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BEFORE THE

## Senate Committee on Commerce, Science, and Transportation

## Subcommittee on Surface Transportation and Merchant Marine

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# Economics, Service, and Capacity in the Freight Railroad Industry

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TESTIMONY OF

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Wednesday, June 21, 2006
10:00 a.m.
562 Dirksen Senate Office Building

Mr. Chairman and Members of the Committee:

My name is Glenn English, and I am the Chief Executive Officer of the National Rural Electric Cooperative Association (NRECA). I also serve as Chairman of Consumers United for Rail Equity (C.U.R.E.), a captive rail customer advocacy group representing a broad array of vital industries – chemical manufacturers and processors; paper, pulp and forest products companies; agricultural commodities producers and processors; cement and building materials suppliers; and many more.

I appreciate this opportunity to appear today to discuss railroad issues that have rapidly risen to the top of the policy agenda for members of NRECA, a trade association consisting of 930 cooperatives providing electricity to more than 39 million consumers living in 47 states. As member-owned, not-for-profit organizations, the obligation of cooperatives is to provide a reliable supply of electricity to all consumers in our service areas at the lowest possible price. We take our obligation to serve very seriously – the wellbeing, safety, and economic health of our members, our communities and our nation depends on it. Electric cooperatives serve primarily the more sparsely populated parts of our nation, but cover roughly 75 percent of the land mass of the nation.

Today I want to emphasize for the subcommittee the very critical issues currently facing rail freight shippers throughout the country, especially those shippers who are "captive" because they are only served by one rail carrier and have limited or no access to competition.

Since the enactment of the Staggers Rail Act in 1980, the railroad industry has dramatically changed. Despite their claims to the contrary, the structure and the practices of the railroads under current law are detrimental to the economic survival of many domestic U. S. businesses and industries. Left unchecked, the *status quo* jeopardizes our national economy and even our national security capabilities. Consider the following:

- In 1980 there were 41 Class I railroads, but today six remain with *four* of them – two in the east and two in the west – carrying about 94 percent of all rail freight.

- More than 20 percent of all rail freight shipments are "captive" to the monopoly market power of only one rail carrier.

- The four major carriers have been allowed under current law to artificially tighten their monopolistic stranglehold over "captive" shippers through practices that restrain competition and deny shippers the ability to freely seek access at points where competition might otherwise be available.

- "Captive" rail shippers are forced in an arbitrary "take-it-or-leave-it" fashion to face enormously higher rail transportation costs than those shippers that have access to competition.

- In areas where competition is minimal or does not exist, the federal regulatory watchdog established under the Staggers Act to protect "captive" rail shippers – the Surface Transportation Board (STB) – has failed to fulfill its responsibility to ensure that rail rates and practices are fair and equitable and in the overall national best interest.

- Similar to the availability and reliability of adequate electric power, a robust and efficient rail transportation system is critically important to the nation's economy and security, and requires a common carrier obligation to adequately serve the broader public interest.

I want to recognize the efforts of Senators Burns, Rockefeller, Dorgan – and others who have gone on record – for their keen interest in resolving two major issues facing the rail industry and its customers: the need to mandate regulatory reforms in the industry; <u>and</u> the shortfall in U.S. railway capacity. Any legislation moving forward must address both problems.

We commend Senator Burns for introducing S. 919, the Railroad Competition Act of 2005, along with Senators Rockefeller and Dorgan. The legislation would reform many of the anti-competitive practices that the railroads currently exert over captive shippers. S.919 also recognizes the need to provide some mechanism or incentive to stimulate the capital investment needed to address the current capacity shortfall.

**The Captive Shipper/Railroad Monopoly Problem**

Mr. Chairman, about 50% of the nation's electricity is generated from coal. In the electric cooperative community, about 80% of the electricity generated by our plants is from coal. Very few of our generating facilities are located at coal mine sites, so most of the coal consumed by our plants is delivered by rail.

Under most circumstances, co-ops buy the coal at the mine site and arrange for its transportation, so the shipping agreements are between the railroad companies and the cooperative. Generally, our co-ops provide and maintain the "train sets" – the unit trains that today normally number from 120 to 130 cars. We also provide unloading facilities and make other capital investments related to rail transportation of coal to our plants. Most of these costs were previously borne by the carrier and factored into rates. Today, in the movement of coal to our plants, the railroads basically provide only the locomotives, tracks, crews, and the diesel fuel.

Increasingly, our members must deal with substandard service and higher costs for their coal transportation than ever before. Consolidation of the rail industry has resulted in many of our generators being held "captive" to one single railroad for coal transportation. As a result, these electric generators are subject to railroad monopoly power over price and service with no access to competition. The railroads have extensive exemptions from the nation's antitrust laws. Under the Staggers Rail Act, the Interstate Commerce Commission (now Surface Transportation Board) mission was to deregulate competitive rail traffic, while also protecting against monopoly abuse of "single served" or "captive" traffic. That protection is not being provided.

Application of the Antitrust Laws. Railroad spokespersons have recently represented in hearings before the House Transportation & Infrastructure Committee and the Senate Energy & Natural Resources Committee that the railroads are subject to "most" antitrust laws. Two quick examples rebut this claim. First, section 16 of the Clayton Act, 15 U.S.C. § 26, prohibits private parties from seeking antitrust law-based injunctions against "any common carrier subject to the jurisdiction of the Surface Transportation Board." Second, the Supreme Court's decision in *Keogh v. Chicago & Northwestern Ry.*, 260 U.S. 156 (1922), generally prevents shippers from obtaining treble damages in matters involving railroad freight rates that might be found discriminatory. Following enactment of Staggers, the *Keogh* decision continues to preclude most shipper actions for treble damages against the railroads. *Square D Co. v. Niagara Frontier Tariff Bureau, Inc.*, 476 U.S. 409, 422 (1986).

Given the general unavailability for private injunctive actions and treble damages, the recent claims by the railroads that they are fully subject to the antitrust laws is misleading at best.

Compounding the problem, the STB has interpreted Staggers in a manner that allows railroads to deny shippers access to competing railroads, has allowed other anti-competitive practices, and has a rate challenge process so complex, costly and time consuming as to provide virtually no protection to rail customers. For example, freight rates nearly doubled this year for Dairyland Generation and Transmission Co-op in Wisconsin. Unfortunately, given the complexity, the cost, and the history of futile challenges before the STB, Dairyland had no realistic option other than to accede to the "take-it-or-leave-it" demands of the railroad.

**Railroads Claim "Rates" Are Down – Shippers Find "Costs" Are Up**

In addition to the rail capacity concerns and monopolistic rail business practices being examined by the subcommittee, Congress should also be concerned about the cost of coal transportation to electric generating facilities that must depend on a single railroad for coal delivery. Coal transportation costs flow straight through to electricity consumers,

many of whom – farmers, chemical producers and processors, manufacturers, providers of forest products, paper and pulp, and many more – are already being forced to pay high rail transport costs on the movement of their products because they are also "captive" to a single provider. When co-ops must rely on a single railroad to move coal to our plants, and there is no recourse for a fair rate review, we are in no position to negotiate a mutually acceptable price. Rather, the railroad carrier dictates both price and service. With the railroads largely exempt from the nation's antitrust laws, the only option available to customers served by a single railroad is to petition the Surface Transportation Board for relief.

Members can refer to the following chart showing a close approximation of the rail rates that apply to "captive" shippers of products versus shippers of those products who are not held hostage to just one Class I rail carrier.

On a Per Ton Basis, Difference between Captive and Competitive Rates by Commodity & Major Railroad

The following information was calculated by Escalation Consultants, Inc. of Gaithersburg, Maryland. This "per ton" information is calculated from the 2003 STB "Revenue Shortfall Allocation Methodology" (RSAM) study, the latest study available from the Board.

| | **NS** | **CSX** | **BN** | **UP** |
|---|---|---|---|---|
| Farm Products Captive Rate | $21.37 | $36.74 | $45.28 | $37.99 |
| Farm Products Non-Captive Rate | $11.88 | $20.83 | $26.09 | $21.29 |
| Coal Captive Rate | $17.56 | $17.22 | $16.77 | $17.00 |
| Coal Non-Captive Rate | $9.76 | $9.76 | $9.66 | $9.53 |
| Chemicals Captive Rate | $36.98 | $34.33 | $42.57 | $38.94 |
| Chemicals Non-Captive Rate | $20.56 | $19.46 | $24.52 | $21.82 |
| Lumber or Wood Captive Rate | $29.43 | $36.13 | $59.19 | $59.49 |
| Lumber or Wood Non-Captive Rate | $16.36 | $20.48 | $34.10 | $33.34 |
| Pulp, Paper Captive Rate | $39.48 | $40.82 | $62.14 | $55.40 |
| Pulp, Paper Non-Captive Rate | $21.95 | $23.14 | $35.80 | $31.05 |

The railroads have all but perfected the art of using "global" data and statistics to obscure the true impact of their "rates" and their practices in different regions of the country and especially as applied to "captive" rail customers. They will tout graphs

demonstrating how "rates" have steadily declined for shippers . . . what they don't tell you is that much of the "cost" of rail transportation that was previously built into the "rate" (the costs of trainsets, maintenance, loading and other trackside facilities) has been shifted over the period onto the backs of the shippers. While "rates" have indeed come down, the "cost" to shippers in many cases has dramatically increased.

Although the railroads suggested they are subject to regulation and that shippers have a right to file complaints, it is important to understand the very limited extent to which railroad rates are subject to review at the STB. Contracts are outside of the STB's jurisdiction altogether (49 U.S.C. § 10709), and the STB has exempted much other traffic (including intermodal traffic) from its rate regulation.

For the small remaining category of traffic that is subject to regulation, the railroads have the initial flexibility to establish any rate they want (49 U.S.C. § 10701(c)). Shippers may challenge a rate, but bear the burden of showing that the carrier has market dominance in both qualitative (an absence of effective competition) and quantitative (the rate exceeds the jurisdictional threshold of 180% of variable costs) terms (49 U.S.C. § 10707). The shipper must also prove that the rate exceeds a reasonable maximum under "Constrained Market Pricing," which largely means stand-alone cost (a variant of replacement cost). In recent years, it has been impossible for shippers to get meaningful relief at the STB. In addition, the cases take a long time (at least two years to get the first decision on the merits) and are very expensive ($3-5 million at a minimum).

At the end of a twenty-year contract with Laramie River Station, BNSF more than doubled the coal-hauling rate for the plant. On October 19, 2004, a complaint was filed with the STB to review BNSF's rate increases. Rate complaints at the STB are costly, lengthy, complex, and rarely result in any relief for the rail customer. The cost simply to file the LRS/Western Fuels complaint was $102,000, but that filing fee since has been increased to $140,600. By contrast, the cost of filing a similar case in the federal district court is $150.

In contrast to most other regulatory systems in the nation, the customer must prove first that it is subject to a railroad monopoly, and then must carry the burden of proving that the rate is unreasonably high. In a normal regulatory process, the burden of justifying a rate falls on the monopoly that is being regulated. The rate reasonableness standard under the STB is not the normal "cost plus a reasonable rate of return" test.

The rate reasonableness standard employed by the Surface Transportation Board requires the customer to prove that it can build and maintain its own railroad to move its product at a price less than the rate that is being challenged. This requires the rail customer to employ economists to construct a highly efficient "virtual" railroad that roughly follows the route and bears the same costs at the incumbent railroad. Not surprisingly, this proof is complicated and expensive. To date, LRS and its co-owners have spent nearly $5 million on the prosecution of the rate case, which has been pending almost two years. A final judgment is not expected in this case for at least another year.

The situation facing us today goes far beyond just the very high prices being charged captive shippers – both directly and indirectly – by the railroads. Currently, the nation faces a situation wherein the railroads are either unable or unwilling to deliver reliable supplies of coal to our generators in a timely fashion. So, in a very real sense, our members are paying much more and receiving far less when it comes to rail transportation. Policies must be changed to address a rapidly worsening situation that is harming critical industries. The fact is that electric generation is now threatened by the railroads' poor performance and their lack of reliability.

**Current Coal Delivery Problems Adversely Impact Electricity**

In a world suffering from shortages of energy supplies, our nation is blessed with enormous reserves of coal that can provide for electricity and other uses for many decades in the future. Our coal resources are sufficient to meet our energy needs for more than 250 years. Some have referred to the United States as the Saudi Arabia of coal. In a 2001 speech, Vice President Dick Cheney pointed out that the overall demand for electric power is expected to rise by 43 percent over the next 20 years, and that just meeting the

demand would require between 1,300 and 1,900 new power plants. That averages to more than one new power plant per week, every week, for the next 20 years. "We all speak of the new economy and its marvels," he said, "sometimes forgetting that it all runs on electric power."

What the Vice President might not have recognized at the time of his speech was that the railroads responsible for moving this strategically important fuel supply were already in the process of making America's most abundant and affordable energy supply scarce and expensive. Electric co-ops are forced to look to South America, Indonesia, and other foreign coal sources because the railroads cannot make timely domestic deliveries.

The delivery system for half the nation's electricity consists of coal mines, rail transportation, generators, and transmission and distribution systems. Due to rail delivery problems, many of the electric cooperative generators have been concerned as they prepared for this year's summer cooling season. Some generating facilities were dangerously close to a point where continued operation could not be sustained.

Let me focus on the coal delivery problem confronting just one very large coal-fired electric generator in Wyoming – the Laramie River Station (the same plant embroiled in a rate case at the STB). In the spring of 2005, there were two derailments on tracks coming from the Powder River Basin (PRB), reducing rail coal deliveries to 80 percent of previous levels. Deliveries have not yet fully recovered. A BNSF spokesman was recently quoted in CQ Weekly saying that it is just "not feasible" to rebuild the LRS stockpile with current demand for coal so high. It is unclear whether those reductions have been imposed across-the-board, or whether the reductions and related matters, including "parking" of trainsets, have been imposed selectively or accidentally, but the result is the same. It enables the railroads to pick "winners and losers" among generating utilities, and to potentially punish and retaliate against those who seek to invoke whatever protections may be ostensibly available.

The three unit (1650 MW) Laramie River Station is located only 170 miles from the coal source and was down to a 3 to 4 day supply of coal in January. This plant is operated by Basin Electric Power Cooperative for 6 not-for-profit utilities. Loss of this major block of generation could create severe reliability problems for its regional grid. Basin provides electricity to its members in 9 states serving over 1.8 million consumers. Because of reliability concerns, Basin notified DOE and the North American Electric Reliability Council of the stockpile situation when coal reserves dropped below 50 percent of normal levels and developed a generation curtailment plan to conserve coal.

Fortunately, the winter was relatively mild, coal deliveries improved during the last few months, and Unit 1 entered a seven week maintenance outage, which reduced consumption of coal. Since the outage began on April 15, Basin's stockpile has increased to almost 700,000 tons – a 30 day reserve. However, if the plant had been operating at full load during this period, the stockpile would have gained only 100,000 tons to a total of 276,000 tons; a 10 day supply of coal. Now that the plant is once more in full operation, Basin is concerned about coal deliveries for the summer months.

Other co-ops have experienced similar problems and have cut production at those coal plants that are normally the least costly to operate. Electricity generators have resorted to burning more expensive natural gas, purchasing higher cost electricity from the grid, or purchasing more expensive foreign coal and higher sulfur local coal. Arkansas Electric Cooperative estimated that its coal conservation program, using alternate-fuel power generation, cost its customers over $100 million because of the shortage of coal deliveries over the past 12 months to its power plants.

The shortfall in rail coal deliveries has many far-reaching consequences. It is widely acknowledged that there will be at least a 20 million ton shortfall in PRB coal deliveries in 2006. Making up for this shortfall will require the use of about 340-billion cubic feet of natural gas costing about $2.6 billion more than the coal it replaces. The additional use of natural gas instead of coal to generate electricity has also significantly driven up the price of gas across the country, and has increased the costs to those using

natural gas as a feedstock for manufacture of their products. Over the past year, restriction in the supply of PRB coal has also resulted in a tripling of the coal spot market price, increasing those prices from roughly $6 per ton to more than $20 per ton.

So, in addition to the market power and rate-setting problems not being addressed, neither does the Surface Transportation Board assert jurisdiction over railroad customer service issues. The STB has been completely passive during the current coal delivery problems. For example, when the CEO of Arkansas Electric Cooperative sent a letter on this subject to the STB last August, not only did he never receive a response from the STB, his letter was answered by a Vice President of the Burlington Northern Railroad – the railroad about whom he was complaining!

**Railroad Obligation to Serve – Wall Street vs. Main Street**

We believe that an overriding national public interest applies to the railroad industry as it does with our electric utility industry. No electric utility – whether a rural electric cooperative, a municipal power system or an investor owned utility – is free to conduct business in any manner it likes, including "maximizing" profits. City officials overseeing municipal utilities are subject to the vote of the people; rural electric co-op boards must earn election by their member-owners; and investor owned utilities are subject to the oversight of both state public service commissions and the Federal Energy Regulatory Commission.

Railroad companies tell only one side of the story, emphasizing freight railroad traffic "constraints" – the "capacity crunch" – while alleging a need for financial incentives to lure the additional capital necessary to modernize and expand America's rail infrastructure and capacity.

We know the infrastructure and the capacity of our railroads need significant expansion and improvement. Railroad constraints – coupled with their exercise of monopoly power over captive customers – have led to ever growing profit levels for the major rail corporations. The railroads and Wall Street have been focused on making large

profits while Main Street Americans are focused on the "big picture" of growing and expanding our overall economy – not just one sector.

Morgan Stanley Equity Research N.A. recently released a periodic analysis of railroad financial performance. This analysis was produced for its intended audience, the investor community. The report noted that the major railroads are enjoying robust financial health based on "pricing freedom" and lack of railroad capacity. According to the report, "the six major North American railroads (Kansas City Southern is not included) will see their stocks appreciate 50% - 100% over the next four years." *("Air Freight and Surface Transportation," Morgan Stanley Equity Research North America, January 23, 2006, James Valentine).*

Since rising stock prices are an indicator of financial health that will attract and retain capital, this analysis clearly suggests that, according to Wall Street the railroads will be "revenue adequate" over the next four years. Furthermore, the analyst said that there is little or no regulatory risk in the current Washington environment—an indication that he believes the current STB, Congress and Administration are unconcerned about the "secular pricing" power and other actions of the railroads. "Secular pricing" is the code for the ability of a monopoly to exercise market power in exacting cash from those dependent on the monopoly's goods or services.

We contend that the railroad industry also has – like electric utilities – an obligation to serve the national public interest. This obligation may sometimes be called a "common carrier" obligation, but in the end it means the duty to provide reliable transportation service to all customers at fair and reasonable prices. Without mandating an obligation to serve by the railroads, the economy of this nation cannot move forward. Adequate, dependable, and reasonably priced rail service is almost as critical to our national and economic security interests as electricity, and the public interest cries out for the imposition of a formal "obligation to serve" mandate in order to correct the current arrogant and abusive tendencies of the railroads.

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Some tell us that the economic self-interest of the railroads will solve the railroad service and capacity problems over time. That certainly was the premise of the Staggers Rail Act – deregulate the railroads and they will become healthy and provide the rail service needed by the nation at fair and reasonable prices. Railroad customers have good reason to doubt that assertion.

In the absence of strong signals from the government about service and capacity to meet the needs of "Main Street" America, the railroads will take their signals only from "Wall Street." Financial analysts today rate railroad stocks high because the railroads possess "pricing power" based on the fact that demand for rail transportation exceeds capacity. Moreover, Wall Street tends to grade railroad stocks down when the railroads make heavy investments in their systems. So, Mr. Chairman, there is significant concern among the rail customer community that actually providing sufficient capacity and reliable service for them will be perceived by Wall Street as adverse to the economic interests of the rail industry.

Questions about future reliable rail service at fair prices are a significant concern to the electricity industry as it attempts to provide the additional coal-fired power plants the nation will need in the future. Can we depend on reliable rail transportation of coal in the future at a fair and reasonable price?

**Assistance to Help Ensure Rail Profits Requires an Obligation to Serve**

Finally, Mr. Chairman, we understand the railroads are now seeking legislation to provide a 25 percent investment tax credit and "expensing" provisions for investments in railroad infrastructure. We might very well support such a federal incentive, but only so long as it includes a package of legislation that also addresses the concerns of rail customers that are subject to railroad monopoly power, and only so long as the tax credit and other benefits are also available to rail customers when they make similar investments in infrastructure to improve overall rail capacity.

Moreover, we recommend that certain conditions should be imposed on the investments that would be eligible for the tax credits and expensing benefits. For example, the investments that qualify should be limited to first prioritize improving the infrastructure that currently provides insufficient service to captive or single-served rail customers. Eligible investments should be focused first on infrastructure improvements that benefit the movement of domestic products and commodities as opposed to infrastructure that benefits imports. Finally, any infrastructure that benefits from the tax credit should be deployed in a pro-competitive manner as suggested in S. 919, rather than further expanding the monopoly market power of the railroads.

The rationale for providing any level of assistance to the railroads is because of the important role they play in our nation's overall economy. Electric utilities are viewed as absolutely critical not only to the economy, but also indispensable in helping to ensure our homeland security. Railroads obviously occupy a similar role. All reasonable assistance should be provided to ensure the rail transportation system is robust and efficient. However, benefits to help ensure the profitability of the rail industry should come with a clear "obligation to serve" the best interests of Main Street America – not just Wall Street.

**NRECA Supports S. 919 – The Right Direction for Reform**

I mentioned earlier the legislation that Senators Burns, Rockefeller, and Dorgan have introduced that will begin to address many of the current problems facing rail shippers – especially captive rail shippers – as they try to deal with the railroads. S. 919 is a good starting point for discussions among those who truly want to improve the current rail transportation system in this country. We strongly urge this subcommittee to give a high priority to legislation this year.

**Conclusion**

Mr. Chairman, thank you for conducting this hearing today. We support a strong and viable rail industry that will provide reliable service to its customers at fair and reasonable prices. The *status quo* will not result in this type of rail system for the nation. The kinds of reforms suggested in S. 919 must be adopted as federal policy, and the public

benefits that result from competition in the marketplace must be applied to the rail transportation system by removing the rail industry's exemptions from the nation's antitrust laws.

I can assure the subcommittee that the 39 million consumer-owners of the NRECA electric cooperative family look forward to working with you, and with all of the other stakeholders involved, in resolving these critical rail transportation issues in an objective and constructive manner.

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