in the bill virtually ensures conflicting results.

<u>H.R. 1140 would eliminate the downward rate flexibility that benefitted shippers during the recession of 1982</u>.

The delays and difficulties encountered by regulated railroads in adjusting rates upward during times of high demand made pre-Staggers carriers reluctant to lower rates during slack economic periods. That changed with the passage of the Staggers Rail Act, which gave railroads the ability to adjust rates upward and downward to match market conditions. As a consequence, thousands of rates were actually lowered during the recession of 1982. This downward flexibility played a key role in helping railroads -- and shippers -- survive the effects of that recession.

By returning carriers to a system in which rate adjustments are subject to protest, litigation, and delay, H.R. 1140 would again eliminate incentives for railroads to reduce their rates to match changing market conditions. This loss of downward flexibility will hurt both shippers and carriers over the long run.

<u>H.R. 1140 will weaken the ability of a reregulated rail industry to compete with a deregulated trucking industry</u>.

In areas where railroads compete head-to-head with a deregulated trucking industry, the ability to make rapid -- even daily -- adjustments in rates and services is critical to effective competition. By saddling railroads with a dual system of regulation, and discouraging timely pricing changes and efficient differential pricing, the bill would make it difficult if not impossible for railroads to remain competitive with the deregulated truckers for agricultural commodities, fruits and vegetables, and other truck traffic.

<u>H.R. 1140 would undo the progress made in getting shippers and carriers to negotiate innovative solutions to their own issues</u>.

One of the great accomplishments of the Staggers Act lies in the encouragement it has given railroads and shippers to negotiate rate and service issues directly with one another, rather than referring them for resolution to a board of political appointees. The success of that incentive can be measured in the more than 38,000 contracts entered by railroads and shippers since 1980, as well as the historic agreement reached between the railroads and the National Industrial Transportation League on the issues of joint rates and competitive access. The bill destroys the incentive for railroads and their customers to work together to negotiate similar arrangements in the future, since it will be all too easy to return to the pre-Staggers environment, and simply refer the issues to the courts for resolution.

To assess the real position of the railroads and their shippers, it is essential to bear in mind where we were six years ago, and contrast that with the industry we know today.

When the Congress was debating the Staggers Act, nearly one-quarter of the nation's track was in bankruptcy reorganization. The relatively prosperous 1970's had witnessed the failure of 10 major carriers, coupled with a complete collapse of regional systems in the Northeast and Midwest. Even the strongest railroads had a tenuous hold on stability. Return on investment (ROI) industrywide hovered at about 1 or 2 percent. Because investment needs had outstripped retained earnings for eighteen of the previous twenty years, the industry faced a ten-year capital shortage in excess of $13 billion. The railroads were on their knees, and nationalization was frequently discussed as a serious policy alternative.

There were no winners under the regulatory system the Congress altered in 1980. The problems afflicting the railroads touched every rail shipper, every community served, and virtually every employee. Rural shippers were hard hit by branch line abandonments as the railroads focused their declining resources on the heaviest density lines. Poor cash flow meant deferred maintenance, which translated into car shortages, derailments, and unreliable service. Train accidents in a cash-starved industry were three times as high as they are today. In fact, the late 1970's brought a new accident category to the Federal Railroad Administration's report data -- the standing derailment, in which a freight car, standing perfectly still, simply fell off a track. That, believe it or not, occurred twice in a single year.

The contrast between then and now is the best testimony to the wisdom of the decisions the Congress made six years ago. Today's rail industry is healthy and profitable on an industry-wide basis. It survived the deepest recession since the 1930's without a single bankruptcy. Investment in roadbed and structures has increased dramatically. I cannot represent that the industry has eliminated every dollar of the $13 billion capital gap, but deferred maintenance has been virtual~~ly~~ eliminated from the nation's main lines, and the pace of branch line abandonments has slowed. The so called "car shortage" was effectively addressed when demand-based pricing and legalization of shipper contracts enabled carriers and shippers to better plan the utilization of their equipment. The number of covered hopper cars is at an all-time high.

The industry's return on investment is close to 5 percent (excluding consideration of special one-time charges) -- a revealing figure, because it tells both sides of the story. This is certainly a dramatic increase from the 1 to 2 percent levels of the past twenty years. But it is still less than the return an investor could receive by simply depositing money in a savings account. As the nation's utilities have argued so persuasively -- and correctly -- in their own rate cases, an industry that cannot generate a return on capital equal to the cost of borrowing is an endangered species. These ROI figures emphasize the extent, and at the same time the fragility, of the industry's recovery. The progress is real, but it can be easily eroded.

In assessing the impact of these accomplishments on national policy, it is essential to recognize that no one has gained more from the railroad's turnaround than the railroad shipper. It was only a few years ago that "railroad marketing" seemed to be a contradiction in terms. Today, price and service innovations like unit train grain rates, just-in-time service, and reduced rate backhauls have become standard shipper benefits. Shippers have used the power to contract to lock in rates and service commitments in close to 38,000 contracts. I am convinced that we have only scratched the surface of what the industry will accomplish as it becomes more accustomed to marketing in a deregulated environment.

In addition to becoming more price competitive, railroad service has become more reliable. The industry moved the record grain harvests of the last two years without costly bottlenecks. And there is no doubt that the railroads will be able to smoothly handle record export grain moves such as those experienced in the late 1970's, when the need again arises. The elimination of deferred maintenance from the nation's main lines has meant more timely and reliable service for shippers of time-sensitive commodities. Shippers have also shared in the public benefits of the Staggers Act. The industry's financial recovery has enabled the Federal government to cut its appropriations and new authorizations for rail freight assistance from $1.99 billion in fiscal year 1978 to $64 million appropriated for fiscal year 1985. And with stronger capital investment levels has come an historic improvement in railroad safety. Train accidents have been cut by two-thirds since the adoption of the Staggers Act, an improvement that tracks across every reportable accident category. As the industry's financial picture continues to solidify, these numbers will grow better.

Simple statistics make it indisputably clear that the railroads' improved financial condition has not come at the shippers' expense. Rather than simply increasing prices across the board, railroads have utilized their new-found pricing flexibility to attract a greater share of existing markets, and provide competition for commodities like perishables, for which they had been noncompetitive for decades. This base-broadening, along with more efficient equipment utilization made possible by deregulation, enabled the industry to increase its cash flow while cutting the rate of increase in rail rates by more than 50 percent.

During the 5 years preceding the Staggers Act, rail rates rose by an annual average of 10.6 percent, unadjusted for inflation, compared with only 4.6 percent per year in the first five years after Staggers. If the BLS rate index is adjusted by the GNP deflator, rates rose 3.2 percent per year in the five years before the Act, and actually dropped 0.6 percent per year in the five years since. And even these numbers understate deregulation's benefit to the shipper, because they primarily measure published rates -- not contract rates, which are lower and longer-term. A recent report done for the railroad industry by an independent accounting firm compared rates covering more than 80 percent of rail-carried grain tonnage, and found that -- when contracts are added into the equation -- grain rates have actually declined by over 25 percent since passage of the Staggers Act. Shippers of all sizes are shipping under contracts with the railroads. The benefits also spread to the farmers, as the lower charges for transportation leave more of a margin that can be paid for the grain at the farm.

Coal shippers have entered more than 1,700 contracts, and many utilities have cited the substantial savings they will make as a result of their ability to negotiate contracts. To assist export coal shippers at Tidewater ports, the railroads have since 1982 voluntarily foregone the inflation adjustments they were entitled to take under Staggers Act provisions. Average rail rates for coal are lower today in real terms than they were when the Staggers Act was passed. Less than 15 percent of railroads' coal traffic is even moving at rates above the 180 percent threshold. In a special study of the effects of the

Staggers Act on electric utilities, the Department of Energy specifically looked into the "worst case" examples of rail rates to coal-burning powerplants and found that rail rates have not gone up unreasonably under the Staggers Act.

But perhaps the best testimony to the success of the Staggers Act lies not in what it has accomplished, but in what it has not produced. Because it is simply fact that the dire consequences feared by critics when the Act became law five years ago have not materialized. Rates did not skyrocket, even when the economy came out of the deep recession of 1982. They are rising more slowly today than at any time in the last two decades. Shortline carriers have not disappeared. Their numbers are growing at record rates, and they have prospered with the marketing flexibility made possible by the Act. The marketing choices available to shippers today are unequalled by any in the industry's history.

I have no intention of representing to the Committee that these changes, for all their benefit, came easily or painlessly. The Staggers Act changed shipping and pricing patterns that had been established for nearly a half century. There were pains of transition. There are, in fact, hard cases which must be addressed on a case-by-case basis. And the existence of the captive shipper is a reality, not a myth.

But the theme that should come through clearly from an oversight of the Staggers experience is that the railroad industry has not abused its pricing and marketing opportunities, and because of those opportunities, has become stable while providing better shipper service. It should also be clear that while no system dependent on human judgments will ever be flawless, allowing the commercial relationship between shippers and carriers to be shaped by market forces produces better results, for shippers and carriers, than a system which delegates the major share of these decisions to a board of political appointees.

Such a system creates incentives for the parties to defer, rather than resolve, the issues of greatest importance in their relationships. Placing the majority of railroad pricing decisions in the hands of the ICC imposed a slow and cumbersome process on railroads and shippers, one in which marketing is done by rate attorneys and ICC practitioners. It was a process that served the shipper and the public poorly. Placing pricing decisions in the hands of the courts would have the same effect.

The Congress showed great wisdom in adopting the Staggers Act reforms six years ago. They have enabled a partially deregulated railroad industry to compete effectively with a deregulated truck industry and a largely unregulated barge industry. There have been transition pains and hard cases, as there inevitably will be in any system. But they do not imply a structural or systemic weakness in the Staggers reforms. The present regulations provide both the authority and the tools to resolve such problems on a case-by-case basis.